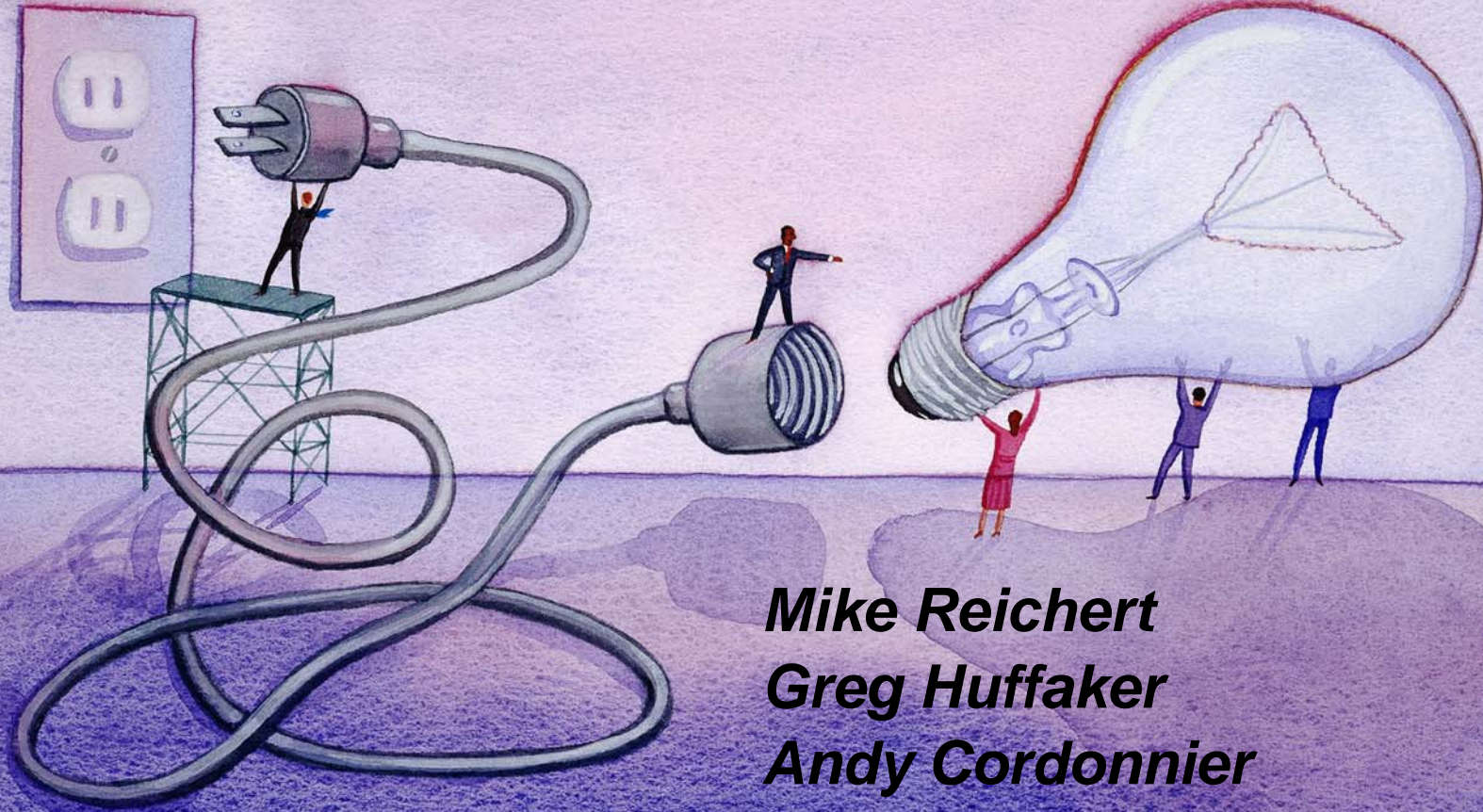


# FAS 141R



***Mike Reichert  
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Andy Cordonnier***



**FAS 141R**

**Accounting Principles**

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**Oracle**

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## Business combinations — Important developments not covered that you should be aware of

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- **FAS 109** modified (DTA is recorded for Tax > Book goodwill)
- Accounting for minority interests (now noncontrolling interest governed by **FAS 160**)
- EITF 04-01 incorporated — (Accounting for preexisting relationships between the parties to a business combination)
- Bargain purchase rules changed (All nongoodwill assets recorded at FV — No allocation of “negative goodwill” to reduce assets)
- Purchases and sales of a subsidiary’s stock after control is obtained are now equity transactions (i.e., no SAB 51 gains or losses)
- Reacquired rights (Acquirer recognizes settlement gain or loss when it reacquires a right that it had previously granted to the acquired entity)

## Business combinations — FASB statements 141R

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- **Statement 141** (revised 12/4/2007), *Business Combinations*, revises purchase method procedures that **statement 141** carried forward without reconsideration from APB Opinion 16
- Requirements to apply the acquisition (purchase) method and identify the acquirer for all business combinations
- Contractual-legal and separability criteria to define identifiable assets. An assembled work-force is not identifiable.
- Expanded scope –
  - New definitions of business and *business combination*
  - New measurement and recognition requirements
- Primarily full acquisition date fair value, not cost accumulation or blend of separately valued layers
- New disclosure objectives and requirements

## General principles underlying **statement 141R**

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- In a business combination under **Statement 141R**, an acquirer recognizes
  - What? A business. Only consideration transferred for an acquired business and net assets of the acquiree received in exchange
  - When? As of the acquisition date (the date the acquirer obtains control)
  - How much? Acquisition-date fair value

## Scope — Definition of a business combination

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**Business combination** — A transaction or other event in which an acquirer obtains control [*controlling financial interest*] of one or more businesses.

**Includes:**

- **Mergers of equals**
- **Obtaining control without exchange of consideration**
  - For example, obtaining control by contract alone or by expiration of minority rights
- **Becoming the primary beneficiary of a variable interest entity that is a business**
- **Mutual entities**
- **Some transactions currently considered asset acquisitions, such as acquisition of some development stage companies**

# Business combinations — **Statement 141R** expanded scope

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## **Statement 141R** will increase

- **Types of events and transactions that will be business combinations**
- **Differences between asset acquisition and business combination accounting**

# Measuring and recognizing the acquired business

## As of the acquisition date

### Total measure of net assets recognized

- Fair value of consideration transferred for the acquiree
- + Fair value of acquirer's previously acquired equity interests in the acquired business (in a step acquisition)
- + Fair value of remaining noncontrolling interest in acquiree (in a partial acquisition)



### Financial statement elements recognized

#### Net assets

- Identifiable assets acquired and liabilities assumed (generally at fair value)
- Goodwill (or gain on bargain purchase) at residual amount

#### Equity (**statement 160**)

- Noncontrolling equity interests in the acquiree (at fair value)

# Scope — Exclusions

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- **Formation of joint ventures**
- **Combination of entities under common control**
- **Combinations between not-for-profit organization or acquisition of a for-profit business by a not-for-profit organization**

# Impacts and the bottom line

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## Impacts

- **The new rules significantly increase the use of fair value measurements in acquisition method accounting, formerly known as purchase accounting.**
- **The increased use of fair value will inevitably produce more volatility in post-acquisition earnings.**
- **Due diligence and valuation expertise will become even more critical when identifying all assets and liabilities acquired and recording them at fair value.**
- **Some “benefits” of business combination accounting go away.**

Note: Those assets/liabilities measured at fair value in a business combination under **FAS 141R** will also be subject to the FASB's new fair value standard, **FAS 157**.

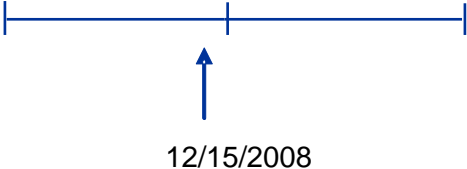
## Bottom line

- **Buyers should ensure that they have modeled deals using rules applicable on the consummation date, and/or using both sets of rules if uncertainty exists surrounding the consummation date.**
- **Buyers should review in-process and contemplated deals and consider whether the effects of the new rules would cause them to change deal timing.**

# Effective date

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**Applicable to transactions completed  
in years beginning after 12/15/2008  
(cut off)**



**Therefore — old transactions  
are not affected but for one  
paragraph related to income  
taxes**

# Transition

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- Early application is prohibited.
- Amendments to **statement 109** and Interpretation 48 applied prospectively for business combinations with acquisition dates before the effective date of **statement 141R**.
- Transition guidance provided for mutual entities that had a purchase business combination under APB opinion 16 or **statement 72**:
  - Reclassification of goodwill and identifiable intangible assets
  - Adopt **statement 142** (for goodwill and intangible assets acquired in a business combination) as of beginning of the first reporting period beginning after December 15, 2008.

## Summary of significant changes

Issue	SFAS 141	SFAS 141 (R)
Measurement date for securities issued	A reasonable period of time before and after terms are agreed to and announced	Fair value at acquisition date
Contingent consideration (e.g., earnout)	Record when determinable; subsequent changes reflected in purchase price	Record fair value at acquisition date; subsequent changes in liabilities hit P&L
Acquisition costs	Capitalize	Expense as incurred
Acquisition of control, but <100%	Record minority interest at historical cost	Record noncontrolling interest at fair value (Record 100% of goodwill)
Pre-acquisition contingences	Fair value during allocation period, or follow FAS 5; no remeasurement	Fair value at acquisition date (i.e., contractual or more likely than not)
Restructuring and exiting costs	Accrued as a cost of the business combination	Expense as incurred
In-process R&D	Included in purchase price allocation then immediately expensed	Included in purchase price allocation. Not expensed.
Negative goodwill	Pro rata reduction of certain noncurrent assets (extraordinary gain)	No reduction of assets, record as gain

# 141R key changes — Purchase price

Measurement date for equity interests issued by the acquirer...

Accounting guidance		Buyer's considerations
Current	New	
A few days before and after terms are agreed to and announced.	Acquisition date.	<p>May be uncomfortable with the purchase price uncertainty, although fluctuations will typically only impact goodwill (a nonamortizing asset).</p> <p>However, a significant run-up in stock price could create/magnify future goodwill impairment charges. Alternatively, a significant stock price decline could result in a gain on a bargain purchase or reduced goodwill.</p>

## Observations:

- Potential increase in cash deals or accelerated closings on equity deals.
- Consider commitments to issue a variable number of shares representing a fixed price – or alternatively, price per share collars — to avoid/limit volatility between announcement and close.

# 141R key changes — Purchase price (cont.)

## Contingent consideration...

Accounting guidance		Buyer's considerations
Current	New	
<p>Only amounts that are determinable at the date of acquisition are initially included in the cost of the acquired business.</p> <p>Distributions upon resolution of contingencies based on (1) earnings result in additional cost of the acquired business, (2) security prices do not change the recorded cost of the acquired business.</p>	<p>Record at fair value, regardless of likelihood of payment, and classify as either a liability or in equity (see <b>FAS 150</b>).</p> <p>Liability-classified earn-out arrangements will be subsequently remeasured to fair value and changes will be recognized in post-acquisition earnings. Equity not remeasured.</p>	<p>May structure to avoid liability-classified earnouts due to the volatility in post-acquisition earnings and the challenges of fair valuing the arrangement each reporting period.</p>

### Observations:

- Classification of contingent consideration as a liability or equity (**FAS 150**) affects accounting.
- Potential increase in stock-settled earnouts or use of shorter timeframes for cash-settled earnouts.
- While the reversal of an amount originally recorded for a cash-settled earnout could create income, it may also indicate that goodwill is impaired as it likely signifies that the acquired business has underperformed.
- Contingent consideration classified as equity is not reversed if Target is not met.

# 141R key changes — Purchase price (cont.)

Measurement period ...

Accounting guidance		Buyer's considerations
Current	New	
Prevailing practice recognizes changes to provisional amounts prospectively as a change in estimate.	Revise comparative information for prior periods in future filings when such information is presented.	<p>The measurement period is the period after the consummation of a business combination during which the acquirer gathers information necessary to complete the business combination accounting (e.g., fair value of assets acquired and liabilities assumed, fair value of consideration transferred, fair value of the acquiree). The measurement period is generally consistent with the allocation period of <b>Statement 141</b>.</p> <p>The measurement period for a particular asset or liability ends as soon as the acquirer receives the necessary information about the facts and circumstances that existed as of the acquisition date. In addition, the measurement period is limited to a maximum of one year from the acquisition date.</p>

## Observations:

- Companies will need to adjust prior-period income statements for changes in depreciation, amortization, etc. Presents challenges in communicating with investors.
- Motivation to finalize purchase price allocation as soon as possible. Additional coordination with external valuation specialists.
- Preferable to close transactions at the beginning of the reporting period.

# 141R key changes — Purchase price (cont.)

## Acquisition-related costs of the acquirer...

Accounting guidance		Buyer's considerations
Current	New	
<p>Direct costs capitalized as part of the business combination. (Examples: Investment banking fees, legal, accounting, valuation, and other.)</p>	<p>Generally expensed. However, debt and equity issuance costs may still be capitalized.</p>	<p>Will produce volatility in acquirer's pre-acquisition earnings and may need to be considered in forward-looking earnings forecasts.</p> <p>May need to discuss M&amp;A activity (in MD&amp;A) prior to a deal's announcement if fees become material.</p> <p>PEIs may prefer new accounting as these costs are not capitalized into the goodwill of portfolio companies, reducing the possibility/magnitude of a future goodwill impairment.</p>

### Observations:

- May impact timing and scope of the due diligence activities of strategics (i.e., buyers may schedule activities for early in the quarter and/or limit certain activities in the early stages).
- There may be diversity in practice around the treatment of costs incurred for transactions prior to the effective date of 141R. Disclosure may be necessary.

# 141R key changes — Acquisition method accounting

## Costs associated with restructuring or exit activities...

Accounting guidance		Buyer's considerations
Current	New	
Recorded as a liability in purchase price allocation if a plan was contemplated upon acquisition and was finalized within one year of consummation (see EITF 95-3 for details).	Generally expensed. Only costs that meet the criteria in <b>Statement 146</b> as of the acquisition date are included in business combination accounting (i.e., present obligation to others).	May find that very few restructuring plans will qualify for accrual in the acquisition method accounting, as the timing of accruals will instead be based on the physical exit of facilities and the notifications given to employees in accordance with <b>FAS 146</b> .

### Observations:

- Eliminates a significant “benefit” of business combination accounting.
- Pre-close restructuring activities completed by the acquired company at the request of the Buyer are treated as post-close acts of the buyer.

# 141R key changes — Acquisition method accounting (cont.)

## In-process research and development (IPR&D)...

Accounting guidance		Buyer's considerations
Current	New	
<p>Include in purchase price allocation, but immediately expense.</p>	<p>Recognize as an indefinite-lived intangible asset separately from goodwill at the acquisition date; amortize over useful life when R&amp;D is complete or expense upon abandonment of project.</p>	<p>May prefer a one-time charge at consummation, which would be ignored by the marketplace, versus capitalization and the associated risk of increased volatility and earnings drag prospectively.</p>

**Observations:**

- Buyers may find that continually assessing acquired IPR&D projects for impairment will be a challenging task.



## **FAS 109 aspects of FAS 141(R)**

**Mike Reichert, Partner**

**Deloitte Tax LLP**

**November 18, 2008**

## Acquisition accounting changes to **FAS** 109

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- **For business combinations in which the acquisition date was before the effective date of this statement, the acquirer shall apply the requirements of **statement** 109, as amended by this statement, prospectively. That is, the acquirer shall not adjust the accounting for prior business combinations for previously recognized changes in acquired tax uncertainties or previously recognized changes in the valuation allowance for acquired deferred tax assets. However, after the effective date of this statement:**

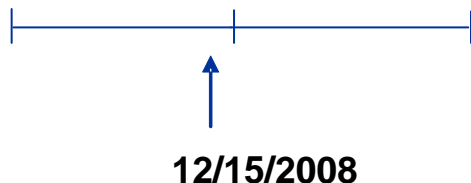
  - **The acquirer shall recognize, as an adjustment to income tax expense (or a direct adjustment to contributed capital in accordance with paragraph 26 of **Statement** 109), changes in the valuation allowance for acquired deferred tax assets.<sup>1</sup>**
  - **The acquirer shall recognize changes in the acquired income tax positions in accordance with Interpretation 48, as amended by this statement.<sup>2</sup>**

<sup>1</sup> Par. 30/37/268/43 of **FAS** 109 modified

<sup>2</sup> EITF 93-7 nullified

## Acquisition accounting changes to **FAS 109** (cont.)

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After **FAS 141R** is adopted, all changes to valuation allowances<sup>1</sup> and FIN 48 reserves<sup>2</sup> will go to the tax provision (without regard to whether the transaction closed pre or post adoption).

- <sup>1</sup> This can only be "good" as it relates to the VA as it can only reduce the tax provision (a benefit that would otherwise have gone to G/W) while increases already go to the tax provision
- <sup>2</sup> This might be "good" but it also might be "bad" (since the FIN 48 reserve, unlike the VA, can move in both directions through G/W)

## Acquisition accounting changes to **FAS 109** — Illustration

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\_\_\_\_\_ Facts: \_\_\_\_\_

- Acquirer purchases Target on 02/15/07 and the transaction is accounted for under **FAS 141**. Target has recorded a FIN 48 liability of \$100 related to state tax nexus issues and a VA of \$500 related to net operating loss carryover DTA's that are not MLTN to be realized.
- Acquirer and Target both have a calendar year-end and will adopt **FAS 141R** on 01/01/2009.
- Subsequent to finalizing the initial purchase accounting, Target concludes that both FIN 48 and VA are no longer needed.

# Re-measurement of acquired tax uncertainties

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## FAS 141 (application of EITF 93-7)

### ■ To record the elimination of Target's FIN 48 liability

– DR — FIN 48 Liability	100
• CR — Goodwill	100

## FAS 141R

### ■ To record the elimination of the Target's FIN 48 liability

– DR — FIN 48 Liability	100
• CR — Tax provision	100

# Post-acquisition release of Target VA

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## FAS 141 (par. 30/37/268/43)

### ■ To record the elimination of Target VA

– DR — VA	500
• CR — Goodwill	500

## FAS 141R

### ■ To record the elimination of Target VA

– DR — VA	500
• CR — Tax provision	500

# Acquisition date release of Acquirer VA

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## \_\_\_\_\_ Facts: \_\_\_\_\_

- **Acquirer purchases Target.**  
Target will join acquirer's consolidated tax group.
- **Prior to acquisition, acquirer has recorded full valuation against its DTA.**
- **Acquirer releases its \$100 VA because of Target's significant DTLs recorded in the business combination.**

## Acquisition date release of Acquirer VA (cont.)

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### FAS 141 (FAS 109 ¶135)

#### ■ To record release of Acquirer VA

– DR — Acquirer VA	100
• CR — Target G/W	100

### FAS 141R (FAS 109 ¶135 removed)

#### ■ To record release of Acquirer VA

– DR — Acquirer VA	100
• CR — Tax Provision	100

# Re-measurement of acquired tax uncertainties

## What to do next...

Issue	Action step
<p>Existing uncertain tax positions — how to minimize post-adoption volatility to tax provision.</p>	<ul style="list-style-type: none"><li>■ Consider whether “new information” exists in order to re-measure (under FIN 48) acquired tax uncertainties from prior transactions before <b>FAS 141(R)</b> is adopted.</li><li>■ Consider proactive steps (e.g., VDA, amended returns, etc.) to facilitate resolution of uncertainties prior to adoption.</li></ul>
<p>Future acquisitions — how to minimize volatility to tax provision after measurement period.</p>	<ul style="list-style-type: none"><li>■ Plan diligence procedures such that greater precision related to quantification of unrecognized tax benefits.</li><li>■ Initiate more detailed post-close diligence procedures to capture entire population of uncertain tax positions.</li><li>■ Carefully consider interest/penalty exposure.</li><li>■ Consider proactive steps to resolve uncertainties within the measurement period.</li></ul>

## Transaction costs

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	141	141(R)
Transaction costs — Book	Capitalized	Expensed

- Under **FAS 141**, there commonly was a purchase accounting question related to “what to do” with the tax benefit related to transaction costs deducted for tax but capitalized for book (with tax usually being able to deduct a subset of the total).
- Under **FAS 141(R)**, purchase accounting question will be how to account for amounts expensed for book but potentially capitalized for tax into either asset or stock basis depending upon the form that the transaction takes (the problem is the reverse of the historical problem)

# Transaction costs illustration

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## \_\_\_\_\_ Facts: \_\_\_\_\_

- Acquirer incurs \$100 transaction costs in the acquisition of Target. Target also incurs \$100 in the process.
- 50% of the acquisition costs incurred by Acquirer and Target are deductible.
- Tax rate is 40%.
- This is a taxable stock purchase.

# Acquirer transaction costs illustration

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## Accounting under FAS 141

### ■ To record transaction costs of Acquirer

- DR — Goodwill 100
- CR — Vendor payables 100

### ■ To record tax effect of transaction costs deducted for tax purposes

- View 1
- DR — Tax payable or DTA 20
- CR — Goodwill 20
- View 2
- DR — Tax Payable 20
- CR — DTL 20

## Accounting under FAS 141R

### ■ To record transaction costs of Acquirer

- DR — Expense 100
- CR — Vendor Payables 100

### ■ To record tax effect of transaction costs deducted for tax purposes

- DR — Tax Payable or DTA 20
- CR — Tax Provision 20

## Target transaction costs illustration (No change)

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### Accounting under **FAS 141** and **141(R)**

- To record transaction costs of Target (in Target's books)

– DR — Expense	100
• CR — Vendor payable	100

- To record tax effect of capitalized transaction costs

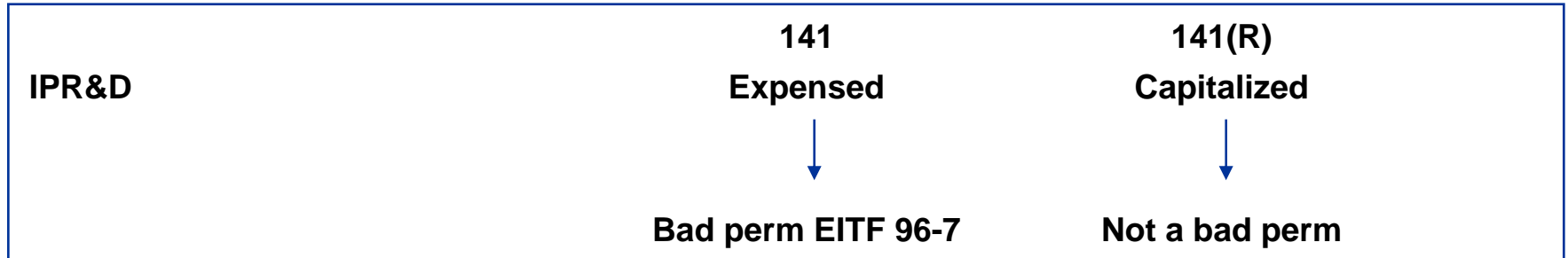
– DR — Tax payable or DTA	20
• CR — Tax provision	20

# Transaction costs

## What to do next...

Issue	Action step
<p>How to achieve accuracy of provision effect of acquisition costs in the quarter of the acquisition close.</p>	<ul style="list-style-type: none"><li>■ <b>Consider modifying/accelerating analysis of deductibility of transaction costs concurrent with transaction close:</b><ul style="list-style-type: none"><li>– Decision date analysis</li><li>– Analysis of costs that may be facilitative</li><li>– Interviews with vendors and data gathering</li><li>– FIN 48 analysis</li><li>– Communication with audit firm</li></ul></li><li>■ <b>Develop agreed-upon approach with finance to capture relevant data on a timely basis, including:</b><ul style="list-style-type: none"><li>– Engagement letters</li><li>– Invoices</li></ul></li></ul>

## In-process R&D — FIN 4 changed



- Under **FAS 141**, amounts allocated to IPR&D had to be immediately expensed. Under EITF 96-7, the expensing of IPR&D was deemed to occur prior to the establishment of deferred taxes (resulting in a bad perm if a nontaxable transaction). In a taxable asset acquisition, the expensing of IPR&D would result in a temporary difference recorded in the tax provision.
- Under **FAS 141(R)**, IPR&D is capitalized with deferred taxes recorded on any temporary differences (so no “bad perm” at acquisition or later when IPR&D is expensed or amortized).

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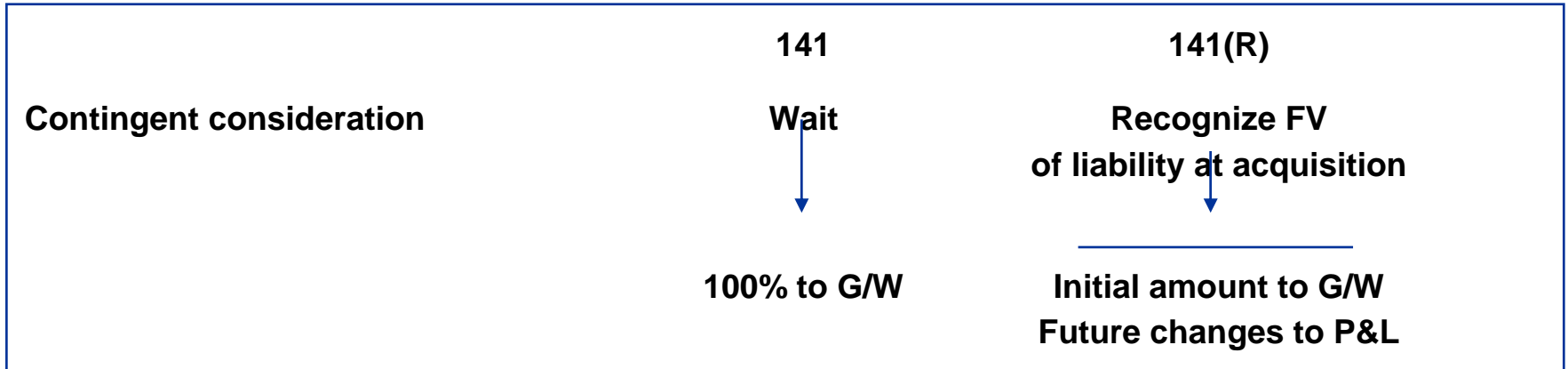
**Grant Thornton**

## **FAS 141R**

**Andy Cordonnier, Partner  
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National Tax Office – Washington, DC  
November 18, 2008**

**Deloitte.**

# Contingent consideration



- Under **FAS 141**, no provision effects arose from payment of contingent consideration — timing and measure was same for book and tax.
- Under **FAS 141(R)**, book and tax virtually certain to be different, creating a potential for provision effects (no benefit is also a “provision effect”).

# Example — Contingent consideration in a taxable stock purchase

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\_\_\_\_\_ Facts: \_\_\_\_\_

- Acquirer purchases Target stock for \$200 including a contingent payment with a fair value of \$50.
- The fair value of the identifiable assets is \$200 and the tax basis is \$25.
- The tax rate is 40%.

Date 1 accounting:

▪ DR — Assets	200
▪ DR — Goodwill	120
– CR — Target equity	200
– CR — Contingent consideration liability	50
– CR — DTL (200-25 × 40%)	70

## Example — Contingent consideration in a taxable stock purchase (cont.)

### Scenario 1

Settle at the initial amount accrued:

▪ DR — Contingent consideration liability	
	50
– CR — Cash	50

### Scenario 2

Settle at \$50 greater than initial amount accrued:

▪ DR — Expense	50
▪ DR — Contingent consideration liability	
	50
– CR — Cash	100

In taxable stock purchases, settlement of contingent consideration classified as a liability for an amount greater than the initial amount is recorded as an expense for book purposes and as increased stock purchase price for tax purposes. An unfavorable permanent difference is generally created because **FAS 109 ¶34** prohibits the recognition of a DTA when the tax basis exceeds the book basis in stock of a subsidiary.

### Scenario 3

Settle at \$40 lower than initial amount accrued:

▪ DR — Contingent consideration liability	
	50
– CR — Income	40
– CR — Cash	10

Settlement for an amount less than the initial amount is recorded as income for book purposes and as decreased stock purchase price for tax purposes. A favorable permanent difference may arise if (1) the Target is a domestic corporation; (2) the stock basis difference can be eliminated in a tax-free manner (e.g., liquidation), and (3) the Acquirer intends to use that means to realize the stock basis difference (**FAS 109 ¶33** exception to DTL applicable to a domestic subsidiary). Other exceptions might apply to a foreign target company.

# Example — Contingent consideration in a taxable asset acquisition

## \_\_\_\_\_ Facts: \_\_\_\_\_

- Acquirer purchases Target’s assets for \$200 and a contingent payment with a fair value of \$50.
- Tax rate is 40%

## Date 1 accounting:

▪ DR — Assets	200
▪ DR — Goodwill	50
– CR — Target equity	200
– CR — Contingent consideration liability	50

At the acquisition date, no temporary differences are considered to exist in Target’s assets because payment of the contingent consideration (which is “expected”) will result in additional amortizable/depreciable tax basis in the goodwill.

## Example — Contingent consideration in a taxable asset acquisition (*cont.*)

### Scenario 1

Settle at the initial amount accrued:

▪ DR — Contingent consideration liability	50
– CR — Cash	50

### Scenario 2

Settle at \$50 greater than initial amount accrued:

▪ DR — Expense	50
▪ DR — Contingent consideration liability	50
– CR — Cash	100
▪ DR — DTA	20
– CR — Deferred tax provision	20

In a taxable asset acquisition, settlement of contingent consideration classified as a liability for an amount greater than the initial amount is recorded as an expense for book purposes and as increased asset basis for tax purposes. Deferred taxes are always recorded on inside basis differences unless an exception applies. This DTA (for future tax deductible goodwill > book goodwill) can be recognized since (1) it is arising from a P&L event and **FAS 109 ¶35** would allocate the DTA to the tax provision and (2) there is no prohibition on recording this DTA.

### Scenario 3

Settle at \$40 lower than initial amount accrued:

▪ DR — Contingent consideration liability	50
– CR — Income	40
– CR — Cash	10
▪ DR — Deferred tax provision	16
– CR — DTL	16

In a taxable asset acquisition, settlement of contingent consideration classified as a liability for an amount less than the initial amount is recorded as income for book purposes and as decreased asset basis for tax purposes. A DTL is recorded on the temporary difference resulting from the change in “expected” tax basis. The deduction M-1 (to eliminate the \$40 of book income) is treated as the tax deduction of an equal amount of the original \$50 of goodwill.

# Contingent consideration — Tax

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- **Open transaction ("wait and see") methodology is generally dead for sellers:**
  - **Must make best estimate and then "true-up" at later date**
- **Buyer obtains tax basis only when contingency matures:**
  - **No catch-up adjustment**
  - **May amortize intangible over "remaining" period**

# Assets and liabilities arising from contingencies -- Acquisition Date

Statement 5 does not apply to acquisition date accounting

- **Contractual contingencies (contingencies related to contracts):**
  - Recognize assets and liabilities at fair value
  
- **Noncontractual contingencies:**
  - If it is more likely than not the contingency gives rise to an asset or liability at acquisition date, recognize asset or liability at fair value
    - Recognize liability when it is more likely than not that the acquirer has a present obligation to pay if a specified event occurs

## Assets and liabilities arising from contingencies -- Subsequent Accounting

- **Should be retrospectively adjusted as of the acquisition date if the conditions for a measurement-period adjustment are met.**

## Assets and liabilities arising from contingencies -- Subsequent Accounting (cont.)

If accounted for under **FASB 5** outside a business combination, will not be adjusted until new information is obtained. When new info is obtained, the acquirer would measure:

- A liability at the higher of (>)
  - Its acquisition-date fair value
  - The amount recognized by applying FASB 5
  
- An asset at the lower of (<)
  - Its acquisition-date fair value
  - The best estimate of its future settlement amount

## **Assets and liabilities arising from contingencies -- Subsequent Accounting**

**Acquired noncontractual contingencies that do not meet the more-likely-than-not recognition threshold are subsequently accounted for in accordance with other generally accepted accounting principles, as appropriate.**

## Assets and liabilities arising from contingencies -- Derecognition

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- Only when the contingency is resolved.
- Not reduced below the amount recognized until derecognition, regardless of whether new information indicates that both the fair value and the **FASB 5** measurement of the liability would be significantly less than its carrying amount.

# Contingent liabilities for tax

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- Unclear issues for tax
- Seller estimates amount and recognizes gain
- Principle Issue: Who gets the deduction?
- When did the events most important to the liability occur?
  - Consider health care claims
  - *Illinois Tool Works* Case
- Qualified Pension Plans
- Nonqualified Deferred Comp Plans and Compensation
- Sec. 461(h) liabilities

# Bargain purchase

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- **Statement 141R** — Bargain purchases create current income recognition.
  - Measurement period adjustments: reduce goodwill to zero, income recognition for the remainder
- **Federal Income Tax** — Bargain purchases are reflected in the asset allocation amounts pursuant to the 7 class residual allocation method. There is no income inclusion and no concept of negative goodwill.

# Indemnification — You are the seller

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- **What is the treatment of FIN 48 liabilities of Target by the Seller?**
  - **Consider who is the primary obligor — the person legally obligated to pay the liability to the tax authorities**
  - **Indemnification obligations to the Acquirer are accounted for under FIN 45 and not FIN 48 (The FIN 48 liability would be removed and a new liability would be reserved for under FIN 45 representing the fair-value of the indemnification)**

## Indemnification — You are the seller (*cont.*)

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### Accounting under **FAS 141**

- To record the elimination of the FIN 48 liability

– DR — FIN 48 liability	100
• CR — Gain/Loss on sale	100

- To record the indemnification obligation  
(FV of expected payment obligation)

– DR — Gain/Loss on sale	75
• CR — Guarantor liability	75

### Accounting under **FAS 141R**

- Same

# Indemnification — You are the acquirer

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What is the treatment of FIN 48 liabilities of “T” by the acquirer?

- Consider who is the primary obligor — the person legally obligated to pay the tax liability.
- Should a FIN 48 liability be recognized notwithstanding a contractual arrangement to obtain reimbursement?
- Should a receivable be recognized to reflect the amounts due under such arrangement, as an offset to a FIN 48 liability?

## Indemnification — You are the acquirer (*cont.*)

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### Accounting under **FAS 141R**

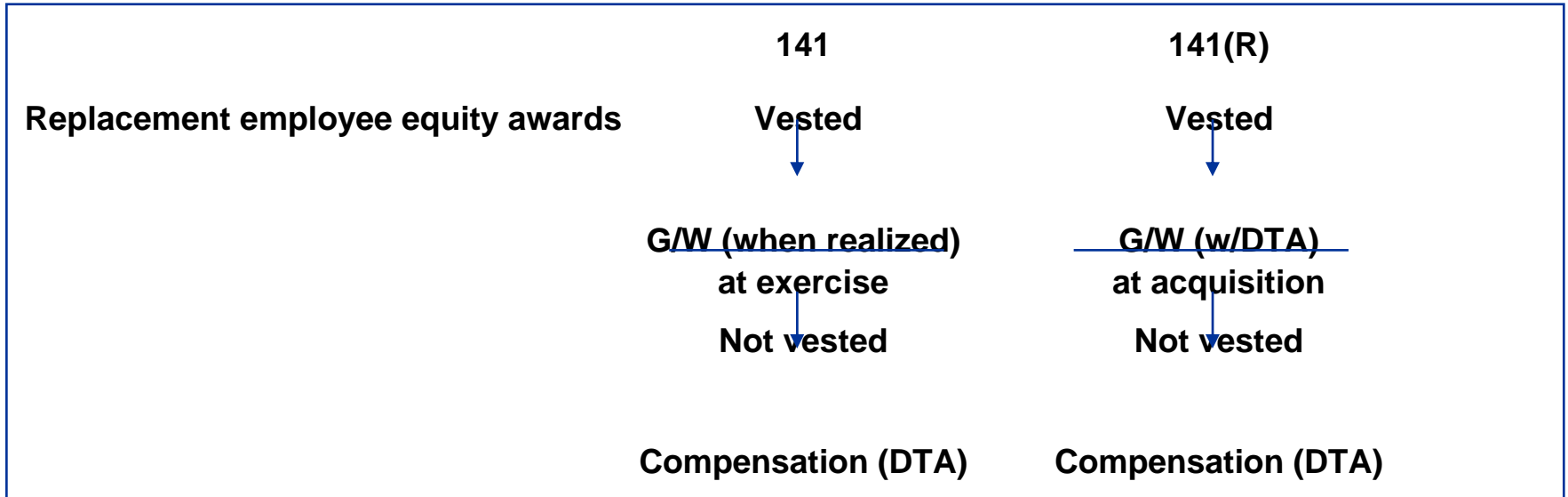
- To record the liability
  - DR — Goodwill 100
  - CR — FIN 48 Liability 100
  
- To record the indemnification arrangement
  - DR — Receivable 100
  - CR — Goodwill 100

What if the FIN 48 liability is later re-measured to \$70?

### Accounting under **FAS 141R**

- To record the liability
  - DR — FIN 48 Liability 30
  - CR — Tax provision 30
  
- To record the indemnification arrangement
  - DR — Pre-tax earnings 30
  - CR — Receivable 30

# Replacement employee equity awards



- Under **FAS 141**, tax benefit on fully vested replacement awards reduce goodwill. DTA is recorded for the nonvested portion of replacement awards as compensation expense is recognized pursuant to **FAS 123(R)**.
- Under **FAS 141(R)**, if the acquirer is obligated to replace the awards (e.g., terms of acquisition agreement), then the acquirer includes the liability for the portion of the awards attributed to precombination employee service as part of the consideration in the business combination (net of the benefit of a related DTA). The portion of the awards attributed to postcombination services should be recognized as compensation costs in the post acquisition financial statements (DTA is recognized as compensation is recognized under **FAS 123(R)**).

# Replacement employee equity awards — Examples

## Example 1

- No post-combination services
- Replacement award @ \$110 FV
- Replaced award @ \$100 FV

Expense \$10 @ close

## Example 2

- 1 year post-combination services req'd to vest in replacement award
- Replaced award fully vested (4 years)
- FV equals \$100 (N/C)

Expense \$20 over 1 year; G/W for \$80

## Example 3

- Post-combination services required
- Replaced award not fully vested
- 2 years of 4 years done
- Replacement award requires 1 year
- FV equals \$100 (N/C)

2 (years done) = 50% (to G/W)

4

(> of original (4) or total required (3))

## Example 4

- Same as example 9
- But no post-combination services required

Expense \$50 immediately

## Replacement employee equity awards — Journal entries

### Example 1

#### At closing

▪ DR — Goodwill	100
▪ DR — Compensation Expense	10
– CR — APIC	110
▪ DR — DTA	44
– CR — Goodwill	40
– CR — Deferred Provision Benefit	4

### Example 2

#### At closing

▪ DR — Goodwill	80
– CR — APIC	80
▪ DR — DTA	32
– CR — Goodwill	32

#### Over one year immediately after closing

▪ DR — Compensation Expense	20
– CR — APIC	20
▪ DR — DTA	8
– CR — Deferred Provision Benefit	8

## Replacement employee equity awards — Journal entries (*cont.*)

### Example 3

#### At closing

▪ DR — Goodwill	50
– CR — APIC	50
▪ DR — DTA	20
– CR — Goodwill	20

#### Over one year immediately after closing

▪ DR — Compensation Expense	50
– CR — APIC	50
▪ DR — DTA	20
– CR — Deferred Provision Benefit	20

### Example 4

#### At closing

▪ DR — Goodwill	50
▪ DR — Compensation Expense	50
– CR — APIC	100
▪ DR — DTA	40
– CR — Goodwill	20
– CR — Deferred Provision Benefit	20

# Replacement employee equity awards

What to do  
next...

Issue	Action step
<p>How to manage dual systems of accounting for pre-adoption and post-adoption acquisitions.</p>	<ul style="list-style-type: none"><li>▪ Develop/document accounting framework to follow for pre-adoption transactions (i.e., EITF 00-23 accounting) vs. post-adoption transactions (discussed earlier).</li><li>▪ Consider systems requirements of dual systems during transition period.</li></ul>
<p>How to configure system for expense accounting (and thus DTA set-up/reversal).</p>	<ul style="list-style-type: none"><li>▪ Understand the mechanics of entering the full fair value into stock tracking system while somehow limiting post-acquisition expense to just the unvested portion.</li></ul>
<p>How to address company-specific concerns.</p>	<ul style="list-style-type: none"><li>▪ Brainstorm and formalize implications for:<ul style="list-style-type: none"><li>– Tax benefits of assumed ISOs.</li><li>– Shortfalls (because under <b>141R</b>, even shortfalls for the vested portion will hit APIC pool or income tax expense, if no APIC pool).</li></ul></li></ul>

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# Open Forum for Questions and Comments

