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New Requirements in the Valuation of Acquired Assets

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Statement on Financial Accounting Standard 141 - Business Combinations (FAS 141) was issued in 2001 and provided guidance regarding how an acquirer measures and recognizes identifiable assets, assumed liabilities, and any non-controlling interests of the acquiree. It also addresses the measurement and recognition of acquired goodwill, gains resulting from a bargain purchases, and specifies disclosures that enables the users of the financial statements to better evaluate the financial effects of the business combination.

In FAS 141, the FASB went to great lengths to provide guidance in regard to the separation of identifiable intangible assets from goodwill. Specifically, it was the observation of the Financial Accounting Standard Board (FASB) that intangible assets comprised an increased proportion of the assets of many, if not most entities. Further, during the business combination process the intangible assets acquired were often included in the amount recognized as goodwill. As a result, the need for an explicit set of criteria for the determination whether an intangible assets should be recognized separately from Goodwill was identified. To this end, the FASB has provided a list of 29 different intangible asset categories to assist in the identification of intangible assets. The categories provided range from those expected to be owned by businesses - trade names, patents, and non-compete agreements - to those less commonly encountered, such as song lyrics, ballets, and newspaper mastheads.

FAS 141 set forth a number of changes to the requirements of accounting for business combinations. Many of the changes address fair value of an acquired company's assets, specifically how fair value is calculated and how the calculated values are handled on the books of the acquirer.

Statement 141 requires the acquisition price to be allocated to the identifiable assets, which are defined as those that are separable or meet the contractual-legal criterion. Generally accepted accounting principles (GAAP) currently directs management to report acquired assets and assumed liabilities at cost, which reflects the assumption that at the time of the acquisition, cost and fair value are equivalent. Under FAS 141, an acquirer must allocate a portion of the purchase price to tangible assets and to identifiable intangible assets. If there is a difference between the purchase price and the sum of the fair values assigned to the assets, the difference is recorded as goodwill.

In December 2007, significant revisions were made to the original statement that became effective for business combinations in which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. Below are some of the significant revisions appearing in FAS 141(R).

Acquisition Costs - all costs to consummate the combination must be expensed as incurred, where previously these costs were capitalized as part of the acquisition price.

Allowance for Loan Losses –
The revised statement eliminates the carry over provisions for loan loss allowances on non-impaired loans to become part of the acquirer's allowance calculation after the close of the transaction. Whether impaired or not, all loans must now be marked to fair value as of the transaction date, with no carryover of prior allowances.

Restructuring Costs – Planned restructuring costs, occurring subsequent to the close of the transaction can no longer be recorded as a liability at closing. They must now be recorded as they are incurred, subsequent to the close. Previously, these costs were recorded as a liability at the time of closing. Now, the only costs included are the actual costs the acquirer is obligated to pay at the time of closing.

Bargain Purchases – Under the original standard, if the fair value of the net assets acquired exceeded the total consideration paid, there was a pro-rata reduction of the assets' carrying value to eliminate a "negative goodwill" balance. The revised statement eliminates the reduction of the assets' carrying value and allows an acquirer to recognize a bargain purchase gain on its income statement.

Contingent Consideration – The value of all contingent consideration payments must be estimated as of the closing date and any future difference between that estimate and actual consideration paid is recognized through earnings. Contingent consideration classified as an asset or a liability must be revalued to fair value at each reporting date until the contingency is resolved, with changes recognized in earnings. Previously, contingent consideration was not part of the purchase price until additional consideration was earned and paid.

Subsequent to the issuance of FAS 141(R), various industry participants expressed concern over the FASB's proposed method of accounting for assets and liabilities assumed in a business combination that arise from contingencies. Earn out agreements and pending litigation were cited as being particularly difficult to value. On April 1, 2009, the FASB issued FASB Staff Position 141(R)-(a) to redefine which contingent asset or liabilities must be recognized. Essentially, a contingent liability must now be recognized at its fair value, but only if (a) fair value can be determined, or (b) at the end of the reporting period it was apparent that the existence of the contingency was probable at the acquisition date and its value can be reasonable estimated.

The FASB provided no details about how the fair value of a contingency should be determined or how a contingency should be measured subsequent to its initial recognition. In their deliberations, the Board generally agreed that FAS 141(R) directs the reader to FAS 5 for this additional guidance. The Board further agreed FAS 5 does not provide the appropriate guidance. The majority of the Board also did not support subsequent periodic accounting adjustments to fair value. The result is likely to be continued incomparability of financial statements and revaluation surprises for investors and creditors.

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