Transaction Accounting Insights

Business Combinations and the Related Financial Accounting Standards

Hestian Stoica and Lisa H. Tran

The issuance of several Financial Accounting Standards Board (FASB) statements relating to business combinations has created some implementation challenges for corporate financial managers. And, the implementation of these FASB statements often requires the expertise of valuation specialists. This discussion summarizes (1) the FASB statements related to the business combination purchase price allocation process and (2) the treatment of acquired intangible assets after the acquisition date. In addition, the discussion summarizes a recent study conducted by Willamette Management Associates that analyzed approximately 200 purchase price allocations in the prepackaged software industry.

Introduction

In a merger and acquisition (M&A) transaction (i.e., a business combination), an allocation of the purchase price is typically performed for income tax and/or financial accounting purposes. Purchase price allocation is the process of assigning fair values (for financial accounting purposes) to the assets acquired and liabilities assumed of an acquired enterprise at the acquisition date.

In the case of an asset purchase transaction, the allocation of a purchase price for federal income tax purposes is governed by Internal Revenue Code (IRC) Section 1060. Section 1060 and the corresponding regulations require the acquirer to allocate the purchase price in an asset purchase transaction among five different classes of assets. Section 197 provides guidance on how to account for purchased intangible assets as part of a taxable asset purchase transaction.

The Statement of Financial Accounting Standards (SFAS) No. 141, *Business Combinations* (effective in June 2001) provides guidance related to the accounting for business combinations for financial statement reporting purposes. After December 15, 2008, SFAS No. 141 will be replaced by the revised SFAS No. 141 (141R).

This discussion provides an overview of the relevant Financial Accounting Standards Board (FASB) statements that affect the purchase price allocation for financial accounting purposes. In addition, the discussion presents a summary of a recent study conducted by Willamette Management Associates that examined the purchase price allocations of M&A transactions involving companies in standard industrial classification (SIC) code 7372. This SIC code includes companies that are primarily engaged in the design, development, and production of prepackaged computer software.

Applicable Statements of Financial Accounting Standards

The following discussion summarizes the relevant financial accounting standards that provide guidance on the purchase price allocation process and the subsequent treatment of acquired goodwill and other identifiable intangible assets:

- SFAS No. 141, *Business Combinations*, effective June 30, 2001
- SFAS No. 142, *Goodwill and Other Intangible Assets*, effective December 15, 2001
- SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, effective December 31, 2001
- SFAS No. 157, *Fair Value Measurements*, effective November 15, 2007

- SFAS No. 141(R), revised version of SFAS No. 141, effective December 15, 2008

These FASB statements have important implications for companies that are planning or currently undergoing M&A transactions.

SFAS No. 141 and SFAS No. 142

In June 2001, after five years of research and development, the FASB issued SFAS No. 141 and SFAS No. 142. Since the issuance of APB Opinion No. 16 in 1970, the FASB has spent considerable time and resources trying to develop better ways to account for M&A transactions.

Overall, SFAS No. 141 and SFAS No. 142 improved previous accounting practices. The conceptually flawed pooling of interests method was eliminated, and corporate acquiror financial statements were made more comparable. At the same time, these two FASB statements made accounting for goodwill more complex, increasing the liability and risk of management and auditors.

SFAS No. 141 supersedes the Accounting Principles Board (APB) Opinion No. 16, also titled *Business Combinations*. SFAS No. 142 supersedes APB Opinion No. 17, *Intangible Assets*.

The purposes of the issuance of SFAS No. 141 and No. 142 were primarily to:

- improve financial reporting and comparability,
- provide more complete financial information,
- better reflect the investment made in an acquired entity, and
- align the international standards on business combinations to those in the United States.

SFAS No. 141

Companies that make acquisitions that are defined as a business combination are required to prepare financial statements consistent with SFAS No. 141.

Before the introduction of SFAS No. 141, two accounting methods were used to account for mergers and acquisitions: (1) the purchase method and (2) the pooling of interests method. Basically, the purchase method required that the acquirer record the acquisition at the fair value of the net assets acquired. In the pooling method, the financial statements of the separate entities were added together at their historical book values.

The main accounting change resulting from the adoption of SFAS No. 141 was that business combinations were accounted for using the purchase method (i.e., the pooling method was eliminated). The application of the purchase method involved the following procedures:

1. Determine the purchase price paid by the acquiring company.
2. Determine the fair value of each of the identifiable assets and liabilities of the acquired company.
3. Record as goodwill any excess of the purchase price over the fair value of the identifiable net assets. Accordingly, the value of goodwill purchased in a business combination was calculated as:

	Total acquisition purchase price
Less:	Fair value of financial assets
Less:	Fair value of tangible assets
Less:	Fair value of identified intangible assets
Equals:	Fair value of purchased goodwill

The most significant change in the purchase price allocation procedure was the new criteria established in SFAS No. 141 to recognize intangible assets apart from goodwill. The criteria for separate recognition of intangible assets in a business combination were (1) the contractual-legal criterion and (2) the separability criterion.

An asset is separable if it is capable of being (1) separated or divided from the acquired entity and (2) sold, transferred, licensed, rented, or exchanged individually or in combination with a related contract, asset, or liability.

There were five categories of intangible assets defined in SFAS No. 141:

1. marketing-related intangible assets
2. customer-related intangible assets
3. artistic-related intangible assets
4. contract-based intangible assets
5. technology-based intangible assets

Any acquired intangible asset that did not meet the revised criteria for recognition as a separate asset was required to be included in goodwill (assembled workforce was no longer considered separable from goodwill).

The most important reasons for reconsidering accounting for business combinations were as follows:

- the increased transition from tangible-asset-intensive companies to technology-based companies which placed greater relative importance on intangible assets and their contribution to profitability and value
- the increase in M&A activity, which resulted in competitive inequity and significant differences in financial

statements, depending on the method of accounting used (pooling method versus purchase method)

- the need for greater uniformity in domestic accounting and international standards, in a time of increased global interaction and exchange of capital flows across international boundaries

SFAS No. 142

This FASB statement addresses the financial reporting and accounting of goodwill and other intangible assets subsequent to their acquisition. Prior to SFAS No. 142, APB Opinion No. 17 required that acquired goodwill be amortized over a period not to exceed 40 years.

SFAS No. 142 distinguishes between:

1. goodwill and intangible assets that have indefinite useful lives and
2. intangible assets that have finite useful lives.

The first type of intangible assets are not amortized, but they are to be tested at least annually for impairment pursuant to SFAS No. 142. Intangible assets that have finite useful lives continue to be amortized over their useful lives and should be periodically reviewed for impairment.

SFAS No. 142 requires that companies periodically test for goodwill impairment at the reporting unit level. A reporting unit level is an operating segment that operates on a stand-alone basis and does not necessarily equal the total entity level.

For intangible assets with indefinite lives, the impairment testing is performed at least annually. It is performed between annual tests if there is an indication that the asset may be impaired. Goodwill should be tested annually at any time during the company's fiscal year (the testing date must be consistent from year to year).

SFAS No. 142 provides guidance on how to evaluate purchased goodwill on an ongoing basis. Goodwill is tested for impairment in a two step process:

- Step 1: Compare the fair value of the reporting unit equity to its book value. If the fair value of the reporting unit equity is lower than its book value, then goodwill potentially could be impaired, and step 2 of the impairment test should be performed.
- Step 2: Compare the implied fair value of the reporting unit goodwill with the carrying value of that goodwill. The implied fair value of the goodwill is determined by allocating the fair value of the reporting unit to its assets and liabilities as if the reporting unit had been acquired in a business combination.

  The excess of the fair value of a reporting unit over the amounts assigned to the assets and liabilities is the implied fair value of the goodwill.

SFAS No. 144

While SFAS No. 142 governs the impairment of goodwill and other indefinite life intangible assets, SFAS No. 144 provides guidance on the impairment of finite life tangible and intangible assets. In August 2001, the FASB issued SFAS No. 144. SFAS No. 144 replaced SFAS No. 121 and a portion of APB Opinion 30 that relates to the disposal of assets. SFAS No. 144 also amended ARB No. 51, to eliminate the exception to consolidation for a subsidiary for which control is likely to be temporary.

A long-lived asset should be tested for recoverability whenever circumstances indicate that its carrying amount may not be recoverable and exceeds its fair value. Examples of such circumstances include: significant adverse changes in the market price, usage, physical condition, legal, and business climate that could affect the value of a long-lived asset.

Pursuant to SFAS No. 144, the carrying value of a long-lived asset is not recoverable if it exceeds the sum of its undiscounted cash flow. The impairment loss is measured as the amount by which the carrying amount of a long-lived asset exceeds its fair value.

SFAS No. 157, Fair Value Measurements

The appropriate standard of value for SFAS No. 141, 142, and 144 is fair value. This standard of value is generally recognized to represent a marketable, controlling ownership interest level of value.

SFAS No. 142 and No. 144 define fair value as "the amount at which the asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced sale or liquidation."

SFAS No. 157 effectively amends all prior statements and all prior APB pronouncements that related to fair value. SFAS No. 157 was issued in September 2006, and it became effective (in part) on November 15, 2007.

SFAS No. 157 defines fair value as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."

This statement highlights that fair value is a market-based measurement—and not an entity-specific measurement. Pursuant to SFAS No. 157, a hypothetical transaction is a sale transaction in the principal (or most advantageous) market for the subject asset or liability.

In other words, the transaction is considered from the perspective of a market participant that already holds the asset or owes the liability. Accordingly, the generally accepted accounting principle (GAAP) fair value definition focuses on the price that would be received to sell the asset or paid to transfer the liability (i.e., the exit price).

In addition to providing a comprehensive definition of fair value, SFAS No. 157 both (1) developed a procedural framework for measuring fair value for GAAP purposes and (2) expanded the required financial statement disclosures regarding fair value measurements. SFAS No. 157 did not expand the types of transactions for which fair value measurement is required.

SFAS No. 141R (revised 2007)

On December 7, 2007, the FASB issued a revised version of SFAS No. 141. SFAS No. 141R continues the FASB movement toward fair value accounting and international convergence of accounting standards.

Acquiring companies should consider SFAS No. 141R when negotiating or entering M&A transactions that will close after December 15, 2008. SFAS No. 141R significantly affects a domestic acquirer's financial statement presentation, both before and after an M&A transaction.

In SFAS No. 141R, the purchase method was renamed the "acquisition method," in an effort to show more clearly what types of transactions result in a business combination. Under SFAS No. 141R, the consideration for an acquisition (including the acquirer's equity securities and contingent consideration) will be measured and recognized at fair value at the acquisition date.

Some of the important changes under SFAS No. 141R include the following:

- Transaction costs are expensed in the period incurred under SFAS No. 141R, instead of being included in the purchase price and capitalized as under SFAS No. 141.
- Contingent consideration is recorded at fair value at the acquisition date and remeasured at the end of each reporting period until resolved under SFAS No. 141R. Under SFAS No. 141, contingent consideration was not recognized and was recorded as goodwill, if and when paid.
- In-process R&D is recorded at fair value, has an indefinite life, and is subject to future impairment testing until completed or abandoned under SFAS No. 141R. In-process R&D was expensed at the acquisition date under SFAS No. 141.
- If an acquiring company obtains control but less than 100 percent of the target company, then any residual goodwill is allocated between the controlling interests and the noncontrolling interests. Under previous GAAP, the residual goodwill was only allocated to the controlling interest.

The underlying principle of SFAS No. 141R is to recognize all assets acquired and liabilities assumed at fair value at the acquisition date, with some exceptions. These exceptions should continue to be measured in accordance with other GAAP provisions and include: deferred income taxes, employee benefits, and share-based payments.

Willamette Management Associates Study of Acquisition Purchase Price Allocations

Willamette Management Associates analyzed 199 purchase price allocations of transactions reported in the U.S. Securities and Exchange Commission (SEC) Form 10-K of companies in SIC code 7372. The purchase transactions studied were completed during the July 2003 through April 2008 time period. Exhibit 3 presents the underlying detail of the 199 acquisition purchase price allocations. We conducted our study for the purpose of determining what major intangible assets are typically included in the purchase price.

Based on the Willamette Management Associates study, the purchase price of the 199 transactions ranged from a high of $8.6 billion to a low of $240,000, with a median of $20.5 million.

Goodwill—the excess of the cost of the acquired entity over the net amounts assigned to the assets acquired and liabilities assumed—was reported in 93 percent of the transactions studied.

Our study showed that the most frequently reported identifiable intangible assets in the transactions were developed technology and customer relationships.

Exhibit 1 presents a summary of the acquired intangible assets reported in the transactions studied—expressed as a percentage of the total purchase price.

Exhibit 2 presents a summary of the median intangible assets reported in the transactions studied—expressed as a percentage of the total purchase price for 2005 through 2008.

For transactions that provided information regarding the remaining useful life of the acquired intangible assets, the lives assigned to the identifiable intangible assets ranged from one year to 22 years.

The following ranges of useful lives were reported in the transactions analyzed:

- Developed technology: 1 year – 10 years
- Customer relationships: 1 year – 22 years
- Trade name and trademarks: 1 year – 18 years
- Noncompete agreements: 1 year – 8 years

The accounting for a recognized intangible asset is based on its useful life to the acquirer entity. The useful life of an intangible asset is that period of time that the asset is expected to directly or indirectly generate cash flows for the entity.

An intangible asset with a finite useful life is amortized. An intangible asset with an indefinite useful life is not amortized. SFAS No. 142 provides guidance on the accounting for goodwill and other intangible assets after the purchase price allocation.

The remaining useful life of an intangible asset usually depends on technological or functional obsolescence. In addition, the level of expenditures necessary to maintain the value of an intangible asset may provide an indication of its remaining useful life.

For example, marketing expenditures related to a trademark is an indication of a limited remaining useful life for that particular intangible asset.

For some identifiable intangible assets, the remaining useful life could be determined to be indefinite if no factors limit the useful life of those assets. Of the 199 transactions analyzed in the study, 74 companies assigned an estimated useful life to the trade name. In contrast, only one company reported an indefinite life for the trade name asset.

Summary and Conclusion

Over the years, the FASB has issued and revised a series of statements governing the accounting for intangible assets acquired in a business combination. These FASB statements include (1) SFAS No. 141 and No. 141R, which relate to the allocation of a purchase price in an acquisition, and (2) SFAS No. 142 and No. 144, which address the subsequent treatment of the acquired tangible and intangible assets.

While the intent of these statements is to provide more clarity for the financial community, improve U.S. financial statement comparability and align U.S. standards with international accounting, these standards have also increased reporting requirements that may create challenges for companies that are planning or currently structuring M&A transactions.

Lisa Tran is a manager in our Portland, Oregon, office. She can be reached at lhtran@willamette.com or (503) 243-7510.

Hestian Stoica is an associate in our Portland, Oregon, office. He can be reached at hstoica@willamette.com or (503) 243-7529.

Exhibit 1
Willamette Management Associates Study of 199 Acquisitions Completed in the Prepackaged Software Industry Summary of Acquired Intangible Assets

	Percent of Total Purchase Price						
	Goodwill	Developed Technology	In-Process R&D	Customer Relationships	Trade name & Trademark	Noncompete Agreements	Other Intangibles
High	102.5%	100.0	40.2%	62.2%	46.1%	35.8%	100.0%
Low	5.2%	0.3%	0.3%	0.4%	0.1%	0.0%	0.0%
Mean	61.8%	18.7%	5.8%	14.4%	3.7%	4.2%	23.0%
Median	64.1%	14.5%	3.3%	10.5%	1.8%	1.7%	13.4%

Note: The high, low, mean, and median calculations for each intangible asset category are calculated based only on data for transactions that reported a portion of the purchase price being allocated to that intangible asset.

Exhibit 2
Willamette Management Associates Study of 199 Acquisitions Summary of the Median Intangible Asset Purchase Price Allocation Percentage

	Percent of Total Acquisition Purchase Price						
	Goodwill	Developed Technology	In-Process R&D	Customer Relationships	Trade name & Trademark	Noncompete Agreements	Other Intangibles
2008 Median	65.0%	12.5%	7.1%	8.0%	0.8%	1.5%	4.3%
2007 Median	63.3%	13.6%	2.2%	11.0%	1.7%	1.6%	11.6%
2006 Median	66.9%	15.4%	3.6%	12.1%	2.8%	2.3%	16.2%
2005 Median	58.5%	15.1%	2.7%	8.5%	1.3%	1.3%	24.9%

Exhibit 3
Purchase Price Allocation Detail
Prepackaged Software Company Transactions

Acquiring Company	Target Company	Date	($) Purchase Price ($000)	Goodwill ($000)	Developed Technology ($000)	Developed Technology Estimated Useful Life (years)	In-Process R&D ($000)	Customer Relationships ($000)	Customer Relationships Estimated Useful Life (years)	Trademarks/Tradenames ($000)	Trademarks/Tradenames Estimated Useful Life (years)	Noncompete Agreements ($000)	Noncompete Agreements Estimated Useful Life (years)	Other Identifiable Intangible Assets ($000)	Other Identifiable Intangible Assets Estimated Useful Life (years)
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36 [illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
37 [illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
38 [illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
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42 [illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
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44 [illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
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47 [illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
48 [illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
49 [illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
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51 [illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
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Exhibit 3 (continued)
Purchase Price Allocation Detail
Prepackaged Software Company Transactions

Exhibit 3 (continued)
Purchase Price Allocation Detail
Prepackaged Software Company Transactions

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Exhibit 3 (continued)
Purchase Price Allocation Detail
Prepackaged Software Company Transactions

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