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An Overview of SFAS 141R

The Financial Accounting Standards Board released a revised version of Statement of Financial Accounting Standards No. 141, *Business Combinations*, ("SFAS 141R") on December 7, 2007. While the standard will not be effective for most practitioners until early 2009, financial managers should familiarize themselves with the rule changes now, so that they can be adequately prepared when SFAS 141R becomes effective. The revised standard sharpens the accounting guidance for business combinations as well as the scope of situations applicable to these rules, and also provides a significantly larger body of implementation guidance than its predecessor.

REPORTING REQUIREMENTS

The increased timing sensitivity and lengthened list of disclosure requirements in the revised standard will likely prove to be the most immediate challenge for financial managers. While current rules prescribe only a vague timeline for the reporting of business combinations, SFAS 141R establishes a defined *measurement period* that governs the time period within which the business combination must be reported. If the accounting for a business combination is not completed by the end of the reporting period the transaction occurred, a company must report provisional amounts for the incomplete items. The measurement period is the period (of up to one year following the close of a transaction) during which the company gathers the necessary information to complete the accounting. During this period, changes to the provisional amounts can be made without reporting the changes as errors in accounting.

In addition, the revised standard significantly expands the scope of disclosure requirements. The full list of required disclosures can be found in paragraphs 67 – 73 of SFAS 141R. Of note, if the company does not complete the business combination accounting by the end of the reporting period when the business combination occurred, the company must disclose the reasons why the accounting is incomplete. This requirement may create significant pressure for companies to complete the business combination accounting during that reporting period, which would be a dramatic change of pace for the completion of business combination accounting for many reporting companies. Given the changes in reporting requirements, discussing the pertinent valuation issues with the valuation specialist early in the process will be helpful in minimizing the potential for unsavory surprises.

PURCHASE CONSIDERATION

SFAS 141R includes several important changes to the measurement of purchase consideration, the most significant of which is the inclusion of contingent consideration (i.e. earn-out consideration). When the revised standard becomes effective, consideration transferred in a business combination will be defined as the aggregate of the fair values of assets transferred from, liabilities incurred, and equity interests issued by the acquirer to the target company and its previous owners.

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This definition specifically includes contingent consideration, which must be recognized at its fair value as of the transaction date. Two significant implications of this rule change for financial managers are: 1) reported purchase consideration for transactions with the potential for significant earn-out payments will be reported greater under SFAS 141R compared to current rules, and 2) the need to measure the fair value of contingent consideration, which is by nature characterized by significant uncertainty, will inevitably increase the complexity of the purchase price allocation process.

Other notable changes in the definition of purchase consideration are the exclusion of acquisition costs and clarified treatment of share-based payments to existing employees of the target company. While current rules allow a company to capitalize deal costs into the purchase price, SFAS 141R requires that such costs be expensed as they occur. More detailed discussion of the appropriate treatment of share-based payments in this context can be found in paragraphs 43 – 46 of SFAS 141R.

GOODWILL MEASUREMENT

Under the new standard, the measurement of goodwill is defined as the aggregate fair value of 1) purchase consideration, 2) any non-controlling interests in the target company, and 3) any equity interests in the target company already held by the acquirer on the transaction date less the net fair value of identifiable assets acquired and liabilities assumed in the business combination. Currently, goodwill is measured as the residual of the cost of the acquisition less the net fair value of identifiable assets acquired and liabilities assumed. This change will have the greatest effect in acquisitions of less than 100% of the target company and acquisitions completed in a series of transactions.

The underlying concept is that the fair values of the entire target company and its identifiable assets are measured, rather than just the component represented by the transaction. Note that this will generally increase reported total asset values, annual intangible asset amortization, as well as decrease the margin for error regarding future goodwill and long-lived intangible asset impairment.

OTHER CHANGES

Other notable rule changes in SFAS 141R from the current standard include:

- » **Research & Development** – Under existing rules, an acquirer must measure the fair value of acquired in-process research and development and immediately charge off that amount. When the revised standard becomes effective, acquired IPR&D will be recognized as an identifiable intangible asset.
- » **Acquisition Date** – SFAS 141R clarifies the definition of the acquisition date for a business combination. Under the revised standard, the acquisition date is always the date when the actual change of control occurs. Currently, the relevant measurement date for some components of a business combination can be different than the change of control date (e.g. the announcement date for a transaction).
- » **Negative Goodwill** – SFAS 141R also eliminates the potential for the recognition of negative goodwill related to a bargain purchase. Under the revised standard, if the fair value of net identifiable assets acquired is greater than the sum of purchase consideration and the fair values of any non-controlling interests and existing equity interests, the excess must be recorded as a gain in earnings as of the transaction date.
- » **Expanded Scope** – The scope of SFAS 141R was expanded to include business combinations that occur without the transfer of consideration (e.g. transfer of control through the lapse of minority veto rights).

CONVERGENCE

Financial managers that regularly wrestle with international accounting should be pleased with the significant progress in convergence with international accounting standards represented by the issuance of SFAS 141R and IASB's revised IFRS 3, *Business Combinations*. Certain remaining differences include the treatment of non-controlling interests and contingent consideration. More information related to the status of convergence between the two standards can be found in Appendix G to SFAS 141R.

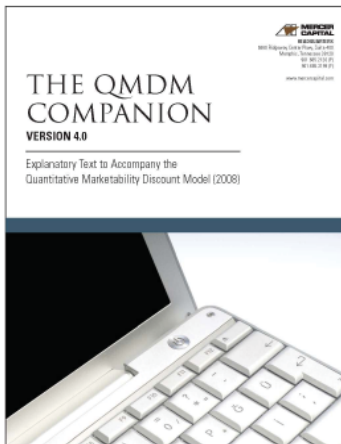
AT THE END OF THE DAY

SFAS 141R will create challenges for financial managers with the increased reporting requirements and significant number of rule changes. That being said, the revised standard includes more detailed practical implementation guidance, which should ease the accounting difficulties caused by ambiguity in the current standard. Alert financial managers need to know that the effective date for SFAS 141R is around the corner, become aware of the changes that it will bring, and to adequately prepare for its arrival. With such preparation, the challenges presented by SFAS 141R need not be insurmountable.



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The QMDM Companion, Version 4.0 (2008)



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Valuing Financial Institutions	We are responding to requests to put this 1992 book back into print and we are doing so as an E-Book	\$65.00	<i>Currently Available</i>
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QMDM Fact Sheet	The latest information about the QMDM in a pdf format	Complimentary	<i>Currently Available</i>

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TITLE	DESCRIPTION	INVESTMENT	RELEASE DATE
NEW			
Understand the Value of an Electrical Distributorship	Electrical equipment wholesalers operate in a highly fragmented industry, consisting largely of family-owned business with a few locations within a relatively close proximity. This article is intended to provide insight into the situational (when and why) and analytical (how) aspects of valuing electrical distributors.	Complimentary	<i>Currently Available</i>
NEW			
Understand the Value of a Start-Up Business	Valuation for start-up enterprises can be a tricky proposition. Regardless of industry, start-ups generally share a common set of operational characteristics and valuation needs that are distinct from mature firms. This article discusses specific valuation considerations relevant to start-up companies.	Complimentary	<i>Currently Available</i>
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Understand the Value of Your Truck Dealership	Contrary to popular belief, not all truck dealers are worth book value. This article provides useful information as to how truck dealers are valued and what impact that might have on their owners.	Complimentary	<i>Currently Available</i>
Understand the Value of Your Brick Business	This article provides an informative overview regarding the valuation of businesses operating in the brick industry, including a discussion of value as it relates generally to both manufacturers and wholesalers, as understanding how brick businesses are valued may help you understand how to grow the value of your business.	Complimentary	<i>Currently Available</i>
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Understand the Value of Your Wholesale Distributorship of Malt Beverage Products	The financial landscape is littered with rules of thumb pertaining to the value of privately owned businesses. Perhaps in no other industry is the rule of thumb concept more prevalent than in beer distribution. It is critical that value be determined and articulated in a credible fashion.	Complimentary	<i>Currently Available</i>

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