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Legal Updates

FASB Amends Guidance for Recognizing Lawsuits and Other Contingencies Acquired in M&A Deals

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On April 1, 2009, the FASB, in response to various comments, amended its guidance for recognizing contingent assets acquired and liabilities assumed in M&A deals. The revised rule, known as FSP (for "FASB Staff Position") FAS 141R-1, amends Statement of Financial Accounting Standards No. 141R, Business Combinations ("FAS 141R"), promulgated in December 2007 to address a number of accounting issues in connection with M&A transactions.[1] FAS 141R otherwise continues in effect as previously promulgated.

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The Revised Rule. The revised rule requires companies acquiring contingent assets or assuming contingent liabilities in M&A transactions to either:

- If the assets' or liabilities' fair value can be determined, recognize them at fair value, at the acquisition date,[2] or
- If the assets' or liabilities' fair value cannot be determined, but (i) it is probable that an asset existed or that a liability had been incurred at the acquisition date and (ii) the amount of the asset or liability can be reasonably estimated, recognize them at their estimated amount, at the acquisition date.

If the fair value of these contingencies cannot be determined and they are not probable or cannot be reasonably estimated, then companies should not recognize these contingencies as of the acquisition date and instead should account for them in subsequent periods by following other applicable GAAP (including FASB Statement No. 5 (Accounting for Contingencies)).

FSP FAS 141R-1 also eliminates the FAS 141R requirement of disclosing in the footnotes to the financial statements the range of expected outcomes for a recognized contingency.

Like FAS 141R, the revised rule applies to M&A deals closing after the start of a company's first annual reporting period after December 15, 2008 (for companies whose fiscal year is the calendar year, that means deals closing on or after January 1, 2009).

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Rationale for Amending FAS 141R. FAS 141R, as originally promulgated, required companies to recognize contingencies acquired in deals when the acquired contingencies were "more likely than not" to occur. The FASB's rationale for implementing the "more likely than not" standard was to improve the completeness of information reported about a business combination. However, in response to the concerns over applying the "more likely than not" standard to pending lawsuits and other practical difficulties in application, the FASB reconsidered these standards in December 2008 and February 2009 and revised the rule as described above.

The elimination of the footnote disclosure also was prompted by concerns regarding the potential for revealing sensitive information that could adversely impact legal strategies in outstanding lawsuits. As a result of this change, companies must follow FASB Statement No. 5 when disclosing contingencies and do not have to disclose a range of outcomes for recognized contingencies.

Impact of Rule Change. Acquirors considering M&A transactions should consider the impact of FSP FAS 141R-1 as well as FAS 141R when evaluating potential deals and the potential for required disclosure as well as the impact on their financial statements.

Please contact your Morrison & Foerster LLP attorneys if you have any questions as to the matters discussed in this client alert.

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[1] Morrison & Foerster published an alert regarding FAS 141R in January of this year summarizing this and other portions of the rule. This client alert is available here.

[2] The FASB did not provide specific guidance for applying this standard. However, the FASB noted that FAS 157 (Fair Value Measurements) provides guidance on how to determine fair value in a variety of contexts, which may suggest that fair value should be able to be determined in many, if not most, circumstances, at least for some types of contingencies, such as warranty obligations.

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