A whole new world for business combinations

A long-awaited overhaul of accounting for business combinations and consolidations was recently completed by the Financial Accounting Standards Board (the "FASB").

FASB issued a revised version of FAS 141, Business Combinations (FAS 141(R)) and the new FAS 160, Noncontrolling Interest in Consolidated Financial Statements, which is an amendment of ARB No. 51.

The pronouncements represent FASB's continuing effort with regard to convergence with International Financial Reporting Standards, incorporating fair value into GAAP, and providing greater transparency, relevance and understandability for financial statements.

The new business consolidations and combinations commence in 2009. Statement preparers, statement users and auditors need to understand how this new guidance will affect what they do. FASB's movement toward fair value, principles-based standards and international convergence involves significant policy and technical changes. These statements are part of that movement, and preparers and users need to know what these changes entail.

The changes contained in these two pronouncements represent significant improvements to FASB's approach: They expand coverage to more transactions and entities than before, covering entities that consolidate or deconsolidate; they incorporate more fair value usage, often at the expense of FAS 5; they define non-controlling interest as equity; and they adjust carrying amounts to fair value upon consolidation or deconsolidation.

Both statements are effective for fiscal years and their interim periods beginning on or after Dec. 15, 2008. The statements provide transitional guidance, including dealing with initial adoption, calculating earnings per share, and recording taxes under FAS 109 and FIN 48. Both statements must be adopted simultaneously and apply prospectively.

No restatement of prior periods is permitted, except for retrospective presentation and disclosure, including reclassifications, to conform to current statements. Retroactive adjustment of prior combinations is not permitted, and early adoption is prohibited.

According to FAS 141(R), business combinations must follow the "acquisition method," previously called the "purchase method." The name change acknowledges that control can be obtained without a purchase. FAS 141(R) applies to all business combinations, with specific exceptions for areas covered elsewhere in GAAP, including joint ventures, acquisition of assets that are not a business, combinations of entities or businesses under common control, and combinations involving not-for-profits.

Acquisitions occur by transferring cash or other assets, assuming liabilities, issuing equity, or by contract alone, and perhaps, without consideration. Consolidations may arise from variable-interest entities under FIN 46(R), lapse of minority rights that prevent the majority owner from asserting control, and investee re-acquisition of equity to cause an investment to become a majority interest.

Know that there are other types of transactions that may not qualify as business combinations. When identifying the acquirer, remember that the legal acquirer and the accounting acquirer may not be the same. For accounting purposes, the acquirer is generally the larger or the survivor, the company whose name or location continues, or the entity that controls management, paid a premium on the other's stock, or initiated the transaction. Facts and circumstances, however, will be the ultimate decider, since a new entity may be informed from several others or the acquiree's name and location may be adopted.

Acquisitions are measured as of the acquisition date at fair value of the total identifiable assets acquired including goodwill liabilities assumed, and any previous non-controlling interest in the acquiree.

Despite flaws in measurement, accuracy and verifiability, fair value is the best measure of an acquisition, replacing the FAS 141 process that used fair-value-based cost allocations.

The acquirer may recognize intangibles that were written off, developed internally, or expensed and never capitalized. Assets producing uncertain cash flows are measured without valuation allowances.

For example, receivables of $1 million, with a presumed valuation allowance of $50,000, are recorded at a book value of $950,000, without a valuation allowance. There may be practical issue in determining which receivables to adjust. You must now reduce the fair value of assets that the acquirer does not intend to use or will use but not at the highest and best use.

Fair value is separate from the business combination, so acquiring another entity virtually requires an appraisal or independent measurement of some sort. One cannot assume that purchase price equals value. Items covered elsewhere in GAAP follow their own recognition and measurement requirements, such as income taxes, employee benefits and share-based payments. The cost of re-acquired rights is amortized over their remaining contractual term without regard to renewals or extensions. There may be a gain or loss on reacquisition or disposition.

Contingencies qualifying as assets or liabilities are to be recorded at fair value when the probability of occurrence is more likely than not (greater than 50 percent). This is a move away from FAS 5, which required high probabilities for liabilities and certainty for assets. Contractual contingencies are recorded at the acquisition-date fair value, while non-contractual contingencies follow the more-likely-than-not test. Thus, a $1 million contingency with 70% probability would be recorded at $700,000, and later adjusted upward or downward as more information becomes available. Record nothing for probabilities equal to or less than 50%. Earn-out and similar provisions are now much likelier to be recorded.

Remeasure contingencies that change during the measurement or provisional post-acquisition period as if occurring at acquisition. Those resolved may require retrospective adjustment, adjustment of goodwill or a change in accounting estimate.

Contingent consideration involving equity is not remeasured, and subsequent settlements are equity transactions. Contingent consideration involving assets and liabilities is remeasured at fair value at each subsequent reporting date until resolutions. Remeasure liabilities at the higher of either acquisition-date fair value or the FAS 5 amount. Remeasure assets at the lower of either acquisition-date fair value or the best estimate of future settlement. Derecognize contingent assets or liabilities only if the contingency is resolved, settle, cancelled, expired, or the rights to assets are used or lost.

Acquired research and development is no longer directly written off. Instead, it is retained until impaired without any depreciation or amortization. Research and development may be an acquisition trigger, and clearly has value, although it is difficult to measure. The revision in this area represents a major shift in GAAP, and a significant move toward IFRS and fair value. Capitalized research and development is an intangible with an indefinite life, subject to impairment but not amortization with possible impairment.

Goodwill is the excess of the fair value of a consideration transferred, plus any non-controlling interest in the acquiree, and, in step-acquisitions, the acquirer's previously held interest over acquisition-date fair value of all identified assets acquired and liabilities assumed.

Bargain purchases, on the other hand, arise when there is a motivated or compelled seller, the seller undervalues or the buyer overvalues, or synergies dictate a value in excess of market to the buyer.

Excess value is offset against goodwill. If goodwill is eliminated, the remaining unabsorbed excess is a gain upon acquisition. This differs from previous GAAP, where gain was first offset against goodwill and then long-term tangible and intangible assets, and only recognized after those assets were eliminated. Since fair value measurements of long-term assets are feasible, there should be no reduction or elimination.

No immediate loss is taken if the buyer overpays. Overpayment is difficult to detect initially, but if the acquirer overpaid, goodwill or other assets eventually become impaired. Some entities may accept the tradeoff, but most consider the losses in credibility from subsequent impairments to far outweigh gains from higher valuations.

Underpayments are not necessarily bargain purchases. Lower prices may reflect anticipated underutilization, under-performances or future losses.

Certain costs previously capitalized as acquisition cost are now expenses. These costs had increased goodwill by effectively raising the purchase price. Since these costs - legal, valuation, accounting, finder's fees, and so on - lack attributes of acquisition, they are to be expensed when incurred. That includes reimbursements paid to the acquiree or its former owners for the acquirer's expenses.

There is no change in accounting for issuing debt and equity. Although the exposure draft required expensing these costs, FASB deferred final resolution to its Liabilities and Equity Project. Post-combination restructuring costs are expensed, without regard to FAS 146 requirements, whether or not contemplated, as they are not acquisition costs.

Share-based awards to acquiree employees paid by the acquirer, or by the acquiree at the acquirer's request, are expensed at fair value when replacing or retiring other awards. The acquirer is obligated if the acquiree or its employees can enforce replacement. Depending on their nature, some awards may be FAS 150 liabilities. The acquirer attributes part of awards requiring post-combination services to the post-combination period, even when employees rendered services before acquisition. Replacement or new awards to acquiree employees subsequent to acquisition are compensation.

Some acquisitions occur in stages. When a greater-than-50% threshold is attained, suspend the cost-accumulation basis and remeasure all assets and liabilities, and non-controlling (minority) interest and controlling (majority) interest fair market value. The write-up to market provides increased completeness and better comparability. Carrying amounts are written up or down, previously unrealized holding gains and losses are taken into income, and a gain or loss is recognized.

For example, Company A carries a 40% equity method investment in Company B at $1 million, and then acquires another 20% for $1 million. Company A's interest is now 60%, with a basis of $2 million. Noncontrolling interest increases from its carrying amount on Company B's books to $2 million, or 40%, and controlling interest of $3 million (60%). Assets, goodwill and liabilities would be remeasured at fair value, and Company A would recognize a gain or loss upon acquisition.

Acquisitions or sales of business ownership interest without changing control are equity transactions without gain or loss, not subsequent steps or parts of the combination.

FAS 141(R) enumerates many disclosure requirements. These disclosures provide information that enable statement readers to evaluate the nature and effect of combinations occurring during the current period, or after the report date but before statements are issued. Be sure to provide the necessary information for complete and understandable disclosure, including initial accounting; what information is incomplete and why; changes made though collection, settlement and revaluation; and outstanding unresolved issues.

FAS 160 applies to all consolidations and de-consolidations, other than those involving not-for-profits. There is, however, no change in consolidations as to purpose or policy, eliminating intercompany balances, or a parent consolidating all entities it controls.

FASB changed “majority interest” and “minority interest” to “controlling interest” and “non-controlling interest” to emphasize that control, not ownership, drives consolidations. A non-controlling interest is equity not attributable to, or under the control of, the parent. It is equity because it represents a residual interest in subsidiary net assets. Only instruments comprising equity on the subsidiary’s balance sheet are non-controlling interests in consolidated statements.

Non-controlling interests must be clearly identified, labeled and presented on the consolidated balance sheet within equity, but separate from parent equity. It is not a “deferred credit,” or a liability.

You now have to differentiate between the interests of the parent and non-controlling owners. Non-controlling interests are presented in total. Otherwise, the parent company must separately disclose non-controlling interests for all its subsidiaries. Consolidated net income attributable to the parent and non-controlling interest must be separately identified and presented on the face of the consolidated income statement. Major components of net income appear in total, as well as by components attributable to each ownership group.

Adjust income allocations for prior claims on income. A similar breakdown applies to comprehensive income and its components. Reconcile beginning and ending total equity, as well as those parts attributable to the parent and subsidiaries. Also required is a separate schedule that shows the effects of changes in the parent’s ownership in a subsidiary on the parent’s equity. The exposure draft for FAS 160 called for per-share amounts of income components for both controlling and non-controlling interests, but this was excluded from the final statement. However, both total and parent per-share amounts are required. Losses will continue to be attributed to non-controlling interests, even if doing so created a deficit balance in non-controlling equity, since additional capital contributions are not required. Previous GAAP required deficits to be re-allocated against controlling interest.

Ownership changes without changes in control are capital transactions, without gain or loss. Thus, an equity transaction occurs when a parent owning greater than 50% of subsidiary stock buys or sells shares without affecting control. Similarly, subsidiary stock dividends are equity transactions only of the subsidiary. As in previous GAAP, a subsidiary's retained earnings, or accumulated deficit, is eliminated in consolidation. At initial consolidation, the consolidated financials include subsidiary revenues, expenses, gains and losses from the consolidation date forward. GAAP no longer permits including subsidiary operations for the year with a deduction for the pre-consolidation part. Additional pro forma disclosures require operations to be presented as if the consolidation occurred at the beginning of the parent's year and pro forma prior-year consolidated statements including the subsidiary.

Deconsolidations occur when a parent no longer controls a subsidiary for some reason, such as the following:

- The parent sold all or enough of its interest to no longer hold more than 50% ownership;
- A contract that gave control to the parent expired;
- The subsidiary issued additional shares that reduced parent ownership below control; or,
- The subsidiary became subject to the control of a government, court, administrator or regulator.

Upon deconsolidation, the parent eliminates equity attributable to other non-controlling owners and becomes a non-controlling owner. Any retained non-controlling interest should be remeasured at fair value, and the gain or loss on deconsolidation recognized.

There is no gain or loss if deconsolidation is by non-reciprocal transfer to owners, such as a spinoff. A parent that later reacquires control could write the investment up to fair value at that time, as in a step acquisition. In theory, a company could acquire control and write up the subsidiary to fair value, subsequently lose control and reset to new fair value while recognizing a gain or loss on the transaction, then regain control and write up again. The process could continue indefinitely.