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FASB ISSUES SFAS 141R, NEW ACCOUNTING RULES FOR ACQUISITIONS

On December 4 2007, the FASB issued SFAS 141R, *Business Combinations*, which becomes effective December 15, 2008 (early adoption is prohibited).

Background on Accounting for Acquisitions

The original SFAS 141, issued in June 2001, addressed financial accounting and reporting for business combinations. Prior to the issuance of SFAS 141, business combinations were accounted for using one of two methods, the pooling-of-interests method (pooling method) or the purchase method. Use of the pooling method was required whenever 12 specific criteria were met; otherwise, the purchase method was to be used. Because those 12 criteria did not distinguish economically dissimilar transactions, similar business combinations were accounted for using different methods that produced dramatically different financial statement results. Upon the issuance of SFAS 141, business combinations were accounted for using one method; the purchase method. Revising SFAS 141 has been an arduous process, involving multiple exposure drafts, record levels of comment letters, and collaboration with the IASB.

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UPDATE ON SECTION 409A

On September 9, 2007, the IRS and Treasury announced that taxpayers will be provided transition relief for compliance with Section 409A. The deadline to adopt documents that comply with Section 409A has been extended to December 31, 2008, subject to limited requirements regarding the timely written designation of a time and form of payment. The IRS and Treasury also anticipate issuing guidance regarding a limited voluntary compliance program that will permit taxpayers to correct certain unintentional operational violations of Section 409A and thereby limit the amount of additional taxes due under Section 409A.

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SFAS 144 PRIMER: WHEN TO TEST A LONG-LIVED ASSET FOR RECOVERABILITY

SFAS 144 requires the periodic impairment testing of intangible assets and other long-lived assets. Long-lived assets (or asset groups) shall be tested for recoverability whenever events or changes in circumstances indicate that its carrying amount may not be recoverable. The following are examples of such events or changes in circumstances:

- a. A significant decrease in the market price of a long-lived asset (or asset group);
- b. A significant adverse change in the extent or manner in which a long-lived asset (or asset group) is being used or in its physical condition;
- c. A significant adverse change in legal factors or in the business climate that could affect the value of a long-lived asset (or asset group), including an adverse action or assessment by a regulator;

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The McLean Group's Valuation Practice

As a core competency and complement to its merger & acquisition practice, The McLean Group provides business valuation services, including intangible asset and financial security valuations for a variety of transaction, financial reporting and tax purposes.

SFAS 144 PRIMER: WHEN TO TEST A LONG-LIVED ASSET FOR RECOVERABILITY *(continued from page 1)*

- d. An accumulation of costs significantly in excess of the amount originally expected for the acquisition or construction of a long-lived asset (or asset group);
- e. A current-period operating or cash flow loss combined with a history of operating or cash flow losses or a projection or forecast that demonstrates continuing losses associated with the use of a long-lived asset (or asset group); and
- f. A current expectation that, more likely than not, a long-lived asset (or asset group) will be sold or otherwise disposed of significantly before the end of its previously estimated useful life.

SFAS 144 is effectively a two-step test. First, the carrying amount of the intangible asset is compared to the undiscounted cash flows for the asset. If the carrying amount is greater than the sum of its undiscounted cash flows, it is then re-measured to fair value (with present value techniques). A present value technique is often the best available valuation technique with which to estimate the fair value of a long-lived asset (asset group). If a present value technique is used, estimates of future cash flows should be consistent with fair value measurement techniques. Accordingly, assumptions that marketplace participants would use in their estimates of fair value should be incorporated in the analysis.

UPDATE ON SECTION 409A *(continued from page 1)*

Background on Section 409A

On April 10, 2007, the IRS issued the final regulations for Section 409A of the Internal Revenue Code (IRC). The 397 page document details the rules governing the application of Section 409A to nonqualified deferred compensation plans.

Section 409A was added to the IRC through the American Jobs Creation Act. The section generally provides that unless certain requirements are met, amounts deferred under a nonqualified deferred compensation plan for all taxable years are currently includible in gross income to the extent they are not subject to a substantial risk of forfeiture.

The rules under Section 409A were created in response to the wave of corporate scandals relating to the backdating of stock options. The IRS wants to ensure stock options, stock appreciation rights (SARs), and other equity incentives are not just a form of deferred compensation, but instead issued with a strike price equal to the fair market value of the stock at the grant date.

Implementation of Section 409A

All nonqualified deferred compensation plans must be in compliance with Section 409A by December 31, 2008. ***Although an independent appraisal of the fair market value of a company's stock is not required by the regulations, an appraisal performed by a qualified individual can ease the concern that the "valuation was determined by the reasonable application of a reasonable valuation method," which is required by the regulations.*** A violation of Section 409A results in the assessment of a 20 percent tax and interest, in addition to regular income and employment taxes.



FASB ISSUES SFAS 141R, NEW ACCOUNTING RULES FOR ACQUISITIONS *(continued from page 1)*

The Acquisition Method

The revised Statement requires the application of a new accounting method for business combinations, known as the “acquisition method.” In accordance with this method, the acquirer recognizes the acquiree as a whole, and measures the assets and liabilities acquired at their fair values as of the acquisition date. The recognition and measurement of a business combination should be as of the acquisition date – that is, the date the acquirer obtains control of the acquiree. Also, the Statement asserts that an acquirer should be identified in every business combination.

SFAS 141R applies to all transactions where an entity obtains control of one or more businesses, including mergers and where a combination may be achieved without the transfer of consideration. The Statement does not apply to joint ventures, an acquisition of assets that do not constitute a business, or acquisitions by non-for-profit organizations.

SFAS 141R Highlights

SFAS 141R includes several significant changes, as highlighted below:

- **Transaction Costs**

Transaction costs will be expensed rather than capitalized as part of the purchase price.

- **Contingent Consideration**

All consideration paid for an acquisition (including contingent consideration, such as an earn-out) must be valued as part of the purchase price. This means that the acquirer must estimate the amount of the contingent consideration that will be paid in the future. Subsequent changes in the fair value of the contingent consideration would then be recognized as a gain or loss in the income statement.

- **Bargain Purchase**

A bargain purchase occurs when the fair value of the acquired net assets (tangible and intangible) exceeds the fair value of the consideration paid. Previously, such “negative goodwill” would be the amount assigned to the acquired net assets that exceeds their fair value. SFAS 141 required that negative goodwill be allocated as a pro rata reduction to the net assets (intangible assets first, then certain tangible assets). The revised Statement now requires that the negative goodwill be recognized as an immediate gain in the income statement.

- **Restructuring Costs**

Expected restructuring or other costs will be expensed as post combination expenses when incurred (unless they qualify as liabilities under SFAS 146, thus reversing EITF 95-3).

- **Equity-Based Consideration**

Equity securities issued as consideration are measured at the fair value as of the acquisition date.

- **In-Process Research & Development (IPR&D)**

IPR&D will be recognized as an intangible asset and classified as indefinite-lived until completion or abandonment (subsequent R&D expenditures will continue to be expensed as incurred). The acquired IPR&D will be tested for impairment. Once the IPR&D has reached completion, the capitalized amount will be amortized over its useful life. IPR&D will no longer be expensed at acquisition.

Other changes affect the treatment of deferred taxes and step-up acquisitions.

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SPOTLIGHT ON COURT CASES**Rosvold v. LSM Systems Engineering, Inc.
November 6, 2007**

The judge in this case ruled that the plaintiff's valuation expert was not qualified to be an expert despite having a master's degree from the Wharton School of Business at the University of Pennsylvania. The expert's resume had no mention of experience in valuation. In addition, this was the first time he was giving testimony for a lawsuit, he hadn't written or published any books or articles on business valuation, and he was not part of any recognized business valuation associations. As a result, the testimony of the plaintiff's valuation expert was not included. This is consistent with FRE 702 and Daubert in terms of the guidance on the qualifications an "expert" must meet.

**Nanovation Technologies v. BearingPoint
May 17, 2007**

In this case, the trustee of Nanovation Technologies filed a valuation malpractice suit against BearingPoint (formerly KPMG). The expert hired by the trustee concluded a value of \$0.15 per share while BearingPoint's conclusion of value was \$9.20 per share as of September 30, 2000. The court ruled against the expert because he ignored stock transactions which were indicating values of \$15 to \$25 per share in the two-month time period preceding September 30, 2000. Also, the trustee's expert applied the lowest market multiple which the court did not consider in accordance with business valuation standards. As a result, the court dismissed the malpractice suit against BearingPoint.

**Kimberlin v. Commissioner
May 8, 2007**

In this case, the respondent's expert failed to use the correct standard of value in valuing a distribution of warrants of a company that were exercised. The court agreed with the petitioner's expert that the distributed warrants should be valued based on fair market value. The court cited section 61 (sec. 1.1001(a)) of the IRS income tax regulations: "The fair market value of property is a question of fact and only in rare and extraordinary cases will property be considered to have no fair market value." In other words, the court stated "the transferred warrants are taxable in the year of grant if they had an ascertainable fair market value at that time." Also, the court determined that "[when] a distribution is a distribution other than cash, the fair market value of the property is determined as of the date of distribution."

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