

**Advanced Accounting Update on Business Combinations (Chapters 1-8)  
July 20, 2004**

Potential changes are listed by the chapter that they first impact.

Bolded items are from sources other than the contemplated exposure draft on business combinations.

Ch.	Exposure draft expected in 4 <sup>th</sup> quarter of 2004. Final standard planned in 2 <sup>nd</sup> half of 2005.
1	<p><b>Purchase method procedures</b> Fair values are determined on the date control is gained (the closing date rather than the date of the offer)</p> <ul style="list-style-type: none"> <li>• If consideration is cash or other financial assets (or liabilities incurred), the fair value of the consideration given is normally more evident than the value of the business acquired, absent evidence to the contrary, the fair value of the consideration is used to record the purchase.</li> <li>• If the fair value of the business acquired is more evident than the fair value of the consideration given, it is used to record the purchase.</li> </ul> <p><b>The hierarchical guidance in determining a fair value comes from the project on Fair Value Measurement Exposure Draft, issued June 23, 2004. There is a precise hierarchy to be observed in assigning fair value to each asset and liability. In general, market value is to be used. If that is not possible, an adjusted market value is to be used, and if that is not possible, other estimates, usually based on discounted cash flow analysis, are to be used. The hierarchy is further explained as follows</b></p> <p><b><i>Level 1, Market value</i></b> – this is based on observable market values for identical assets or liabilities using transactions on or near the measurement date.</p> <p><b><i>Level 2, Adjusted market value</i></b> – This is an observable price based on market transaction on or near the measurement date for a similar asset or liability, with an adjustment for differences between the asset or liability in the transaction and the asset or liability acquired in the purchase of the acquired company. An example would be to use, as a reference, the recent sale of a similar building adjusted for the difference in the value of the land, and the size and condition of the buildings.</p> <p><b><i>Level 3, Other valuations</i></b> – Estimates should be based on market-based value that would estimate what a person not a party to the current purchase would pay for a similar asset or liability. In most cases, this would be the market-based estimate of future cash flows discounted at an appropriate discount rate. <b>Concept Statement No. 7 advocates discounting expected (probabilistically weighted estimated cash flows) by a risk free interest rate. It is also acceptable</b></p>

**to use a rate that includes a risk premium if the rate incorporates a risk premium applicable to the cash flows being valued. Only if there are no market-based estimates available would the acquiring or selling company's internally generated estimates be used.**

#### Bargain Purchase

- If the price paid were less than fair value of net identifiable assets, an extraordinary gain would be recorded. The current practice of first discounting nonpriority accounts would end.

#### Measurement issues

- Direct cost of the purchase would be expensed (rather than current treatment of adding them to acquisition cost)
- The period of time available to assign fair values (allocation period) is one year from the acquisition date or when all available information has been obtained. The issue is always determining the value on the acquisition date, and not a later date.
- Costs that will be incurred to terminate an activity, terminate employees, or relocate employees are expensed after the purchase. They are not an assumed liability unless the liability already existed on the purchase date.

#### Contingent Consideration

- Contingent consideration should be included in purchase price at fair value. Current practice makes no entry until the contingency is resolved.
- Contingent equity issuances are measured on acquisition date and are not re-measured.
- Contingent liabilities are recorded at fair value on acquisition date and are adjusted in later statements. Any adjustment does not change the purchase price. Later, it is an income statement item.

#### In-Process R&D

- Acquired in-process R&D would be recorded at fair value as an intangible asset, but costs subsequent to the purchase cannot be added to the asset value.
- Until the point of completion, the asset is subject to impairment testing.
- At the point of completion, the asset is amortized and tested for impairment.

#### Deferred Tax Benefits

- There is a rebuttable presumption that a decrease in the valuation allowance for a deferred tax asset should be an adjustment to goodwill.

	<ul style="list-style-type: none"> <li>• The rebuttable presumption is overcome if there was a discrete event of circumstance subsequent to the acquisition date that was not included in the original estimate of the valuation allowance. In such a case, the reduction in the allowance would reduce income tax expense for the period.</li> </ul> <p>Other Issues</p> <ul style="list-style-type: none"> <li>• A transaction is not included in the assignment of cost if the purchaser structured it to avoid expense recognition. This would include transactions costs and termination or other postcombination exit costs.</li> <li>• Replacement agreements refer to the replacement of existing stock option agreements of the acquired company. Their estimated fair value is part of the liabilities recorded if there is an obligation to replace existing awards. There are complicated rules for valuing the replacement award.</li> <li>• Assets to be sold are recorded at fair value less cost of disposal.</li> </ul>
1	<p><b>Goodwill in banking or thrift institutions</b>  <b>FASB Statement No. 147</b></p> <p><b>The FASB reconsidered the exception that requires banking and thrift institutions to continue to amortize goodwill. Goodwill is no longer to be amortized under this prior exception.</b></p>
2	<p><b>Consolidation Policy</b>  <b>Exposure Draft, issued Feb. 1999, Jan. 2001. FASB decision not to proceed to a final statement. The exposure draft is discussed on pages 2-4 and 2-5 of the 8<sup>th</sup> edition.</b></p> <p>If a company becomes the primary beneficiary of Variable Interest equity (VIE) that meets the definition of a business, the transaction is recorded as a purchase including the recording of goodwill. If the acquired VIE does not qualify as a business, assets and liabilities are still recorded at fair value, but no goodwill is recorded. Instead, the difference between the net assets and the price paid is a gain or a loss.</p>
2	<p><b>Measurement of assets and liabilities in a business combination</b>  When less than a 100% interest is acquired, the assets (including goodwill) and liabilities of the company purchased would still be adjusted to 100% of fair value. <i>This procedure is covered in the Text, Special Appendix 1, which includes the “full goodwill” method.</i></p>

	<p>Current practice and the text (other than Special Appendix1) presently revalue only the parent's share of subsidiary assets. The new procedure would be to revalue the entire subsidiary company and allocate the adjustments to the controlling and noncontrolling interests.</p>
2	<p><b>Combinations of Mutual Enterprises</b> The purchase method would be applied to combinations of mutual enterprises.</p>
2	<p><b>Combinations of Not-for-Profit Organizations</b> <b>Separate exposure draft expected in 4th quarter of 2004</b></p> <p><b>Criteria are established to distinguish combination from donation.</b> <b>Combinations would follow similar rules to those of for profit organizations.</b></p>
2 3	<p><b>Presentation of noncontrolling interest</b></p> <ul style="list-style-type: none"> <li>• The noncontrolling interest in net income is shown as a distribution of consolidated income, not as an expense. <i>This is the method currently used in the text in Chapters 3–8.</i></li> <li>• The noncontrolling interest is shown on the balance sheet as a component of stockholder's equity. <i>This is the method currently used in the text in Chapters 2–8.</i></li> </ul>
5	<p><b>Gains and losses on debt retirement</b> <b>FASB Statement 145, issued April 2002</b></p> <p><b>Gains and losses on early debt retirement are no longer shown, net of tax, as extraordinary. This means that the worksheet elimination of intercompany bonds would now result in only an ordinary gain or loss on retirement.</b></p>
7	<p><b>Step Acquisitions</b></p> <ul style="list-style-type: none"> <li>• When control is achieved through a later acquisition, previously owned shares are adjusted to fair value. A realized gain or loss is recorded. The total price paid for the controlling interest would be the sum of the price paid for the later block plus the fair value of the previously owned shares.</li> <li>• Changes in the ownership interest after control is achieved are viewed as changes in equity that are not reflected in income; these transactions would impact paid in capital in excess of par (or retained earnings if there is a debit effect).</li> <li>• A gain or loss is only recorded when control is lost.</li> </ul>

8	<p><b>Subsidiary equity transactions</b></p> <ul style="list-style-type: none"> <li>The change in the controlling interest caused by subsidiary stock transactions is an adjustment to paid-in capital (retained earnings if debit effect) and is not reflected in income. <i>This is the method currently used in Chapter 8.</i></li> </ul>
9	<p>Major forces behind the effort to harmonize international accounting standards are the International Accounting Standards Board (formerly the International Accounting Standards Committee (IASC)) and the International Federation of Accountants.<sup>1</sup> The International Accounting Standards Board (IASB) is concerned with the promulgation and harmonization of international accounting standards. The International Federation of Accountants is concerned with a variety of issues affecting the professional practice of accounting on a worldwide basis, including the harmonization of accounting standards, rather than the actual promulgation of international accounting standards.</p> <p><b>The International Accounting Standards Board</b></p> <p>In the late 1990s, the IASC engaged in a strategy review that resulted in a restructuring of the IASC. In early 2001, the restructured IASC became the International Accounting Standards Board (IASB). The IASB assumed responsibility for establishing a single set of international accounting standards and achieving convergence in or harmonization of accounting standards around the world. The IASC Foundation was formed in 2001 as the parent entity of the IASB, which is based London. The structure of the IASB consists of the Trustees, the Board, the Standing Interpretations Committee, and the Standards Advisory Council.</p> <p>The IASB consists of fourteen members that are appointed by the Trustees. In order to achieve proper balance, Board membership must consist of the following: a minimum of five members with a background as practicing auditors, a minimum of three with a background in the preparation of financial statements, a minimum of three with a background as users of financial statements, and at least one with an academic background. The Trustees are responsible for making sure that a particular constituency and/or geographical area does not dominate the Board. In order to achieve harmonization of accounting standards and cooperation among standard setters, seven of the Board members will have formal liaison responsibilities with national standard setters. The Board has full discretion over the technical agenda and has complete responsibility for all technical matters, including preparing and issuing International Accounting Standards and exposure drafts, and has final approval of interpretations presented by the Standing Interpretations Committee.</p> <p>The Board has responsibility for establishing a single set of international</p>

<sup>1</sup> See page 9-17 for a discussion of the IFAC.

accounting standards now designated as International Financial Reporting Standards (IFRS). However, the International Accounting Standards (IAS) issued by the IASC has been adopted by the IASB and continue to be referred to as IASs. The IASB follows a conceptual accounting framework, “Framework for the Preparation and Presentation of Financial Statements,” that was approved in 1989 by the IASC. The framework sets forth the concepts that underlie the preparation and presentation of financial statements for external users and serves as a platform against which future standards are developed and existing standards are reviewed. The Board follows a rigorous due process leading to the issuance of an IFRS. This process includes open meetings, the possible use of an advisory committee and the publication of discussion documents and exposure drafts for public comment. The Board has the discretion to use field tests and to hold public hearings regarding proposed standards. The publication of a standard, exposure draft, or interpretation requires approval by at least eight members of the Board. Other decisions of the Board require a simple majority of the members present at a meeting (at least 60% of the members must be present in person or by telecommunication link). In order to coordinate the standard-setting process of the Board with that of various national standard setters, the Board is proposing a number of procedures that will hopefully lead to an international consensus regarding standards. The Board currently has a number of projects underway that are in various stages of the due process procedure.

### **The International Federation of Accountants**

Organized in 1977 with headquarters in New York, the International Federation of Accountants (IFAC) is a private body whose membership consists of national professional organizations that represent accountants. Membership is open to such organizations recognized by law or general consensus within their respective countries. The IFAC has over 150 members representing over 100 countries. The IFAC is concerned primarily with aspects of the professional practice of accountancy and represents accountants worldwide in all professional areas including public practice, industry, government, and education. It is involved not with establishing accounting standards per se, but rather with developing the profession and harmonizing its standards worldwide. Therefore, the IFAC is more appropriately compared to the AICPA than the FASB, which is more akin to the IASC.

The IFAC is governed overall by a Council comprised of one representative from each member body. Reporting to the Council is a Board comprised of individuals from fifteen countries. The Board is responsible for setting policy and overseeing operations, implementation of programs, and the work of technical groups. Technical, professional, and ethical publications and guidance are developed by a number of technical committees and task forces. For example, the International Auditing Practice Committee (soon to become the International Audit and Assurance Standards Board) focuses on creating worldwide uniformity in the practice of auditing through the issuance of International Standards on Auditing.

	<p>The Ethics Committee develops guidance on professional ethics and practices and has developed an IFAC Code of Ethics that serves as a model for national standards of ethical conduct. The Transnational Auditors Committee is the executive committee of the Forum of Firms. Membership in the Forum is open to firms engaged in transnational audits. Member firms commit to quality standards and a global peer review process. The various committees issue statements and guidelines on a variety of topics.</p>
DM 10 - 14	<p>There are no significant changes to the Derivative Module (DM) or Chapters 10 through 14.</p>
15	<p>GASB40 - modifies Statement No. 3, Deposits with Financial Institutions, Investments (including Repurchase Agreements), and Reverse Repurchase Agreements, to limit footnotes to:</p> <ul style="list-style-type: none"> <li>• Deposits that are not covered by depository insurance and are (a) uncollateralized, (b) collateralized with securities held by the pledging financial institution, or (c) collateralized with securities held by the pledging financial institution's trust department or agent but not in the depositor-government's name.</li> <li>• Investment securities that are uninsured, are not registered in the name of the government, and are held by either (a) the counterparty or (b) the counterparty's trust department or agent but not in the government's name.</li> </ul>
15	<p>GASB41 - establishes that a capital asset is considered impaired if both (a) the decline in service utility of the capital asset is large in magnitude and (b) the event or change in circumstance is outside the normal life cycle of the capital asset. Impaired capital assets that will no longer be used by the government should be reported at the lower of carrying value or fair value. Impairment losses on capital assets that will continue to be used by the government should be measured using a method that best reflects the diminished service utility of the capital asset.</p>
16	<p>GASB41 - establishes that a capital asset is considered impaired if both (a) the decline in service utility of the capital asset is large in magnitude and (b) the event or change in circumstance is outside the normal life cycle of the capital asset. Impaired capital assets that will no longer be used by the government should be reported at the lower of carrying value or fair value. Impairment losses on capital assets that will continue to be used by the government should be measured using a method that best reflects the diminished service utility of the capital asset.</p> <p>GASB45 - establishes standards for the measurement, recognition, and display of OPEB expense/expenditures and related liabilities (assets), note disclosures, in the financial reports of state and local governmental employers following the approach adopted in Statement No. 27, Accounting for Pensions by State and Local Governmental Employers, with modifications to reflect differences between pension benefits and OPEB. This statement improves the relevance and usefulness</p>

	<p>of financial reporting by (a) requiring systematic, accrual-basis measurement and recognition of OPEB cost (expense) over a period that approximates employees' years of service and (b) providing information about actuarial accrued liabilities associated with OPEB and whether and to what extent progress is being made in funding the plan. Annual OPEB cost is equal to the employer's annual required contribution to the plan (ARC), with certain adjustments if the employer has a net OPEB obligation for past under or over contributions.</p>
17	<p>GASB39 - requires organizations that are legally separate, tax-exempt entities and that meet all of the following criteria be discretely presented as component units.</p> <ul style="list-style-type: none"> <li>• The economic resources received or held by the separate organization are entirely or almost entirely for the direct benefit of the primary government, its component units, or its constituents.</li> <li>• The primary government, or its component units, is entitled to, or has the ability to otherwise access, a majority of the economic resources received or held by the separate organization.</li> <li>• The economic resources received or held by an individual organization that the specific primary government, or its component units, is entitled to, or has the ability to otherwise access, are significant to that primary government.</li> </ul>
17	<p>GASB38 - establishes new requirements for footnotes of the financial statements:</p> <ul style="list-style-type: none"> <li>• Descriptions of the activities accounted for in the major funds, internal service fund type, and fiduciary fund types.</li> <li>• Length of time used to define "available" for purposes of revenue recognition in the governmental fund financial statements.</li> <li>• Actions taken to address significant violations of finance-related legal or contractual provisions.</li> <li>• Debt service requirements to maturity, separately identifying principal and interest for each of the subsequent five years and in five-year increments thereafter.</li> <li>• Obligations under leases for each of the five subsequent years and in five-year increments thereafter.</li> <li>• A schedule of changes in short-term debt and the purpose for which short-term debt was issued.</li> </ul>

- Amounts due from other funds by individual major fund, nonmajor governmental funds in the aggregate, nonmajor enterprise funds in the aggregate, internal service funds in the aggregate, and fiduciary fund type; the purpose for those balances; and amounts that are not expected to be repaid within one year.
- Interest requirements for variable-rate debt computed using the rate effective at year-end.
- Terms of interest rate changes for variable-rate debt.
- Details about major components of receivable and payable balances and identification of receivable balances not expected to be collected within one year.
- Amounts transferred from other funds by individual major fund, nonmajor governmental funds in the aggregate, nonmajor enterprise funds in the aggregate, internal service funds in the aggregate, and fiduciary fund type; a general description of the principal purposes of interfund transfers; and purposes for and amounts of certain transfers.

GASB44 - establishes the objectives of the statistical section and the five categories of information it contains: financial trends information, revenue capacity information, debt capacity information, demographic and economic information, and operating information. Ten-year trends in three types of operating information: government employment levels, operating statistics, and capital asset information are now required. A government's statistical section will now include trend information on governmental fund balances and principal employers. The most significant new information added to the statistical section is the government-wide, accrual-based information required by Statement 34. The statistical section will include ten-year trend information about net assets and changes in net assets. The debt information presented in the statistical section will also be more comprehensive due to the inclusion of information from the government-wide financial statements and notes.

There are several new changes resulting from new statements issued by the Financial Accounting Standards Board, the AICPA and GAO.

- The threshold for a Single Audit has increased to \$500,000.
- The requirements for auditor independence and CEO assurances of Sarbanes-Oxley do not apply to nonprofits, but are considered best practices.

	<ul style="list-style-type: none"> <li>• The FASB has decided to issue a separate standard for nonprofit combinations shortly after the issuance of the business combination standard. The FASB has defined a nonprofit combination as any event that results in the initial inclusion of a combined set of assets and activities (as defined) in a nonprofit organization’s consolidated financial statements.</li> </ul>
<p>18 19</p>	<p>There are several new changes to Chapters 18-19 resulting from new statements issued by the Financial Accounting Standards Board, the AICPA, and GAO.</p> <ul style="list-style-type: none"> <li>• The threshold for a Single Audit has increased to \$500,000.</li> <li>• The requirements for auditor independence and CEO assurances of Sarbanes-Oxley do not apply to nonprofits but are considered best practices.</li> <li>• The FASB has decided to issue a separate standard for nonprofit combinations shortly after the issuance of the business combination standard. The FASB has defined a nonprofit combination as any event that results in the initial inclusion of a combined set of assets and activities (as defined) in a nonprofit organization’s consolidated financial statements.</li> </ul>
<p>20</p>	<p>Several tax law changes have occurred since publication of the 8<sup>th</sup> edition. Although the principles and methodologies set forth in the 8<sup>th</sup> edition are still applicable, students should note that certain tax law provisions have subsequently changed. These changes are as follows:</p> <ul style="list-style-type: none"> <li>• The Taxpayers Relief Act of 1997 contains provisions to adjust the annual exclusion amount for inflation. This adjustment is applicable to decedents dying and gifts made after 1998. The annual exclusion amount for the year 2005 is an \$11,000 gift by a donor per donee (\$22,000 for consenting spouse gifts). Tuition payments to an educational organization and/or medical payments made on another’s behalf are not considered taxable gifts.</li> <li>• The tax rates on taxable estates are progressive and the 2005 rates range from 18% to 47%. Taxable estates up to \$10,000 are taxed at 18%, while taxable amounts exceeding \$2,000,000 are taxed at 47%. The Unified Transfer Tax Rate Schedule is as follows:</li> </ul>

Column A	Column B	Column C	Column D
Taxable Amount Over	Taxable Amount Not Over	Tax on Amount in Column A	Rate of Tax on Excess Over Amount in Column A
\$0	\$10,000	\$0	18%
10,000	20,000	1,800	20
20,000	40,000	3,800	22
40,000	60,000	8,200	24
60,000	80,000	13,000	26
80,000	100,000	18,200	28
100,000	150,000	23,800	30
150,000	250,000	38,800	32
250,000	500,000	70,800	34
500,000	750,000	155,800	37
750,000	1,000,000	248,300	39
1,000,000	1,250,000	345,800	41
1,250,000	1,500,000	448,300	43
1,500,000	2,000,000	555,800	45
2,000,000		780,800	47

- The resulting tentative estate tax, then, is reduced by certain credits. The unified credit in substance results from excluding a portion of taxable estate from taxation. The maximum amount of the credit and excluded amounts are as follows:

For Decedents Dying and Gifts During	Applicable Credit Amount	Applicable Exclusion Amount
2005	\$555,800	\$1,500,000
2006	780,800	2,000,000
2007	780,800	2,000,000
2008	780,800	2,000,000
2009	1,485,800	3,500,000

The applicable credit amount corresponds with the unified transfer tax, which would be due on the applicable exclusion amount. For example, if one had a taxable estate of \$1,500,000 in the year 2005, the unified transfer tax would be \$555,800 which corresponds with the applicable credit. Additional credits against the tax due are based on state (and District of Columbia) death or inheritance taxes paid, foreign death taxes, and taxes already paid on taxable gifts made after 1976. After recognizing applicable credits, the net tax due is paid out of the principal of the estate. If the estate principal does not have adequate cash to pay the taxes, other principal assets must be liquidated in order to generate the necessary cash.

21 There are no significant changes.