

Accounting for business combinations: implications of Statement 141(R) for medtech companies

Accounting

Transactions

Risk

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Industry insights



Introduction

Mergers and acquisitions have long been integral to the medical technology industry business model. Smaller medtech companies often develop innovations with an eye to being purchased by larger entities with manufacturing and commercialization capabilities, while established companies seek to replace revenues from mature product lines with new products. Going forward, we believe M&A activity will continue to shape the medtech industry. With the initial public offering market essentially closed to emerging medtech companies for the time being, private firms are more likely to use acquisitions as an exit strategy. We also believe that the wave of strategic consolidations and carveouts is likely to continue. (For additional discussion of recent M&A trends and drivers, see Ernst & Young's *Pulse of the industry: US medical technology report 2008*.)

Given the extent of M&A activity within the medtech space, upcoming changes in accounting rules could dramatically alter the deal landscape. The new business combination rules – described in FASB Statement No. 141(R), *Business Combinations* – could have a significant impact on an acquirer's future earnings, financial metrics (e.g., return-on-equity and debt-to-equity ratios) and compliance with debt covenants. And while many small companies may not have focused on these changes, the rules will soon be in effect (they apply to transactions with closing dates on or after 1 January 2009 for calendar year companies) and significantly expand the scope of acquisitions accounted for as business combinations. Among other changes, Statement 141(R) affects the accounting for items such as acquired in-process research and development assets (IPR&D), contingent consideration

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arrangements (e.g., milestone and earn-out payments) and assets acquired but not used to their highest extent. Medtech companies should assess the effects of Statement 141(R), including the impact on acquisitions that are in process but may not close before Statement 141(R)'s effective date.

While the new business combination rules could have an obvious impact on buyers, we believe that "sell-side" enterprises should also focus on them. It is often useful for a seller to understand how the financial reporting requirements of an acquirer could affect the deal structure or the price an acquirer is willing to pay.

This document was prepared to assist you in understanding Statement 141(R)'s provisions. We highlight Statement 141(R)'s key changes and discuss the implications of these changes and considerations in structuring business combinations. We also provide a hypothetical business combination to illustrate key differences between current GAAP and Statement 141(R). The example includes elements that are common to medtech M&As, including earn-out payments, in-process research and development considerations and exchanges of share-based payments.

In addition, Ernst & Young has released its Financial Reporting Developments publication on FASB Statement No. 141 (R), *Business Combinations* (Statement 141 (R) FRD) (SCORE No. BB1616), which provides guidance to help you understand the provisions of Statement 141 (R). Ernst & Young professionals are available to assist in analyzing the effect of Statement 141 (R).

Overview of Statement 141(R) changes

In addition to changing the accounting for certain aspects of business combinations, Statement 141(R) broadens the scope of business combination accounting by modifying the definition of a "business."

The change to the definition could have significant accounting consequences to the medtech industry. By definition, development-stage enterprises were not businesses under Statement 141. As a result, acquisitions of development-stage enterprises were not considered business combinations but instead asset acquisitions. And because in-process research and development generally did not meet the definition of an asset, any purchase price allocated to IPR&D was expensed at the acquisition date.

Importantly, Statement 141(R) specifically provides that a development-stage enterprise may be considered a business even though it does not have outputs. Instead, in cases where outputs do not currently exist, Statement 141(R) provides factors that are to be used to evaluate whether the acquired set of activities is a business. Those factors generally focus on whether the entity has inputs and processes and is pursuing a plan to produce outputs.

Application of Statement 141(R)'s business definition will increase the number of acquisitions that are to be accounted for as business combinations. Given the significance of the potential change in accounting for acquisitions of development-stage enterprises, we encourage you to understand Statement 141(R)'s provisions, which are discussed in greater detail in the sections that follow.

From a medtech perspective, the most significant changes to business combination accounting pursuant to Statement 141(R) are summarized in the table on page 3.

Statement 141(R) also changes:

- ▶ The measurement date of the fair value of an acquirer's marketable equity securities issued as consideration in a business combination
- ▶ The accounting for share-based payment awards exchanged for awards held by the acquiree's employees

- ▶ The accounting for acquisition-related costs
- ▶ The recognition and measurement of assets and liabilities subject to contingencies
- ▶ The accounting for changes in income tax valuation allowances and tax uncertainty accruals resulting from a business combination transaction
- ▶ The accounting for acquisition-related restructuring costs

These changes, along with the changes highlighted in the table below, are discussed in greater detail in the sections that follow.

Statement 141(R) also requires fair value measurements on virtually all assets acquired and liabilities assumed in a business combination based on a market participant's highest and best use. The expanded use of fair value accounting increases the complexity of business combination accounting. Medtech companies that may

have previously relied upon valuation specialists to determine the fair values of certain tangible and intangible assets under current GAAP may need ongoing additional assistance in determining the fair value of items such as contingent consideration arrangements and pre-acquisition contingencies, as well as evaluating the recoverability of acquired IPR&D assets.

Key Statement 141(R) changes affecting medtech companies

Scope: identifying a business combination

Current GAAP – A business combination occurs when an entity acquires net assets that constitute a business or acquires equity interests of one or more entities that constitute a business and obtains control over that entity (or entities). Statement 141 does not address transactions in which control

is obtained through means other than an acquisition of net assets or equity interests.

Statement 141(R) – A business combination includes *any* transaction or other event in which the acquirer obtains control of one or more businesses. Consistent with current GAAP, joint venture formations are excluded from the scope of Statement 141(R).

Implication – *Statement 141(R) broadens the scope of transactions that will be accounted for as business combinations.* Statement 141(R) broadens the definition of a business combination to include all transactions or other events in which control of one or more businesses is obtained. Therefore, although a business combination typically occurs through the purchase of the net assets or equity interests of a business, a business combination could occur without the transfer of consideration. Examples include situations where control of a business is obtained pursuant to a contractual arrangement, the lapse of minority veto rights that previously

Most significant changes for medtech companies

	Current GAAP	Statement 141(R)
Research and development assets	Acquired in-process research and development (IPR&D) assets that have no alternative future use are measured at fair value and charged to expense as of the acquisition date.	Acquired IPR&D assets are recognized and measured at their acquisition-date fair values. After initial recognition, acquired IPR&D assets are accounted for as indefinite-life intangible assets until completion or abandonment. Development costs incurred after acquisition on acquired IPR&D projects are charged to expense as incurred. Upon completion of development (generally when regulatory approval to market is obtained), acquired IPR&D assets are generally considered amortizable finite-lived assets.
Assets the acquirer does not intend to use or use to the extent of highest and best use	Before adoption of FASB Statement No. 157, Fair Value Measurements, entity-specific assumptions were used to value assets to be abandoned or not fully utilized, often resulting in either a transitional value or no value being allocated to such assets.	All assets are measured at fair value in accordance with Statement 157 (from the perspective of a market participant), without regard to acquirer intent.
Contingent consideration	Recognized as a cost of the acquisition. Generally, not recognized at acquisition date unless contingency is determinable beyond a reasonable doubt.	Recognized and measured at fair value at the acquisition date and classified as either a liability or equity based on existing GAAP. After initial recognition, contingent consideration arrangements that are classified as liabilities are remeasured at fair value with changes in fair value recognized in income. Contingent consideration arrangements that are classified as equity are not remeasured.

prevented a majority owner from controlling a business, or an investee share buyback that results in an existing investor obtaining control of the investee's business.

Definition of a business

Current GAAP – The definition of a business and related application guidance is in Emerging Issues Task Force (EITF) Issue No. 98-3, *Determining Whether a Non-Monetary Transaction Involves a Receipt of Productive Assets or of a Business*. That guidance generally requires that, in order to be considered a business, the acquired net assets must have substantially all the inputs, processes and outputs necessary to be self-sustaining. Further, it specifically provides that a development-stage enterprise is not a business.

Statement 141(R) – The definition of a business is broadened to include “an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants.”

Implication – *The definition of a business is expanded to potentially include development-stage entities.* In order to qualify as a business, an acquired set of assets no longer needs to have all the inputs and processes necessary to be self-sustaining and is not required to have any outputs. Rather, the acquired set of assets needs to have only inputs and processes sufficient to be capable of being utilized by a market participant to produce outputs.

Because Statement 141(R) does not require outputs to be present at the acquisition date, development-stage enterprises might qualify as businesses. In these situations, various factors will need to be assessed to determine whether an acquired set of assets and activities is a business, including whether the acquired set of assets and activities has employees

and other inputs and processes that can be applied to those inputs, is pursuing a plan to produce outputs, and has the ability to obtain access to customers that will purchase those outputs. If some or all of these characteristics are present, the development-stage company is likely to be a business.

While outputs are not a required element of a business as defined in Statement 141(R), and not all inputs and processes need be present, we believe that it would be unusual for a business to be transferred without any significant processes. As a result, we generally believe that acquiring an individual asset or input (for example, acquiring the rights to a technology candidate) with no associated processes would not in and of itself result in a business combination. If instead of acquiring solely the right to a technology candidate, the employees involved in developing the technology candidate and the related operations also joined the acquirer, we think it is more likely that the acquired net assets or entity would constitute a business. However, whether the employees of the target join the acquirer is not necessarily determinative of whether an entity would qualify as a business. All the facts and circumstances must be carefully considered in assessing whether acquired net assets or an acquired entity represents a business.

We expect more transactions to qualify as business combinations under Statement 141(R). Because of the significant differences between the accounting for business combinations and asset acquisitions, the determination of whether the acquiree is a business will be a critical judgment. Given the potential effect on an acquirer's future earnings of applying the provisions of Statement 141(R), medtech companies seeking to expand their pipelines may simply acquire individual assets rather than enter into a business combination to acquire those same assets.

It is also important to note that the definition of a business in Statement 141(R) is also used in other authoritative literature (for example, FASB Interpretation No. 46(R), *Consolidation of Variable Interest Entities*, and FASB Statement No. 142, *Goodwill and Other Intangible Assets*) and, therefore, will also affect how that literature is applied. For example, the broadened definition of a business could affect the number of reporting units identified pursuant to Statement 142. For additional discussion of this and other transition issues related to Statement 141(R), refer to the Ernst & Young Statement 141 (R) FRD referenced in the introduction.

Marketable equity securities of the acquirer

Current GAAP – For purposes of determining the cost of the acquisition, the fair value of an acquirer's marketable equity securities issued as consideration in the business combination is measured around the date the terms of the acquisition are agreed to and announced if certain criteria are met (that is, when the equity exchange ratio is fixed). In other cases, the securities are measured on the acquisition date or, potentially, between the announcement date and the acquisition date. The fair value of all other consideration transferred is measured as of the acquisition date.

Statement 141(R) – The fair value of all consideration transferred is measured as of the acquisition date.

Implication – *The value of equity securities issued as consideration will not be determined until the acquisition date.* Statement 141(R) requires all consideration issued in a business combination to be valued on the acquisition date. Thus, changes in the acquirer's stock price during the period between when an acquisition is agreed to and announced and the acquisition date – which are often observed to be material if only as a result of the market's reaction to the transaction – will cause the purchase price for accounting purposes to fluctuate

until the acquisition date. Because medtech M&A transactions often include equity consideration, this change could have a significant effect on the amount of goodwill recorded in the transaction and may affect an acquirer's decision to use equity instruments as purchase consideration, particularly when the number of shares to be issued is fixed or based on a fixed exchange ratio.

Research and development costs

Current GAAP – Acquired IPR&D assets that have no alternative future use are measured at fair value and charged to expense as of the acquisition date.

Statement 141(R) – Acquired IPR&D assets are recognized and measured at their acquisition-date fair values. After initial recognition, acquired IPR&D assets are accounted for as indefinite-lived intangible assets in accordance with Statement 142, as amended by Statement 141(R), until completion or abandonment. Post-acquisition development costs incurred on acquired IPR&D projects are charged to expense as incurred. Upon completion of development (generally when regulatory approval to market is obtained), acquired IPR&D assets generally are considered amortizable finite-lived assets.

Implication – *Acquired IPR&D will be capitalized rather than expensed at the acquisition date.* A key driver in many acquisitions involving medtech companies is the acquirer's desire to gain access to a new product pipeline or technology platform. Frequently, such technologies represent a majority of the transaction value. Under current GAAP, the portion of purchase consideration allocated to acquired IPR&D assets that have no alternative future use is immediately expensed at the acquisition date. Thus, the acquirer takes a significant charge to earnings when the acquisition closes, and continues to expense future costs to develop the purchased research. Analysts, investors and others that value medtech companies have come to expect such charges

and, in general, there usually is relatively little, if any, negative effect to the acquiring company's valuation as a result.

Under Statement 141(R), an acquirer will now be required to capitalize acquired IPR&D assets as an indefinite-lived intangible asset, but future costs to develop the purchased research will continue to be expensed. As an indefinite-lived intangible asset, acquired IPR&D assets will be subject to periodic impairment reviews pursuant to Statement 142 to determine whether the fair value of the acquired IPR&D asset is less than its carrying value, which would result in the recognition of an impairment charge. The recognition of an impairment charge will reduce the amount capitalized and will result in an expense that may be large and difficult to predict due to the inherent uncertainty of R&D efforts. In the event such research is successful, the acquired IPR&D assets generally will become a finite-lived asset that will be amortized over its useful life in accordance with Statement 142. We generally believe that such amortization would generally be characterized as a component of cost of sales, thereby having an ongoing negative effect on a company's gross margin over the life of the product.

Because Statement 141(R) requires fair value to be determined based on market participant assumptions pursuant to Statement 157, questions have arisen related to the "day 2" accounting for assets the acquirer obtains in a business combination but does not intend to use or use to the extent of highest and best use (for example, acquired IPR&D assets that will be immediately abandoned). The next section discusses this issue in more detail.

It is critical to note that Statement 141(R) does not modify the accounting for transactions that are not business combinations (that is, the acquisition of assets that do not constitute a business). Therefore, if a company were to acquire a technology platform that is not part of

an actual business (that is, the acquisition does not qualify as a business combination), any acquired IPR&D asset would be immediately expensed and the cost of further development would be expensed as incurred, which would give the acquirer a more predictable pattern of future expense recognition. As a result, medtech companies seeking to expand their research portfolios may structure transactions to be asset acquisitions.

Assets the acquirer does not intend to use or use to the extent of highest and best use

Current GAAP – Before the adoption of Statement 157, entity-specific assumptions were sometimes used to value assets to be abandoned or not fully utilized, potentially resulting in no value being allocated to such assets.

Statement 141(R) – Statement 141(R) requires all assets to be measured at their fair values in accordance with Statement 157, without regard to acquirer intent.

Implication – *The estimate of fair value used to measure the assets and liabilities acquired in a business combination will be based on market factors rather than assumptions specific to the acquirer.* Statement 141(R) requires fair value measurements for virtually all assets acquired and liabilities assumed in a business combination to be based on a market participant's highest and best use rather than based on assumptions specific to the acquirer (for example, intangible assets that the acquirer does not plan to use to their full potential). In many cases, this will cause acquiring companies to place additional value (relative to practice prior to the adoption of Statement 157) on those assets it does not intend to fully use.

Consider a business combination in which a company acquires two product candidates, Candidates A and B. However, the acquiring company only plans to pursue development of Candidate A. The acquiring company

believes that Candidate B is a promising technology but chooses not to develop the candidate because the clinical risks are judged to be too high. Prior to the adoption of Statement 157, the acquiring company may have assigned little or no value to Candidate B, as its development was not being pursued. However, under Statement 141(R), the company is required to consider the value of Candidate B from a market participant's perspective, which, depending on the facts and circumstances, could result in a higher value being assigned to the IPR&D as compared to current GAAP.

As noted above, the requirement to apply the concepts of Statement 157 to assets that an acquirer does not intend to fully utilize raises questions regarding the "day 2" accounting for such assets. For example, does the acquired IPR&D asset associated with Candidate B above have an indefinite life, or should it be assigned a definite life and amortized? If the former, when should Candidate B be considered abandoned? If the latter, what is the appropriate amortization period for an asset that is never expected to be used?

On 13 November 2008, the Emerging Issues Task Force (EITF) reached a consensus on EITF Issue 08-7, "Accounting for Defensive Intangible Assets," in which the EITF concluded that a defensive intangible asset should be amortized over the period that the fair value of the defensive intangible asset diminishes, which is a proxy for the period that the defensive intangible asset indirectly contributes to the future cash flows of the entity. The EITF also clarified that it expects the assignment of an indefinite life to defensive intangible assets to be rare and that a defensive intangible asset cannot be considered immediately abandoned. In addition, the EITF removed acquired IPR&D from the scope of Issue 08-7. Entities should account for acquired IPR&D, after the effective date of Statement 141 (R), in accordance with paragraph 16 of Statement

142. As a result, the acquired IPR&D asset related to candidate B in the previous example would be considered an indefinite-lived intangible and would be subject to periodic impairment reviews pursuant to Statement 142.

Contingent consideration

Current GAAP – Recognized as an additional element of the cost of the acquisition (generally goodwill) when the contingency is resolved beyond a reasonable doubt and the additional consideration is issued or becomes issuable.

Statement 141(R) – Recognize and measure at fair value at the acquisition date and classify as either a liability or equity based on current GAAP. After initial recognition, contingent consideration obligations classified as (1) equity are not subsequently remeasured, (2) liabilities that are financial instruments within the scope of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (Statement No. 133), are accounted for pursuant to that standard, or (3) liabilities that are not within the scope of Statement 133 are remeasured at fair value with changes in fair value recognized in earnings.

As described in paragraph 42 of Statement 141(R), contingent consideration might also provide an acquirer with a right of return of previously transferred consideration (commonly referred to as "contingently returnable consideration") if specified future events occur or fail to occur. This asset is initially and subsequently recorded by the acquirer at fair value.

Implication – *Contingent consideration will be valued at the acquisition date with subsequent changes in value often recognized in earnings.* An acquirer may promise to deliver consideration to the former owners if certain specified events occur or conditions are met. These arrangements are commonly used by buyers and sellers when there are differences of opinion as to the fair value of

the acquired business or when the acquirer wishes to entice selling shareholders that are also employees to continue working for the acquired entity after its acquisition. A common example of a contingent consideration arrangement seen in medtech M&A transactions is an earnout provision that requires the acquirer to provide additional purchase consideration in the event certain revenue or earnings targets are met in the future.

Under Statement 141(R), contingent consideration obligations (or contingently returnable consideration) that are not compensatory in nature are recognized at their fair values on the acquisition date, taking into account the relevant circumstances and expectations that exist as of that date, as part of the consideration transferred in exchange for the acquired business. This approach represents a significant change from the current practice of recording contingent consideration obligations when the contingencies are resolved and the consideration is issued or becomes issuable.

Subsequent changes in the fair value of a contingent consideration obligation (or contingently returnable consideration) do not affect the acquisition-date fair value of the consideration transferred to the acquiree (unless they are qualifying measurement-period adjustments, as discussed below). Instead, subsequent changes in the fair value of a contingent consideration arrangement are considered to relate to post-combination events and changes in circumstances of the combined entity. For arrangements that are classified as liabilities (which will be the case for all cash-settled arrangements and many share-settled arrangements), subsequent changes in fair value will be reflected in the earnings of the acquirer after the acquisition date.

Entities with contingent consideration obligations may need to regularly engage third party valuation specialists to assist

in determining fair value. Due to this recurring cost, early stage companies may want to reconsider how these arrangements are structured.

Statement 141(R)'s required disclosures for contingent consideration arrangements include:

- ▶ The amount recognized at the acquisition date
- ▶ A description of the arrangement
- ▶ The basis for determining the amount of the payment
- ▶ An estimate of the range of outcomes (undiscounted) at the acquisition date or, if a range cannot be estimated, that fact and the reasons why a range of outcomes cannot be estimated
- ▶ For each reporting period after the acquisition date, any changes to the recognized amount or the range of outcomes and the reasons for those changes (until the contingency is resolved)

These disclosures require management to provide its expectation of the ultimate resolution of the contingency. As a result, companies will be required to provide information regarding management's views about the likelihood of meeting future earn-out milestones. For example, disclosing that the fair value of the obligation is nearer the low end of the range of possible outcomes may indicate management's expectation that the event requiring payment of the contingent consideration is less likely to occur (e.g., the acquired product candidate is less likely to meet earn-out milestones triggering payment).

Share-based payment awards exchanged for awards held by the acquiree's employees

Current GAAP – The portion of the fair value of the acquirer's replacement awards

included as part of the consideration transferred is the amount attributable to the portion of any service period that has transpired at the acquisition date (exclusive of any excess of the fair value of the replacement awards over the fair value of the exchanged acquiree awards), whether or not the acquirer is obligated to effect the exchange of share-based payments. The portion of the award attributable to prior service is measured based on the terms of the replacement award (e.g., if the replacement award is fully vested, all of the service is attributed to the period prior to the business combination, even if the replaced awards were not fully vested on the date of the business combination). The portion of the fair value of the replacement awards that is recognized as compensation cost by the acquirer is the amount attributable to the portion of service period that has not transpired at the acquisition date plus any excess of the fair value of the replacement awards over the fair value of the exchanged acquiree awards.

Statement 141(R) – In those cases where the acquirer is obligated to issue replacement awards (such an obligation may be contained within the provisions of the target's option plan, or arise via the terms of the purchase agreement, applicable law, or any other agreement between the parties), the portion of the fair value of the acquirer's replacement awards included as part of the consideration transferred is the fair value of the replaced acquiree's award (measured as of the acquisition date) multiplied by the ratio of the past service period to the greater of the total service period or the original service period. The fair value of the acquirer's replacement award less the portion of the fair value of the acquiree's replaced awards included as part of the purchase consideration is recognized by the acquirer as compensation cost over the term of the service period after the acquisition. Therefore, the total value of the acquirer's replacement award is recorded by the acquirer, either as part of the purchase

consideration or as compensation cost over the service period. By this approach, an acquirer's decision to accelerate vesting in connection with the exchange of awards will not result in a reduction of compensation cost, and excess fair value exchanged will continue to be recorded as compensation cost by the acquirer.

If an acquirer issues replacement awards without being obligated to do so, none of the fair value of the replacement award is included as consideration transferred. However, a change in control represents a new basis transaction in which all the assets acquired, liabilities assumed and noncontrolling interest are remeasured (generally at fair value). Accordingly, if the acquired business becomes a subsidiary of the acquirer, we believe that any share-based payments of the acquired company that remain outstanding after the acquisition (that is, share-based payments of a subsidiary of the acquirer) must be remeasured on the acquisition date. In that circumstance, the portion of the share-based payment's remeasured cost relating to the prior service period is recognized as noncontrolling interest, and the portion of the remeasured cost relating to future service is recognized as compensation cost over the remaining requisite service period. If the acquirer (now parent) elects to exchange parent awards for the subsidiary awards, the modification model described in FASB Statement No. 123(R), *Share-Based Payment*, would apply.

If (a) the acquirer does not acquire the stock of the target entity or (b) the share-based payments of the target entity expired on or before the acquisition date, and the acquirer elects to replace the target company awards with acquirer awards when it has no obligation to do so, all of the cost of those replacement awards is recognized as compensation cost by the acquirer.

Implication – *Share-based payments, such as stock options, will no longer be considered purchase consideration (or noncontrolling*

equity interest) unless the value relates to the completed service period prior to considering any changes in terms to those awards.

Given the prevalence of stock options in the industry, business combinations frequently involve consideration related to exchanges of share-based payments. Acquirers often exchange share-based payment awards (that is, replacement awards) for awards held by employees of an acquired business. These exchanges frequently occur to motivate acquiree employees toward the overall performance of the combined, post-acquisition business.

Under Statement 141(R), if an acquirer is obligated to issue replacement awards in exchange for acquiree share-based payment awards held by acquiree employees, then all or a portion of the fair value of the acquirer's replacement awards should be included as part of the consideration transferred by the acquirer. Similarly, if the acquiree awards are left outstanding, all or a portion of the fair value of the awards will be included in the remeasured noncontrolling equity interest if the stock of the acquired entity was purchased. Generally, the portion of the replacement award that may be included as purchase consideration (or noncontrolling interest) is the amount attributable to past service of acquiree employees. Additionally, if the acquirer issues replacement awards with a shorter service period than the acquiree's awards, the acquirer will recognize more compensation cost over the remaining service period (that is, in the post-acquisition financial statements) than under current GAAP.

Other Statement 141(R) practice changes

Acquisition-related costs

Current GAAP – Direct external costs incurred in connection with a business combination, such as finder's fees, advisory, accounting, legal, valuation and other professional fees, are included as part of the cost of the acquired business.

Statement 141(R) – Acquisition-related costs are not considered part of the fair value exchange between the buyer and seller for the acquired business and therefore are to be expensed as incurred. Additionally, any acquisition costs incurred by the target company that are reimbursed by the acquirer are considered expenses of the acquirer and excluded from the business combination.

Implication – *Acquisition-related costs will be expensed as incurred.* Unless related to debt or equity offerings, costs incurred in connection with a business combination will be expensed as incurred under Statement 141(R), whereas under the current rules, direct external acquisition costs are capitalized as part of the purchase price. In addition to the obvious implication of reduced earnings and generally lower goodwill, reporting material expense for acquisition-related costs could signal that a company is involved in a not-yet announced transaction. Capitalization of debt and equity offering costs continues pursuant to existing GAAP.

Assets and liabilities subject to contingencies

Current GAAP – Recognized during allocation period and measured at either fair value or, if fair value is not determinable, then consistent with the guidance in FASB Statement No. 5, *Accounting for Contingencies* (Statement 5).

Statement 141(R) – Note that the FASB has proposed an FSP to amend Statement 141 (R)'s provisions as described in the last paragraph of this section. Contractual pre-acquisition contingencies¹ are measured and recognized at their acquisition-date fair values. Noncontractual pre-acquisition contingencies are recognized at their acquisition-date fair values if it is more likely than not that the contingency meets the definition of an asset or liability (that is, the contingency is more likely than not to materialize). Subsequent accounting for pre-acquisition loss contingencies is based on the greater of the acquisition date fair value or the amount calculated pursuant to Statement 5. Subsequent accounting for pre-acquisition gain contingencies is based on the lesser of the acquisition-date fair value or the best estimate of the future settlement amount. Adjustments after the acquisition date are made only upon obtaining new information² about the possible outcome of the contingency. Any changes to the measurement of pre-acquisition contingencies (other than qualifying measurement period adjustments, as discussed below) are recognized in ongoing results of operations. Absent new information, no adjustments to the acquisition date fair value are made until the contingency is resolved.

Noncontractual contingencies that are not more likely than not of materializing are accounted for in accordance with Statement 5, apart from business combination accounting. That is, the contingencies are not recognized on the acquisition date, but are subsequently recognized through earnings when the Statement 5 criteria are met.

Implication – *Certain pre-acquisition contingencies will be recognized at fair value on the acquisition date with subsequent changes in their carrying amount recognized*

¹ Generally, we believe that the term "contractual" addresses situations where there is no uncertainty about whether a liability exists, but there is uncertainty in whether the liability will be enforced or in the measurement of the liability. We do not believe that merely having a contract with another party in a dispute is sufficient to conclude that a liability is contractual. For example, if a counterparty is asserting a breach of contract, the potential liability would be contractual if it is clear in the contract that a breach occurred and a liability results. If it is not clear that a breach occurred, the potential liability is likely noncontractual.

² Generally, we believe that new information would be information significant enough to change the measurement of the contingency under Statement 5 or the range of reasonably possible loss.

in earnings. With certain exceptions, pre-acquisition gain and loss contingencies must be recognized at their acquisition-date fair values. This accounting may present valuation challenges and will require significant judgment. Exceptions to the recognition criteria relate to non-contractual pre-acquisition contingencies that are not “more-likely-than-not” of materializing (that is, less than 50% likely). The more-likely-than-not recognition threshold is lower than the current “probable” threshold for contingencies. Thus, a business combination that closes after the effective date of Statement 141(R) could result in the recognition of gain or loss contingencies that would not be recognized absent a business combination. Consistent with current practice, for contingencies recognized in a business combination, changes in the measurement of the contingencies (except for qualifying changes made during the measurement period) will affect the future earnings of the combined entity.

At the 29 October 2008 meeting, the FASB discussed a proposed FASB staff position (FSP) to amend current requirements for accounting for assets and liabilities arising from contingencies in a business combination in Statement 141(R). The FASB determined that initial recognition and measurement of assets and liabilities arising from contingencies should follow a model similar to the one in Statement 141, with additional clarification of situations under which fair value is “reasonably estimable” similar to the requirements in FASB Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations*. The FASB agreed to retain the subsequent measurement and accounting guidance in Statement 141(R) for assets and liabilities initially recognized at fair value, with additional clarification to address derecognition. This proposed FSP has not been finalized and readers are encouraged to monitor developments in this area.

Income taxes

Current GAAP – Decreases in an acquirer’s deferred income tax asset valuation allowance that result from a business combination are included as part of the business combination accounting (usually as a decrease to goodwill). Reductions to a deferred income tax asset valuation allowance or a liability for an income tax uncertainty that was recognized in a business combination is first applied to reduce goodwill to zero, then to reduce other noncurrent intangibles to zero, and lastly to reduce income tax expense. Increases in liabilities for income tax uncertainties of the acquired company recognized in a business combination are recognized as an increase in goodwill. A deferred income tax asset is not recognized in business combination accounting for tax benefits arising from tax deductible goodwill that is in excess of goodwill for financial reporting purposes. The tax benefit of that excess is recognized when realized as a tax deduction and applied first to reduce goodwill to zero, then to reduce other noncurrent intangibles to zero, and lastly to reduce income tax expense.

Statement 141(R) – Changes in an acquirer’s deferred income tax asset valuation allowance that result from a business combination are accounted for as an element of income tax expense. All adjustments (other than qualifying measurement period adjustments, as described below) to a deferred income tax asset valuation allowance or a liability for income tax uncertainties of an acquired company recognized in a business combination are recognized as adjustments to income tax expense. A deferred income tax asset is recognized in a business combination for tax benefits arising from tax deductible goodwill that is in excess of goodwill for financial reporting purposes.

Implication – Changes occurring subsequent to the acquisition date to the deferred income tax asset valuation allowances and liabilities for income tax uncertainties of the acquiree recognized in the business combination will be recognized in earnings. These changes

will no longer affect the purchase price allocation but rather will be accounted for as an adjustment to the acquirer’s income tax provision. Further, changes in the acquirer’s valuation allowance resulting from the business combination will also be reflected in the acquirer’s income tax provision, rather than in purchase accounting as is required under current purchase accounting rules. **This change is the only aspect of Statement 141(R) that is applied to business combination transactions consummated prior to the effective date. Thus, these changes in income tax accounting will apply not only to post-Statement 141(R) business combinations but also to deferred income tax asset valuation allowances and liabilities for income tax uncertainties recognized in business combinations before the adoption of Statement 141(R). As a result, the adoption of Statement 141(R) may have a significant effect on an acquirer’s post-acquisition effective tax rate.**

Restructuring activities

Current GAAP – Costs of an acquirer’s plan to exit an activity of the acquiree or to involuntarily terminate or relocate employees of the acquiree are recognized as liabilities assumed and included in the purchase price allocation if the conditions in EITF Issue No. 95-3, *Recognition of Liabilities in Connection with a Business Combination*, are satisfied.

Statement 141(R) – Restructuring costs are recognized separately from the business combination accounting as post-combination expenses of the combined entity unless the criteria in FASB Statement No. 146, *Accounting for Costs Associated with Exit or Disposal Activities* (Statement 146), are met on the acquisition date (that is, the liability was recognized by the acquired company prior to the acquisition date and is assumed by the acquirer).

Implication – The ability to recognize costs associated with restructuring or exit activities as a liability assumed in the business combination will be limited to those liabilities that have actually been incurred by the acquiree at the acquisition date.

Business combinations often result in the closure of duplicate facilities, termination of personnel and other restructuring activities. Often these decisions are made based on analyses performed by the acquirer after the acquisition date. Statement 141(R) provides that “an exit or disposal plan, by itself, does not create a present obligation to others for costs expected to be incurred under the plan; thus, an entity’s commitment to an exit or disposal plan, by itself, is not the requisite past transaction or event for recognition of a liability.”

As a result, Statement 141(R) limits the recognition of restructuring costs in a business combination to restructuring obligations assumed from the target as of the acquisition date and does not permit the recognition of liabilities that result from actions taken by the acquirer, *even if* the restructuring plan is in place and completed on the acquisition date. Costs associated with restructuring or exit activities that are not obligations of the target would be accounted for separately from the business combination, generally as post-combination expenses of the combined entity when incurred.

This restructuring cost guidance contrasts with current guidance, which only requires the commencement of the assessment and formulation of a restructuring plan as of the acquisition date and the completion of the assessment as soon as possible after the acquisition date to recognize a restructuring liability in purchase accounting. After the effective date of Statement 141(R), we expect that it will be rare for an acquirer to recognize an assumed restructuring cost obligation in a business combination unless the obligation was incurred and recognized under Statement 146 by the acquiree before the business combination.

Noncontrolling interest

Current GAAP – Carryover of the historical cost basis of the assets acquired and liabilities assumed to the extent of the noncontrolling interest in the acquired entity.

Statement 141(R) – Noncontrolling interest is recognized at fair value as of

the acquisition date. Fair value of the noncontrolling interest is not to be derived by an extrapolation of consideration transferred by the acquirer (because that includes a control premium).

Implication – *The fair value measurement requirement for noncontrolling interest represents another area where valuation assistance may be required.*

There are at least two ways to derive the fair value of the noncontrolling interest:

- ▶ Derive the fair value of the noncontrolling interest directly; or
- ▶ Derive the fair value of the acquired business as a whole (which should include a control premium) and subtract consideration transferred by the acquirer for its controlling interest to identify the fair value of the noncontrolling interest.

To provide assurance as to the validity of the derivation, it might be prudent in some situations to undertake more than one approach. The choice as to which approach or approaches to use should be based on assessing the availability and reliability of relevant information. For instance, in a partial acquisition of a public company, fair values of an outstanding noncontrolling interest provide information that is not available for use in accounting for a partial acquisition of a nonpublic company. When, in the usual case, consideration transferred by an acquirer is not the most relevant basis for measuring the fair value of the noncontrolling interest as of the acquisition date, valuation techniques might be necessary to measure the fair value of the acquiree or the fair value of the noncontrolling interest. Because of the uniqueness of individual businesses, active markets and observable prices generally do not exist for entities that are similar enough to the acquired business to be used as the sole measure to value an acquired business (or its noncontrolling interest). In these cases, valuation techniques should be utilized.

In a separate development, under FASB Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements*,

noncontrolling interest will no longer be classified in the balance sheet between liabilities and equity but is included as a component of the acquirer’s equity, potentially affecting equity-based financial metrics, ratios and debt covenants.

Goodwill

Current GAAP – Goodwill is recognized as the excess of the cost of an acquirer’s interest in an acquired entity over the acquirer’s interest in the recognized net identifiable intangible assets (generally measured at fair value).

Statement 141(R) – Goodwill is recognized as the extent by which (a) the aggregate of the acquisition-date fair value of (1) the consideration transferred, (2) any noncontrolling interest in the acquiree, and (3) in a business combination achieved in stages, the acquirer’s previously held equity interests in the acquiree exceeds (b) the recognized bases of the net identifiable assets acquired. In other words, goodwill is the excess of the fair value of the acquiree over the fair value of the net identifiable assets acquired. This is referred to as the “full-goodwill” approach.

Implication – *Goodwill will be recognized on the entire business acquired, regardless of the ownership interest acquired.* Regardless of the controlling interest percentage acquired, the total residual goodwill of the acquired entity measured on the date of the acquisition, based on the fair value of the entire acquired company, is recognized. Under current GAAP, goodwill attributable to the noncontrolling interest is generally not recognized.

Measurement period

Current GAAP – Adjustments during the purchase price allocation period to preliminary values assigned at the acquisition date are generally accounted for on a prospective basis.

Statement 141(R) – Adjustments are permitted to be made during the measurement period to (1) the identifiable assets acquired, liabilities assumed and any

noncontrolling interest, (2) the acquirer's interest in the acquiree, including the consideration transferred, and (3) goodwill. Adjustments to preliminary values assigned at the acquisition date are "pushed back" to the date of acquisition. Thus, comparative information for prior periods would be adjusted (for example, by changes to depreciation or amortization expense) retroactively.

Implication – *Changes to the purchase price allocation that are made subsequent to the acquisition date will, if material, "be pushed back."* Current guidance provides for a period of time, referred to as the "allocation period," during which the acquirer may adjust provisional amounts recognized at the acquisition date in the acquirer's purchase price allocation, to their subsequently determined acquisition-date fair values. Statement 141(R) provides for a similar period of time after the acquisition date, referred to as the "measurement period."

Similar to the allocation period, during the measurement period, the acquirer should adjust provisional amounts recognized as of the acquisition date (or recognize additional assets or liabilities) only if new information about facts and circumstances that existed at the acquisition date is obtained that, if known at the time, would have affected the provisional amounts recognized, or would have resulted in the recognition of additional assets and liabilities, as of that date.

The measurement period is not a stated period of time, but is the period of time necessary to obtain and evaluate facts and circumstances existing at the acquisition date, or to learn that such information is not obtainable. The measurement period ends as soon as the acquirer receives and promptly assesses the necessary information, but in no event extends beyond one year past the acquisition date.

Although current GAAP is silent about the treatment of such adjustments, in practice they have been generally accounted for prospectively. However, under Statement 141(R), any adjustments to provisional amounts recorded as of the acquisition date

are required to be "pushed back" to the date of acquisition, as if they were taken into account on the acquisition date. Effectively, an acquirer must recast its previously filed financial statements for any material changes made within this window. This will increase the transparency of changes in the preliminary purchase price allocation made in reporting periods subsequent to the period of the business combination and increase the comparability of financial information. The requirement to recast prior period financial statements does not require a registrant to amend previously filed financial reports, because these adjustments are not considered errors. However, the revised prior period financial statements should be included in any future filings and subsequent registration statements, whether the financial statements are included in or incorporated by reference into the filing.

Conclusion

Statement 141(R) significantly changes current practice and will have a significant effect on the accounting for business combinations. As a result, medtech companies should immediately begin assessing the effect of Statement 141(R) on pending or planned business combinations. These assessments should consider the potential effect of Statement 141(R) on acquisition assessment and structuring, financial modeling, investor communications and post-acquisition earnings and reporting. Companies should also be aware that business combinations that are initiated in 2008 should be accounted for under the new rules if the "acquisition date" does not occur until after the adoption of Statement 141(R) (that is, 1 January 2009 for calendar-year companies). In order to understand completely the financial and reporting implications of any pending acquisition, companies may need to model transactions under both the current accounting standards and Statement 141(R). ►



Appendix: Illustrative business combination transaction

The following example illustrates certain of the concepts described herein (and their potential impact to an acquirer's financial statements).

Assume Acquirer is a calendar-year-end public company with two million outstanding common shares. Target is a closely held, private company with 500,000 outstanding common shares and a net book value of US\$750,000. Acquirer currently owns 10% of the outstanding common shares (or 50,000 shares) of Target, which has a current carrying value of US\$100,000 in Acquirer's financial statements.

Target has multiple FDA-approved products and one product candidate under development. The premarket approval (PMA) related to the product under development has been submitted to the FDA but has not yet been approved (that is, the product under development is an IPR&D asset). In connection with the business combination, Acquirer intends to terminate Target's management and impose certain other workforce reductions.

On 1 September 20X6, Acquirer and Target reach an agreement and announce that Acquirer will purchase an additional 60% of Target's outstanding common shares (or 300,000 shares). During the due diligence process, Acquirer becomes aware of a lawsuit that alleges Target breached an exclusive arrangement related to the distribution of one of its products. On 31 December 20X6, Acquirer exchanges the purchase consideration for common shares of Target and assumes control of Target.

The terms of the merger agreement and other relevant information are as follows:

- ▶ Target's selling shareholders will receive one share of Acquirer's common stock for every three shares of Target common stock they own (1:3 ratio). Shares of Acquirer were trading at the following prices on an exchange:
 - ▶ 1 September 20X6: US\$50.00 (average price from 30 August to 3 September)
 - ▶ 31 December 20X6: US\$52.00
- ▶ The fair value of Target is determined to be US\$10 million, and the control premium paid to acquire an additional 60% of Target is determined to be US\$1.25 million.
- ▶ Target's selling shareholders will also receive an additional cash payment of US\$4 million if Target's PMA is approved before 31 December 20X9. The acquisition-date fair value of this future earn-out is estimated to be US\$1 million. There is no requirement that any selling shareholders remain employed at the combined entity to receive the contingent consideration.
- ▶ Acquirer is obligated to issue fully vested options to Target's employees to replace the existing Target options. Target currently has 42,000 options outstanding, all of which were issued on 31 December 20X4 with an original service period of 4 years. The acquisition-date fair value of Acquirer's options is US\$700,000 and the acquisition-date fair value of Target's options is US\$600,000³.
- ▶ Acquirer incurred acquisition-related costs of US\$250,000, which are incurred effective with the close of the transaction. Target incurred acquisition-related costs of US\$120,000, which Acquirer agreed to reimburse, as indicated in the acquisition agreement.
- ▶ Acquirer completes the workforce reduction and termination of Target's management and meets the criteria of Statement 146 for liability recognition on 31 December 20X6. The total cost of the restructuring is US\$500,000.

³ For purposes of simplicity, it is assumed that the fair value of the options exchanged in connection with the acquisition does not change from the announcement date to the acquisition date. In reality, the fair value of the options exchanged would be determined on the same date as the fair value of the shares issued by Acquirer. Thus, the fair value on the announcement date and the acquisition date would likely be different.

- ▶ At the acquisition date, Acquirer believes the likelihood that a liability exists related to the alleged breach of contract is more-likely-than-not, but less than probable. Acquirer estimates the most likely amount that will be paid to resolve the pre-acquisition contingency is US\$350,000 and the fair value of the pre-acquisition contingency is US\$250,000.
- ▶ Acquirer estimates the acquisition-date fair value of Target's net identifiable assets to be US\$5 million. The US\$5 million of net identifiable assets is comprised of the acquired IPR&D project asset (US\$3 million) and other identifiable assets (US\$2,250,000), net of the pre-acquisition contingent liability (US\$250,000).
- ▶ During 20X7, Acquirer becomes aware that the FDA has concerns about the clinical trial results related to the PMA. Based on the FDA's concerns, Acquirer estimates the fair value of the future earn-out to be US\$770,000 at 31 December 20X7.
- ▶ At 31 December 20X7, Acquirer estimates the pre-acquisition contingency has a fair value of US\$300,000. It has received no significant new information and continues to believe that the likelihood of a payout is more likely than not, but less than probable.
- ▶ On 31 December 20X7, Acquirer purchases half of the outstanding noncontrolling interest (that is, 15%, or 75,000, of the outstanding common shares) for cash consideration of US\$1.8 million. The carrying value of the noncontrolling interest at 31 December 20X7 is US\$3 million under Statement 160 and US\$600,000 under current GAAP.

What is the acquisition date?

Current GAAP – The acquisition date is 31 December 20X6, the date Acquirer took control of Target.

Statement 141(R) – The acquisition date is the same, 31 December 20X6.

Observation – Note that while the acquisition date is the same under both current GAAP and Statement 141(R), the measurement date for consideration transferred is different, as illustrated by the following question.

What is the measurement date for establishing the fair value of the consideration transferred?

Current GAAP – The measurement date for valuing the equity securities issued and options exchanged is the average trading price from 30 August to 3 September 20X6. The contingent consideration is measured and recognized only when FDA approval is obtained.

Statement 141(R) – The measurement date for valuing all of the consideration transferred is 31 December 20X6 (the acquisition date).

What is the fair value of the total consideration transferred?

Current GAAP – The fair value of the consideration transferred is calculated as follows:

Acquirer issues 100,000 common shares in exchange for an additional 60% interest in Target. The shares are valued at \$50 each (based on the average trading prices from 30 August to 3 September 20X6).	\$5,000,000
Acquirer issues fully vested options in exchange for partially vested Target options. Acquirer's options have a higher fair value than Target's options. ⁴	600,000
Acquisition-related costs ⁵	370,000
Total consideration transferred	<u><u>\$5,970,000</u></u>

Statement 141(R) – The fair value of the consideration transferred is calculated as follows:

Acquirer issues 100,000 common shares in exchange for an additional 60% interest in Target. The shares are valued at \$52 each on 31 December 20X6.	\$5,200,000
Acquirer issues fully vested options in exchange for partially vested Target options. Acquirer's options have a higher fair value than Target's options. ⁶	300,000
Contingent consideration	1,000,000
Total consideration transferred	<u><u>\$6,500,000</u></u>

⁴ The total fair value of the replacement options is US\$700,000. However, compensation expense is recognized for the amount by which the fair value of the replacement options exceeds the fair value of the replaced options (US\$100,000).

⁵ Calculated as the sum of Acquirer's acquisition-related costs of US\$250,000 and the acquisition-related costs incurred by Target of US\$120,000 that are subject to a written agreement requiring Acquirer to reimburse such costs.

⁶ Amount is calculated as the acquisition-date fair value of Target's options (US\$600,000) multiplied by the proportion of the service period completed at the acquisition date (2 years/4 years).

At what amounts are the assets acquired and liabilities assumed recognized? At what amount is noncontrolling interest recognized? How much goodwill is allocated to the controlling interest?

Current GAAP – The elements of the purchase price allocation are recorded as follows:⁷

IPR&D expense ⁸	\$1,800,000	
Other net identifiable assets ⁹	1,350,000	
Goodwill	3,320,000	
Equity instruments issued ¹⁰		\$5,600,000
Acquisition-related costs liability		370,000
Restructuring costs liability		500,000

The noncontrolling interest is calculated as follows:

Net assets of Target at historical carrying value	\$750,000
Noncontrolling interest percentage	x 30%
Noncontrolling interest	<u><u>\$225,000</u></u>

The controlling interest goodwill is US\$3.32 million, which represents only the goodwill purchased by Acquirer in this 60% step acquisition. Note that while the acquirer's previous acquisition of a 10% interest likely resulted in the recognition of goodwill in its one-line purchase price allocation, for simplicity this amount has not been included in the total controlling interest goodwill.

⁷ Under the step-acquisition model, only the acquired percentage (60%) of the net assets is subject to purchase accounting. Both Acquirer's previously purchased 10% plus the 30% noncontrolling interest remain at their respective historical cost. Although not reflected in this journal entry, in consolidation, the carrying value of the previously purchased 10% interest (US\$100,000) would need to be expanded from its single line item presentation to reflect the pro-rata allocation to the assets acquired and liabilities assumed as of the date the interest was acquired.

⁸ Under the step-acquisition model, the IPR&D expense is calculated as the fair value of the IPR&D (US\$3 million) multiplied by the percentage of interest acquired (60%). Note that the transition from a cost method investment to consolidation would require the acquirer to restate prior periods to reflect the cost method investment as if it was an equity method investment, pursuant to APB Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock. This transition would result in the acquirer recognizing its share (10%) of the IPR&D expense upon restatement of prior periods. For simplicity, this transition from cost method to consolidation has not been included in this example.

⁹ Because a loss is not considered probable at the acquisition date, this example assumes Statement 5 would be applied and no liability would be recognized. Further, under the step-acquisition model, the other net identifiable assets are calculated as the fair value (US\$2.25 million) multiplied by the percentage interest acquired (60%).

¹⁰ The fair value of the equity instruments issued includes both Acquirer's outstanding shares (US\$5 million) and a portion of the fair value of the options exchanged attributable to the service period completed at the acquisition date, by analogy to EITF Issue No. 00-23, Issues Related to the Accounting for Stock Compensation Under APB Opinion 25 and FASB Interpretation 44, (US\$600,000).

Statement 141(R) – The elements of the purchase price allocation are recorded as follows:¹¹

IPR&D	\$3,000,000	
Other net identifiable assets	2,250,000	
Goodwill ¹²	5,000,000	
Equity instruments issued ¹³		\$5,500,000
Contingent consideration		1,000,000
Pre-acquisition contingency		250,000
Noncontrolling interest		2,625,000
Acquirer's previously held investment ¹⁴		875,000

The noncontrolling interest is calculated as follows:

Fair value of Target		\$10,000,000
Less: control premium		(1,250,000)
		<u>\$8,750,000</u>
Outstanding Target common shares	÷	500,000
		<u>\$17.50</u>
Outstanding noncontrolling interest shares	×	150,000
Noncontrolling interest fair value		<u><u>\$ 2,625,000</u></u>

¹¹ As a reminder, although only an additional 60% interest was acquired, under the full goodwill method, 100% of the fair value (with limited exceptions) of the assets acquired and liabilities assumed are recognized when control is obtained.

¹² Goodwill is the residual amount calculated as the difference between the fair value of Target (US\$10 million) and the net identifiable assets acquired (US\$5 million).

¹³ The fair value of the equity instruments issued includes both Acquirer's shares (US\$5.2 million) and options exchanged attributable to the service period completed at the acquisition date, as defined in Statement 141(R) (US\$300,000).

¹⁴ The application of the full goodwill method requires the derecognition of Acquirer's previously held investment after it is remeasured to fair value on the acquisition date. Acquirer's previously held investment is revalued to the acquisition-date fair value of US\$875,000 (50,000 shares times US\$17.50 per share value). The fair value does not include a control premium as, generally, we do not believe a control premium should be included in the fair value of the previously held noncontrolling interest for purposes of measuring Acquirer's gain or loss.

The controlling interest goodwill is calculated as follows:

Fair value of consideration transferred ¹⁵	\$7,375,000
Less: controlling share of net identifiable assets ¹⁶	(3,500,000)
Total controlling interest goodwill	<u><u>\$3,875,000</u></u>

Observation – As a result of applying the provisions of Statement 141(R), Acquirer records additional items on the balance sheet (for example, contingent consideration obligation) and records items recognized under current GAAP at generally higher amounts (for example, other net identifiable assets). These changes could have an effect on future earnings through such items as impairment charges, amortization and changes in fair value.

Note that a liability for the workforce reduction and termination of Target's management has not been reflected as a component of the purchase price allocation (that is, the amount is an expense of Acquirer as illustrated in the following question), as the liability was not assumed in the business combination. Rather, the liability was incurred by Acquirer.

Although not illustrated in this example, determining the fair values of the contingent consideration and pre-acquisition contingencies may require significant effort.

What is the net effect of the business combination on Acquirer's income statement on the acquisition date?

Current GAAP – The net effect of the business combination on Acquirer's income statement on the acquisition date is calculated as follows:

IPR&D write-off	\$ (1,800,000)
Acquirer's options have a higher fair value than Target's options	(100,000)
Total acquisition-date net expense	<u><u>\$ (1,900,000)</u></u>

¹⁵ The fair value of the consideration transferred is the sum of Acquirer's shares (US\$5.2 million), Acquirer's options (US\$300,000), the contingent consideration (US\$1 million) and the fair value of Acquirer's previously held noncontrolling interest (US\$875,000).

¹⁶ Fair value of net identifiable assets of US\$5 million times 70% controlling interest (10% original interest plus additional 60% interest being acquired). The requirement to attribute some of the goodwill to the noncontrolling interest is for purposes of measuring and separately presenting the noncontrolling interest within equity and attribution of any future goodwill impairment charges. The respective amounts of goodwill (or any other asset or liability) attributable to the controlling and noncontrolling interests are not separately disclosed on the consolidated balance sheet.

Statement 141(R) – The net effect of the business combination on Acquirer’s income statement on the acquisition date is calculated as follows:

Revaluation of Acquirer’s previously held investment ¹⁷	\$775,000
Acquirer’s transaction costs	(250,000)
Target’s transaction costs ¹⁸	(120,000)
Restructuring costs	(500,000)
Acquirer issues fully vested options in exchange for partially vested Target options. Acquirer’s options have a higher fair value than Target’s options. ¹⁹	(400,000)
Total acquisition-date net expense	\$(495,000)

Observation – While the acquisition-date effect on the Acquirer’s income statement is reduced when applying the provisions of Statement 141(R), the potential for future income statement charges is greater as a result of recording larger amounts of goodwill, capitalizing IPR&D and recording obligations for contingent consideration arrangements and pre-acquisition contingencies.

As noted in the previous question, the workforce reduction and management termination costs are considered a cost of the Acquirer, as the liability was not assumed in the business combination.

What is the effect on Acquirer’s net income for the year ended 31 December 20X7 related to the contingent consideration arrangement and the pre-acquisition contingency?

Current GAAP – For the year ended 31 December 20X7, there is no effect on net income related to the contingent consideration arrangement, because no amounts are recognized until the consideration is issued. There is no effect on net income related to the pre-acquisition contingency, because the most likely settlement amount of the liability has not changed (that is, the likelihood of loss remains less than probable).

Statement 141(R) – For the year ended 31 December 20X7, Acquirer’s net income is increased by US\$230,000, which represents the effect of the decrease in the fair value of the contingent consideration arrangement²⁰. Net income is not affected by the pre-acquisition contingency because there is no new information.

¹⁷ Amount is calculated as the difference between the fair value of Acquirer’s previously held noncontrolling interest (50,000 shares x US\$17.50 per share) and Acquirer’s carrying value (US\$100,000). The fair value does not include a control premium as, generally, we do not believe a control premium should be included in the fair value of the previously held noncontrolling interest for purposes of measuring Acquirer’s gain or loss.

¹⁸ Target’s transaction costs are required to be recognized in Acquirer’s income statement due to the agreement by Acquirer to reimburse Target for such costs.

¹⁹ Amount is calculated as the difference between the fair value of the acquirer’s options (US\$700,000) and the portion of the fair value of Target’s options included as consideration transferred (US\$300,000). The amount is recognized in expense on the acquisition date, as the replacement options do not have a vesting period.

What are the accounting entries to record the purchase of an additional 15% of Target?

Current GAAP – The purchase of half of the outstanding noncontrolling interest is accounted for as follows:

Noncontrolling interest ²¹	\$300,000	
Purchase accounting adjustments ²²	1,500,000	
Cash		\$1,800,000

Statement 141(R) – The purchase of half of the outstanding noncontrolling interest is accounted for as follows:

Noncontrolling interest ²³	\$1,500,000	
APIC	300,000	
Cash		\$1,800,000

Observation – Statement 160 governs the purchase of the outstanding noncontrolling interest subsequent to the adoption of Statement 141(R). That is, the carrying amount of the noncontrolling interest is adjusted (decreased in this case) to reflect the noncontrolling interest's reduced ownership interest. Any difference between the consideration paid and the adjustment to the carrying amount of the noncontrolling interest is recognized directly in equity attributable to the controlling interest (that is, additional paid-in capital). ►

²⁰ Note that the FDA's concerns about the clinical trial results, which decreased the value of the contingent consideration, also should be considered an impairment indicator associated with the indefinite-lived IPR&D asset. While we have not illustrated such considerations in this example, if the fair value of the IPR&D asset were determined to be less than its carrying amount, an impairment charge would be recognized by acquirer.

²¹ Reduce the carrying value of the noncontrolling interest (US\$600,000), which was recognized at historical carrying value in the business combination under current GAAP, by 50% to reflect the acquisition by Acquirer of 50% of the remaining outstanding noncontrolling interest.

²² For purposes of simplicity, the purchase accounting adjustments are shown as one line item. In reality, these amounts would be allocated to all assets acquired and liabilities assumed based on the pro-rata interest acquired.

²³ Reduce the carrying value of the noncontrolling interest (US\$3 million), which was recognized at fair value in the business combination pursuant to Statement 141(R), by 50% to reflect the acquisition by Acquirer of 50% of the remaining outstanding noncontrolling interest.

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