



# The M&A Impact of SFAS No. 141R

*The valuation of intangible assets will become increasingly important under the new accounting rules.*

BY ANDREW C. SMITH,  
CMA, CPA/APV, AND  
RYAN R. BERRY, CPA/APV

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or a loss in the income statement. While this will lead to increased volatility in earnings, the FASB believes it will be an improvement in the representational faithfulness and completeness of the information provided about a buyer's obligations and rights under contingent consideration arrangements.

**Gains from bargain purchases.** "Negative goodwill" is the amount assigned to the acquired net assets that exceed their fair value. The original SFAS No. 141 requires negative goodwill to be allocated as a pro rata reduction to the net assets (intangible assets first, then certain tangible assets). With the revised Statement, the negative goodwill is required to be recognized as an immediate gain on the income statement. As such, auditors will pay more attention to the assessment of bargain purchases to ensure the fair values of tangible and intangible assets aren't overestimated.

**Expensing restructuring costs when incurred.** Under SFAS No. 141R, expected restructuring or other costs will be expensed and recognized separately as post-combination expenses when incurred—unless they qualify as liabilities under SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal," thus reversing Emerging Issues Task Force (EITF) Issue No. 95-3, "Recognition of Liabilities in Connection with a Purchase Business Combination." By reversing EITF No. 95-3, opening balance sheets won't be capitalized with restructuring reserves; thus, future costs of restructuring will impact earnings.

**No more expensing IPR&D.** In-process research and development (IPR&D) was previously expensed at the time of acquisition unless an alternative future use existed. Now, under SFAS No. 141R, any IPR&D that was conducted by the acquired company at the time of the acquisition will be recognized as an intangible asset and classified as indefinite-lived until completion or abandonment (subsequent R&D expenditures will continue to be expensed as incurred). The acquired IPR&D will be

tested for impairment under SFAS No. 142. Once the IPR&D has reached completion, the capitalized amount will be amortized over its useful life.

**International applicability.** It's important to note that SFAS No. 141R was written in collaboration with the International Accounting Standards Board (IASB). The drafting of SFAS No. 141R was actually delayed in order to meet the FASB's and IASB's international convergence goals as the accounting world moves toward a global set of accounting standards. Similar accounting rules now apply to both U.S. and international companies in this area of accounting.



### UNDERSTANDING THE NEW RULES

Good deals will always get done, but the art of the deal continues to evolve. With the transition to fair value accounting, additional attention to details in the underlying fair value estimates will be required during the initial planning phase of transactions. The accounting changes under SFAS No. 141R will affect not only the financial reporting of M&A transactions, but also the way in which manage-

ment analyzes potential transactions and plans for due diligence. New assets need to be valued, and additional expenses and liabilities require a more detailed analysis. In today's fair value accounting world, it will be more important than ever that anyone involved in the analysis and eventual accounting for an acquisition understands both the financial *and* accounting impact of the transaction. ■

*Andrew C. Smith, CMA, CPA/ABV, ASA, CVA, is a partner and senior managing director with The McLean Group's corporate valuation practice. You can contact Andrew at (703) 827-0233 or [asmith@mcleanllc.com](mailto:asmith@mcleanllc.com).*

*Ryan R. Berry, CPA/ABV, CVA, is an associate director with The McLean Group. You can contact Ryan at (703) 827-0091 or [rberry@mcleanllc.com](mailto:rberry@mcleanllc.com).*

**L**ate in 2007, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 141R, "Business Combinations." Effective December 15, 2008, the revised Standard will affect the accounting for acquisitions and may change how mergers and acquisitions (M&A) are structured. Deal teams must be aware of the impact of the accounting changes and plan accordingly to ensure they maximize the success of M&A transactions. In finance, "cash is king," but dealmakers would be foolhardy to dismiss the effects that intangible asset valuations can have on the bottom line. When judging the benefits or rationale behind a deal, one of the first questions Wall Street investors ask is whether the deal is accretive or dilutive to earnings per share, and intangible asset valuations and their related amortization expenses can have a significant impact on this analysis.

### BACKGROUND OF SFAS NO. 141

The original SFAS No. 141 was issued in June 2001 to address financial accounting and reporting for business combinations. Prior to its issuance, business combinations were accounted for using one of two methods: the pooling-of-interests (pooling) method or the purchase method. The pooling method was required whenever 12 criteria were met; otherwise, the purchase method was used. Because those 12 criteria didn't distinguish economically dissimilar transactions, however, similar business combinations were frequently accounted for using different methods that produced dramatically different financial statement results. SFAS No. 141 was issued to prevent that occurrence by requiring the use of one method, the purchase method, to account for business combinations.

The newly revised Statement (SFAS No. 141R) marks the FASB's full transition to fair value accounting for business combinations and requires the application of a new method of accounting for M&A transactions: the acquisition method. Now contingent consideration and research and development (R&D) activities will be valued as of the acquisition date, and transaction costs will no longer be capitalized. SFAS No. 141R also asserts that an acquirer can be identified in every business combination and broadens the scope of transactions that may be classified as a business combination. For example, control

may transfer to an acquirer if there is no consideration paid and if contractual provisions change, such as the lapse of minority veto rights or other provisions.

### THE IMPACT ON M&A TRANSACTIONS

SFAS No. 141R includes several significant changes that will affect the accounting for and structure of M&A transactions:

**Timing is critical.** Transactions and any related consideration should be valued on the date the transaction closes. (Previously, when stock was issued as part of an acquisition, it would be valued as of the announcement date.) The change in the measurement date will put additional pressure on companies to close transactions quickly, primarily by investing in substantial due diligence before deals are announced. In addition, tighter share-price protections, in the form of put options or other caps, may be used to maintain the financial integrity of the deal.

**More due diligence.** Under the current accounting standards, companies have the opportunity to fine-tune the accounting estimates related to the acquisition (post-transaction adjustments), such as the intangible asset valuation required in the purchase price allocation process. SFAS No. 141R, however, requires such adjustments to be booked as of the closing date. In order to avoid prior-period restatements, which are always viewed with a bit of skepticism, additional pressure will be placed on the due diligence phase to nail down all transaction-related estimates.

**Expensing transaction costs.** Under SFAS No. 141R, transaction costs will be expensed rather than capitalized as part of the purchase price. This is a fundamental change in the accounting for acquisitions under fair value accounting theory. Previously, transaction costs were capitalized as a normal, necessary cost of acquiring an asset. Under fair value accounting, however, historic costs shouldn't impact the value of the recorded asset.

**Valuation of earn-outs.** All consideration paid for an acquisition (including contingent consideration such as an earn-out) must be included in the purchase price. This means that the acquirer must estimate the amount of the contingent consideration that will be paid in the future at fair value, as defined by SFAS No. 157, "Fair Value Measurements." Subsequent changes in the fair value of the contingent consideration would be recognized as a gain

