MODIFICATIONS TO SFAS 141

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At the joint FASB-IASB meetings held from October 20 to 25th, 2003, where I was an observer, further changes in accounting for mergers and acquisitions were discussed. Both boards are moving closer to a Fair Value model in Phase II of their Business Combinations project. An Exposure Draft is planned for the first quarter of 2004 and the final amended SFAS 141 at the end of that year. The latest proposals would alter some longstanding accounting practices and may affect how transactions are structured. In particular, companies would:

- Incur current period charges for deal fees and acquisition-related restructuring costs.
- Recognize earn-outs and all contingent assets and liabilities on the acquisition, potentially increasing Goodwill.
- Experience subsequent greater earnings volatility.
- Rely more heavily on valuation analysts.

The table below summarizes both the Current Practice and the Proposed Treatment for six major changes; they are then discussed in more detail.

Item	Current Practice	Proposed Treatment
Acquired Contingencies e.g. pending litigation	Generally recognized in the purchase price, if probable and can reasonably be estimated at the time of acquisition.	Immediately recognize all contingent assets and liabilities at Fair Value. Mark contingent liabilities to Fair Value through earnings in subsequent reporting periods.
Contingent Consideration	Recognized as additional purchase price when contingency is settled or resolved.	Recognized at Fair Value on closing and mark to market through earnings each reporting period, thereafter, except when it qualifies as equity.
Measurement Date in Stock Deals	Announcement Date	Closing Date

Modifications to SFAS 141

Item	**Current Practice**	**Proposed Treatment**
Transaction Costs	Include direct changes in the purchase price.	Immediate expense
Restructuring Charges	Capitalize cost of target-related restructuring in purchase price if criteria met.	Immediate expense of all restructuring costs.
Minority Interest (less than 100% of Target is acquired)	Recognize minority interest at Book Value; Fair Value step-up in net assets limited to the percentage acquired.	Recognize minority interest at Fair Value with full Goodwill

Acquired Contingencies

Contingencies are now typically recognized only if they will probably occur. Going forward, all contingencies that come with a Target - not just those likely to materialize - would be recognized on closing, with the probability of occurrence affecting only their Fair Values. More of them are likely to be disclosed in Financial Statements, with contingent liabilities increasing the initial Goodwill and contingent assets, such as pending patent infringement suits, decreasing it.

In subsequent periods, contingent liabilities would be marked to Fair Value until resolved, thereby increasing earnings volatility. Contingent assets may also have a P&L impact, depending on their nature. However, should any of the contingencies not materialize, they would be reversed through the Income Statement as additional expenses (assets) or earnings (liabilities).

Since they may have a significant impact, it is essential that the due diligence establish the nature and value of all the Target's contingencies and this knowledge, including the impact of pending litigation, be used for the valuation analyst's Financial Projections. Identifying and valuing all acquired contingencies may reduce future expenses if they materialize. As managements could be criticized for overstating contingencies to raise subsequent earnings they are likely to not only disclose them adequately in the Financial Statements, but also use outside valuation analysts for such Fair Value measurements.

Although these proposed rules appear logical, they will involve a complex, onerous valuation process, since it is much easier to determine the Fair Value of an event that is likely to occur, than one with doubtful outcomes. For public companies this challenging process will continue each quarter until the contingency is settled or resolved.

Contingent Consideration

Earn-outs contingent consideration linked to performance) are commonly used to mitigate the risk of overpaying or to ensure a deal when the buyer and seller disagree on value, as often happens with early stage or privately held Targets. FASB proposes to treat most Earn-outs as liabilities, recognizing them at Fair Value on closing, generating additional Goodwill. Changes in their Fair Value would be recognized through earnings in each subsequent period until the Earn-out is either paid or cancelled, leading to further earnings volatility.

This decision could have paradoxical results; if a Target meets its performance milestones, the buyer pays the Earn-out and incurs additional costs that reduce the benefits of its superior performance. Conversely, a Target that fails to meet its goals may have a positive impact on the buyer's P&L since the Earn-out liability would be reversed. A further oddity arises with the Goodwill recognized on the Closing Date. Since the Earn-out initially increased it, cancellation, while suggesting that the Target's value has diminished, results in higher reported profits; an ironic outcome given that Earn-outs are intended to avoid overpayments.

Will this affect future transactions? Probably; buyers will have to weigh the trade-off between hedging their purchase price through an Earn-out and the resulting earnings volatility. While economic forces favour the risk mitigation, some managements may opt for more stable profits.

The proposed rules exempt arrangements considered equity from subsequent re-measurement. Therefore using such a contingent consideration, if commercially and economically feasible, would alleviate earnings impacts while mitigating the overpayment risk. To qualify as equity, the transaction must in substance give rise to a residual interest in the company, rather than an obligation.

However, qualifying for equity treatment may be difficult and must be carefully analyzed. For example, warrants exercisable only if the Target achieves a defined operating milestone, may qualify as equity; an Earn-out requiring a fixed payment through the issue of a variable number of shares is a liability. When an Earn-out that is treated as a liability, makes prudent economic sense, the buyer should explain in the Management Analysis & Discussion, its strategic rationale together with an indication of the resulting earnings volatility.

Measurement Date for Stock Deals

FASB intends to move the date for measuring the value of a transaction involving stock from that of the announcement to the closing; this is to allow the final purchase price to reflect both the market's reaction and any changes in overall market conditions. In the event of a steep decline in the acquirer's stock between the announcement and closing dates Goodwill would be reduced, decreasing the likelihood of future impairment charges; should the stock climb, both will increase.

Restructuring Costs

Treating all restructuring costs, including items such as termination benefits, consolidating facilities and relocating employees, as an immediate expense will lower Goodwill and increases short term earnings dilution.

Therefore any post-acquisition restructuring should take place at once so that the costs appear on the P&L immediately after the closing. This may require expanding due diligence to include an implementation time table as well as an integration task force. Experience has shown that planning the changes during due diligence enhances the likelihood of a successful deal and allows buyers to obtain synergies sooner.

Acquisition Costs

Expensing acquisition costs will also increase short-term earnings dilution and reduce Goodwill. While this may not change behaviour or even the level of the costs it makes everything more transparent. Of course managements will highlight them as non-recurring.

Partial Acquisitions

In another departure from current practice, FASB would require a company buying only part of a Target to step up all its net assets to Fair Values on the consolidated Balance Sheet, rather than just the portion acquired. This implies higher depreciation and amortization for all such assets. There would appear to be no effect on Net Income, assuming that the minority interest is charged with its portion of the additional expense. However, in most instances, operating income and possibly gross margins would be lower.

The Impact

If approved, the proposed changes would significantly alter how buyers account for acquisitions, and have considerable implications for Goodwill, earnings and operating performance measures. Since they may also affect buyer's behaviour, it is important for valuation analysts to understand them.

