Financial reporting developments

A comprehensive guide

Business combinations

June 2023

Building a better working world

To our clients and other friends

Companies that engage in business combinations face various financial reporting issues, including determining whether a transaction represents a business combination or an asset acquisition, accounting for consideration transferred in the transaction and measuring and recognizing the fair value of assets acquired and liabilities assumed.

We have updated this Financial reporting developments (FRD) publication to provide further clarifications and enhancements to our interpretive guidance. Refer to Appendix G for further detail on the updates provided.

We hope this publication will help you understand and apply the accounting for business combinations. We are also available to answer your questions and discuss any concerns you may have.

Ernst & Young LLP

June 2023

Contents

Notice to readers:

This publication includes excerpts from and references to the Financial Accounting Standards Board (FASB or Board) Accounting Standards Codification (Codification or ASC). The Codification uses a hierarchy that includes Topics, Subtopics, Sections and Paragraphs. Each Topic includes an Overall Subtopic that generally includes pervasive guidance for the Topic and additional Subtopics, as needed, with incremental or unique guidance. Each Subtopic includes Sections that in turn include numbered Paragraphs. Thus, a Codification reference includes the Topic (XXX), Subtopic (YY), Section (ZZ) and Paragraph (PP).

Throughout this publication references to guidance in the Codification are shown using these reference numbers. References are also made to certain pre-Codification standards (and specific sections or paragraphs of pre-Codification standards) in situations in which the content being discussed is excluded from the Codification.

This publication has been carefully prepared, but it necessarily contains information in summary form and is therefore intended for general guidance only; it is not intended to be a substitute for detailed research or the exercise of professional judgment. The information presented in this publication should not be construed as legal, tax, accounting, or any other professional advice or service. Ernst & Young LLP can accept no responsibility for loss occasioned to any person acting or refraining from action as a result of any material in this publication. You should consult with Ernst & Young LLP or other professional advisors familiar with your particular factual situation for advice concerning specific audit, tax or other matters before making any decisions.

1 Overview of accounting for business combinations

1.1 Overview

Excerpt from Accounting Standards Codification

Business Combinations — Overall

General

805-10-05-1

The Business Combinations Topic provides guidance on the accounting and reporting for transactions that represent **business combinations** to be accounted for under the acquisition method (as described in paragraph 805-10-05-4). In addition, the Topic includes Subtopic 805-50, which provides guidance on transactions sometimes associated with business combinations but that do not meet the requirements to be accounted for as business combinations under the acquisition method. The Business Combinations Topic includes the following Subtopics:

a. Overall

b. Identifiable Assets and Liabilities, and Any Noncontrolling Interest

c. Goodwill or Gain from Bargain Purchase, Including Consideration Transferred

d. Reverse Acquisitions

e. Related Issues

f. Income Taxes.

This FRD publication provides guidance and our observations on the application of the guidance in ASC 805.

1.2 Background

After the issuance of Statements 141 and 142, the FASB began deliberating the second phase of its business combinations project. The objectives of the second phase of the project were to reconsider the guidance on applying the purchase method of accounting that Statement 141 carried forward from APB 16 and Statement 38, and to address other related issues that were not considered in the first phase of the project, including business combinations that are achieved through means other than purchasing the net assets or equity interests in a business, acquisitions of less than 100% of the equity ownership interests in an acquiree (i.e., partial acquisitions) and the accounting for business combinations achieved in stages (commonly referred to as step acquisitions).

The FASB partnered with the International Accounting Standards Board (IASB) on the second phase of the project to promote the international convergence of accounting and reporting standards for business combinations. The FASB and IASB developed common exposure drafts that incorporated the decisions reached in their joint project. The FASB and IASB concurrently deliberated and reached the same conclusions on the fundamental issues that were considered in the second phase of the project, with only limited exceptions. As a result, the final FASB and IASB standards on business combinations are substantially the same. Appendix H of this FRD summarizes the differences that remain between ASC 805 and IFRS 3(R).

1.3 The overall principle in ASC 805: obtaining control results in a new basis

ASC 805 reflects the overall principle that when an entity (the acquirer) takes control of another entity (the target), the fair value of the underlying exchange transaction is used to establish a new accounting basis of the acquired entity. Furthermore, because obtaining control leaves the acquirer responsible and accountable for all of the acquiree's assets, liabilities and operations, the acquirer recognizes and measures the assets acquired and liabilities assumed at their full fair values[1, 2] as of the date control is obtained, regardless of the percentage ownership in the acquiree or how the acquisition was achieved (e.g., a business combination achieved in stages, a single purchase resulting in control, or a change in control without a purchase of equity interests). ASC 805 refers to this method as the acquisition method.

1.4 Scope: identifying business combination transactions

Under ASC 805, a business combination occurs when an entity obtains control of a business by acquiring its net assets, or some or all of its equity interests. The FASB believes that ***all*** transactions or events in which an entity obtains control of a business are economically similar and, therefore, the accounting for a change in control should not differ based on the means by which control is obtained. Thus, although a business combination typically occurs through the purchase of the net assets or equity interests of a business, a business combination could also occur without the transfer of consideration (e.g., through a contractual arrangement).

1.4.1 Definition of a business

As noted above, under ASC 805 a business combination occurs when an entity obtains control of a "business." The determination of whether the acquired set of assets and activities constitute a business is critical because the accounting for a business combination differs significantly from that of an asset acquisition. See Appendix A for guidance on the accounting for asset acquisitions. Because significant judgments are required to conclude whether an acquired set of assets and activities is a business, companies should carefully evaluate their specific facts and circumstances when applying the guidance in ASC 805. See section 2.1.3 for additional information on the definition of a business.

1.4.2 Control assessment

An acquirer in a business combination is the entity that obtains control over a business. When an acquirer obtains its interest through the acquisition of a legal entity (rather than through the acquisition of a group of assets and liabilities) it should consider the following guidance, as well as other applicable literature, to determine whether its interests represent a controlling financial interest that requires the investor to consolidate the entity under ASC 810:

- The investor assesses whether the entity should be consolidated under the provisions of ASC 810. This assessment would first include an evaluation to determine whether the investee is a variable interest entity (VIE), and if so, whether the investor is the VIE's primary beneficiary.
- If the investor determines that the entity is not a VIE, it should evaluate whether it controls the entity pursuant to consolidation guidance for voting interest entities within ASC 810 (including control by contract). See our FRD, ***Consolidation***, for guidance on this assessment.
- The investor should consider industry-specific guidance, such as the real estate industry accounting provisions of ASC 970-810, which address consolidation.

---

[1] The term fair value as used in ASC 805 has the same meaning as in ASC 820.

[2] As discussed in section 3.4 of this FRD, ASC 805 provides certain exceptions to the fair value measurement principle.

1.5 Recognizing and measuring the identifiable assets acquired, the liabilities assumed and any noncontrolling interest in the acquiree

ASC 805 requires that identifiable assets acquired, liabilities assumed and any noncontrolling interest (NCI) in the acquiree be recognized and measured as of the acquisition date at fair value (with certain limited exceptions). The FASB observed that to fairly represent economic circumstances at the acquisition date, in principle, all assets acquired and liabilities assumed should be recognized at the acquisition date and measured at fair value. In addition, although the objectives of the business combinations project were not directly related to "day 2" accounting[3] for assets acquired and liabilities assumed, ASC 805 provides guidance on accounting for certain acquired assets and assumed liabilities after the business combination. Some of the most significant recognition and measurement exceptions included in ASC 805 are as follows:

- Income taxes are recognized and measured in accordance with ASC 740. Under ASC 740, (a) changes that result from a business combination transaction in an acquirer's existing deferred income tax asset valuation allowances and (b) changes in an acquired company's deferred income tax asset valuation allowances and income tax uncertainties that occur subsequent to the business combination, in most cases, are recognized as adjustments to income tax expense.
- If the fair value of a preacquisition contingency is not determinable during the measurement period, the preacquisition contingency still must be recognized if it meets the probable and reasonably estimable criteria in ASC 450.
- Assumed pension and postretirement benefit obligations are measured and recognized in accordance with the guidance in ASC 715. The effects of expected terminations, curtailments or amendments of an assumed acquiree benefit plan are not included in purchase accounting.
- Indemnification assets relating to liabilities recognized in the business combination are recognized and measured using assumptions consistent with those used to measure the liabilities to which they relate, subject to any contractual limitations as to the indemnification amount and management's assessment of collectibility.
- A liability or equity instrument issued to replace the acquiree's share-based payment awards is measured in accordance with the guidance in ASC 718, which is a fair value-based measure.

1.6 Consideration transferred

ASC 805 requires that **all** consideration transferred (i.e., the purchase price) be measured at its acquisition-date fair value. Under ASC 805, consideration transferred is comprised of the acquisition-date fair values of:

- Assets transferred
- Liabilities incurred,[4] including contingent consideration obligations
- Equity interests issued by the acquirer

Consideration transferred may take many forms, including cash, tangible and intangible assets, a business or subsidiary of the acquiring entity, securities of the acquiring entity (e.g., common stock, preferred stock, options, warrants and debt instruments) or other promised future payments of the acquiring entity, including contingent payments. Irrespective of the form, the fair value of all consideration transferred is recognized at the acquisition date. ASC 805 also provides guidance on the "day 2" accounting for contingent consideration that is recognized as consideration transferred in the business combination.

---

[3] "Day 2" accounting refers to the accounting for the acquired entity as part of the combined operations subsequent to the acquisition date of the business combination.

[4] "Liabilities incurred" refers to obligations of the acquirer to former owners of a target company and not to liabilities of the acquiree assumed in a business combination by an acquirer. Liabilities assumed are not considered an element of consideration transferred.

1.7 Recognizing and measuring goodwill or a gain from a bargain purchase

Under ASC 805, an acquirer in a business combination recognizes 100% of the fair value of the business acquired (i.e., the full fair value of the assets acquired, liabilities assumed and any noncontrolling interests) as of the acquisition date. This is referred to as the "full-goodwill" approach and is applicable without regard to the actual controlling ownership interest acquired.[5] This principle applies whether control is obtained by purchasing an acquiree's net assets, purchasing some (or all) of the acquiree's equity interests, by contract alone or by other means. The result under ASC 805 is that recognized goodwill will represent all of the goodwill of the acquired business, as opposed to just the acquirer's share.

1.7.1 Bargain purchases

In rare circumstances, the acquirer's interest in the acquiree (i.e., the fair value of consideration transferred, the fair value of any noncontrolling interest in the acquiree and the fair value of any previously held equity interest in the acquiree) is less than the fair value (or other recognized value for the exceptions to fair value recognition) of the identifiable net assets acquired. Such a transaction results in an economic gain to the acquiring entity. Any such gain is recognized in earnings only after a thorough reassessment of all elements of the accounting for the acquisition.

1.7.2 A business combination achieved in stages

An acquirer may obtain control of an acquiree through a series of acquisitions of two or more different investments, which ASC 805 refers to as a "business combination achieved in stages." If the acquirer holds a noncontrolling equity investment in the acquiree immediately before obtaining control, the acquirer remeasures that investment to fair value as of the acquisition date and recognizes any remeasurement gains or losses in earnings.

After taking control of a target company, further acquisitions of ownership interests (i.e., acquisitions of noncontrolling ownership interests) are accounted for as transactions among shareholders pursuant to the guidance in ASC 810.

1.7.3 Measurement period

ASC 805 provides for a period of time during which the acquirer may adjust provisional amounts recognized at the acquisition date to their subsequently determined acquisition-date fair values, referred to as the "measurement period." Adjustments during the measurement period are not limited to just those relating to assets acquired and liabilities assumed but apply to all aspects of business combination accounting (e.g., the consideration transferred).

Acquirers must recognize measurement period adjustments during the period in which they determine the amounts, including the effect on earnings of any amounts they would have recorded in previous periods if the accounting had been completed at the acquisition date.

1.7.4 Assessing what is part of the exchange for the acquiree

To distinguish elements that should be accounted for as part of the business combination from elements that should be accounted for outside of the business combination, ASC 805 requires an acquirer to assess if any assets acquired, liabilities assumed or portion of the transaction price are not part of the exchange for the acquiree. Exchanged values of any portion of the assets acquired, liabilities assumed or transaction price that is not part of the exchange for the acquiree are accounted for separately from the business combination and may increase or decrease the consideration transferred in the business combination.

---

[5] Under IFRS 3(R), the IASB permits an alternative to the recognition of 100% of residual goodwill, allowing the acquirer to recognize components of noncontrolling interest that are present ownership interests and entitle their holders to a proportionate share of the acquiree's net assets in the event of liquidation at either full fair value or its proportionate share of the fair value of the identifiable net assets.

Examples of payments or other arrangements that would not be considered part of the exchange for the acquiree, and thus not part of the accounting for the business combination, include payments that effectively settle preexisting relationships between the acquirer and acquiree, payments to compensate employees or former owners of the acquiree for future services, acquirer share-based payments exchanged for acquiree awards that are determined not to be part of the consideration transferred, and costs incurred in connection with a business combination (i.e., transaction costs).

1.8 Disclosure requirements

The FASB, like the IASB, developed overall objectives for disclosure of information related to a business combination. ASC 805 provides specific, detailed disclosure requirements that are intended to facilitate meeting these disclosure objectives. However, ASC 805-10-50-7 states that if these specific disclosure requirements and those required by other GAAP do not meet the overall disclosure objectives of the standard, an acquirer should disclose any additional information necessary to meet those objectives.

2 Identifying business combination transactions

2.1 What is a business combination?

Excerpt from Accounting Standards Codification

Business Combinations — Overall

Recognition

805-10-25-1

An entity shall determine whether a transaction or other event is a **business combination** by applying the definition in this Subtopic, which requires that the assets acquired and liabilities assumed constitute a **business**. If the assets acquired are not a business, the reporting entity shall account for the transaction or other event as an asset acquisition. An entity shall account for each business combination by applying the acquisition method.

Implementation Guidance and Illustrations

805-10-55-2

Paragraph 805-10-25-1 requires an entity to determine whether a transaction or event is a business combination. In a business combination, an **acquirer** might obtain **control** of an **acquiree** in a variety of ways, including any of the following:

a. By transferring cash, cash equivalents, or other assets (including net assets that constitute a **business**)

b. By incurring liabilities

c. By issuing **equity interests**

d. By providing more than one type of consideration

e. Without transferring consideration, including by contract alone (see paragraph 805-10-25-11).

805-10-55-3

A business combination may be structured in a variety of ways for legal, taxation, or other reasons, which include but are not limited to, the following:

a. One or more businesses become subsidiaries of an acquirer or the net assets of one or more businesses are legally merged into the acquirer.

b. One combining entity transfers its net assets or its **owners** transfer their equity interests to another combining entity or its owners.

c. All of the combining entities transfer their net assets or the owners of those entities transfer their equity interests to a newly formed entity (sometimes referred to as a roll-up or put-together transaction).

d. A group of former owners of one of the combining entities obtains control of the combined entity.

A glossary of key terms, which are bolded throughout ASC 805, is included at Appendix J of this publication. These key terms include definitions of a *business combination* and a *business* (see section 2.1.3 for a discussion of the definition of a business). The Master Glossary in ASC 805 defines a business combination as "a transaction or other event in which an acquirer obtains control of one or more businesses. Transactions sometimes referred to as true mergers or mergers of equals also are business combinations."

In ASC 805, the FASB concluded that ***all*** transactions in which an entity obtains control of a business are economically similar and, therefore, the accounting for a change in control should not differ based on the means in which control[6] is obtained. The result of the FASB's conclusion is that ASC 805 broadened 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 also occur without the transfer of consideration. Examples of such circumstances, which are discussed in greater detail in the following sections, include:

- The lapse of minority participating rights that previously prevented a majority owner from controlling (and therefore consolidating) a business (section 2.1.1.1)
- An investee's purchase of its shares that results in an existing investor obtaining control of the investee's business (section 2.1.1.2)
- Control of a business is obtained pursuant to a contractual arrangement (e.g., the type of arrangements described in ASC 810-10 (portions of this subtopic was codified from Emerging Issues Task Force (EITF or Task Force) Issue No. 97-2), dual-listed corporations and stapling arrangements) (section 2.1.1.3)
- The initial consolidation of a VIE pursuant to ASC 810 (section 2.1.2)

Under ASC 805, an acquirer accounts for each of the preceding examples, as well as any other transaction that results in obtaining control of a business, using the acquisition method.

During the Statement 141(R) comment letter process, several respondents indicated that they did not believe the definition of a business combination included the merger of equals (or "true mergers") in which there is no clear acquirer. While the FASB did not conclude whether or not true mergers actually exist, they did clarify that in the rare circumstances in which one of the combining entities does not obtain control of another or there is no clear acquirer, the application of the acquisition method in ASC 805 is nonetheless required. In such situations, an accounting acquirer must be identified pursuant to the guidance in ASC 805-10-25-4 and 25-5 and ASC 805-10-55-11 through 55-15 and as discussed in section 3.

The determination of whether or not a transaction is considered a business combination is important because (1) goodwill can arise only in a business combination and (2) the guidance in ASC 805 does not apply to transactions that are not business combinations. See Appendix A for further discussion of the accounting for asset acquisitions.

[6] The term control is defined in ASC 805 as having the meaning of controlling financial interest in paragraph ASC 810-10-15-8.

2.1.1 Control obtained without transferring consideration

Excerpt from Accounting Standards Codification

Business Combinations — Overall

Recognition

805-10-25-11

An acquirer sometimes obtains control of an acquiree without transferring consideration. The acquisition method of accounting for a business combination applies to those combinations. Such circumstances include any of the following:

a. The acquiree repurchases a sufficient number of its own shares for an existing investor (the acquirer) to obtain control.

b. Minority veto rights lapse that previously kept the acquirer from controlling an acquiree in which the acquirer held the majority voting interest.

c. The acquirer and acquiree agree to combine their businesses by contract alone. The acquirer transfers no consideration in exchange for control of an acquiree and holds no **equity interests** in the acquiree, either on the acquisition date or previously. Examples of business combinations achieved by contract alone include bringing two businesses together in a stapling arrangement or forming a dual-listed corporation.

805-10-25-12

In a business combination achieved by contract alone, the acquirer shall attribute to the equity holders of the acquiree the amount of the acquiree's net assets recognized in accordance with the requirements of this Topic. In other words, the equity interests in the acquiree held by parties other than the acquirer are a **noncontrolling interest** in the acquirer's postcombination financial statements even if the result is that all of the equity interests in the acquiree are attributed to the noncontrolling interest.

2.1.1.1 Lapse of participating rights held by minority shareholders

There is a presumption in ASC 810 that all majority-owned entities should be consolidated. However, this presumption may be overcome if noncontrolling interest holders have substantive participation rights. In such situations, the majority investor would not consolidate the majority-owned entity and would account for its investment under the equity method of accounting. Pursuant to ASC 805, the lapse of minority veto rights (i.e., voting control is thus attained by the majority investor) is considered a business combination and requires the recognition of a full new basis (generally fair value) in the underlying assets and liabilities of the newly-controlled entity upon initial consolidation (i.e., the date control initially is obtained). See section 7.4.2 for a discussion of the acquisition-date accounting for an investment held in a newly-controlled entity prior to obtaining control.

2.1.1.2 Investee share repurchase transactions

Control might also be obtained without the transfer of any consideration or without involving the acquirer when an investee repurchases its shares. For example, in a voting interest entity, assume the ownership interests in Investee were held 51% by Investor A and 49% by Investor B, resulting in Investor A controlling and consolidating Investee. If Investee repurchased a sufficient number of shares from Investor A such that Investor B now controlled Investee (i.e., Investor B owns shares greater than 50% of Investee), Investor B would account for its newly-obtained controlling interest in Investee as a business combination, which requires the underlying assets and liabilities to be recorded at their full new basis (generally fair value) on the date control initially is obtained. See section 7.4.2 for a discussion of the acquisition-date accounting for an investment held in a newly-controlled entity prior to obtaining control.

2.1.1.3 Control obtained by contract alone

2.1.1.3.1 Control by contract

In the guidance in ASC 805, the FASB explicitly included transactions in which control is obtained by contract alone in the definition of a business combination. When Statement 141(R) was issued, it nullified most of the consensuses reached in EITF 97-2. However, Issue 1 of EITF 97-2, which provided guidance in assessing whether a physician practice management entity (PPM) has a controlling financial interest in a physician practice entity, was not nullified (codified primarily in ASC 954-810). While that guidance was specific to PPMs, those concepts should be evaluated when assessing whether control has been obtained by contract in other industries as well.

In EITF 97-2 the Task Force concluded that if the PPM is required to consolidate the physician practice, and that practice meets the definition of a business, then the transaction represents a business combination. While the scope of EITF 97-2 was limited to PPMs, the staff of the Securities and Exchange Commission (SEC) indicated that the conclusions reached in EITF 97-2 might apply to similar arrangements in other industries and that guidance should be considered when evaluating the accounting for arrangements in other industries.[7] As a result, the execution of management contracts that grant one entity a controlling financial interest (based on the requirements outlined in EITF 97-2) in another business generally were and continue to be accounted for as business combinations under ASC 805.

2.1.1.3.2 Dual-listed corporation and stapling arrangements

Dual-listed corporations (DLC) (also referred to as dual-holding companies), are sometimes used in combinations of US and foreign companies or in the combination of foreign companies to achieve the substance of a business combination while retaining certain tax benefits to the shareholders (i.e., to defer taxable gains on the disposal of the shares). In a business combination involving a DLC, neither of the combining companies exchange shares or issue consideration to the other company's shareholders. Rather, the companies execute contracts that equalize voting and dividend rights of the two companies' shareholders, establish common governance and executive management policies and provide for equal sharing of economic interests in liquidation. This results in the activities of the two entities being managed as a single economic entity under contractual arrangements while retaining their separate legal identities. The structure achieves the same substantive result as if a new entity had been formed to issue shares to the shareholders of the two combining companies. Because of the mutual and proportionate sharing by the two shareholder groups of control and the economic risks and rewards of the two companies, a DLC transaction is considered a business combination and an accounting acquirer among the two companies must be identified. We understand the SEC staff historically has required that these transactions be accounted for as business combinations.

A stapling arrangement is a situation in which a legal entity has issued equity securities that are combined with ("stapled" to) the securities issued by another legal entity by virtue of a contractual arrangement between the entities. Stapled securities generally are quoted at a single price and cannot be traded or transferred independently. The stapling of two entities is considered a business combination and one of the entities must be identified as the acquirer pursuant to the guidance included in ASC 805. Stapling arrangements often occur between a company and a trust. In that case, an operating company normally would obtain control of the trust and, therefore, the operating company would be identified as the acquirer.

---

[7] Comments by Jane B. Adams, Deputy Chief Accountant in the Office of the Chief Accountant at the SEC, at the 1997 National Conference on Current SEC Developments.

2.1.1.4 Multiple transactions that result in obtaining control

An acquirer may obtain control of a business through a series of two or more steps or transactions (e.g., acquisition of 45% of a business and a subsequent purchase of 15% of the same business shortly thereafter). This also may occur when obtaining control of a business includes delays due to regulatory requirements or when assets and processes are transferred over time in transactions that don't individually meet the definition of a business. If an acquirer determines that each transfer should be accounted for as a separate transaction, assets acquired or liabilities assumed would be accounted for separate from the business combination in accordance with their nature and the applicable GAAP. If an acquirer determines that multiple transactions should be accounted for as a single transaction that results in an acquirer obtaining control of a business, the transaction would be accounted for under the acquisition method in ASC 805.

We believe the following factors listed in ASC 810-10-40-6 (related to deconsolidation) may be considered to determine whether the multiple transactions should be accounted for as a single transaction:

- They are entered into at the same time or in contemplation of one another.
- They form a single transaction designed to achieve an overall commercial effect.
- The occurrence of one arrangement is dependent on the occurrence of at least one other arrangement.
- One arrangement considered on its own is not economically justified, but they are economically justified when considered together. An example is when one disposal is priced below market, compensated for by a subsequent disposal priced above market.

An acquirer also may consider the timing between transactions and whether any subsequent transactions contemplated at the time of the initial transaction are considered perfunctory (which might indicate that the transfers should be accounted for as a single arrangement) or whether certain conditions must be met prior to each transaction (which may indicate that each transaction should be accounted for separately). Determining whether multiple transactions represent a single transaction for accounting purposes depends on the facts and circumstances and requires the use of professional judgment.

Once an entity determines it has obtained control of a business, it must then evaluate whether any part of the transaction must be accounted for separately (i.e., not part of what is included in the exchange for the business combination) in accordance with the guidance in ASC 805-10-25-20 through 25-22. See section 3.4.1.2 for further discussion on what is part of a business combination.

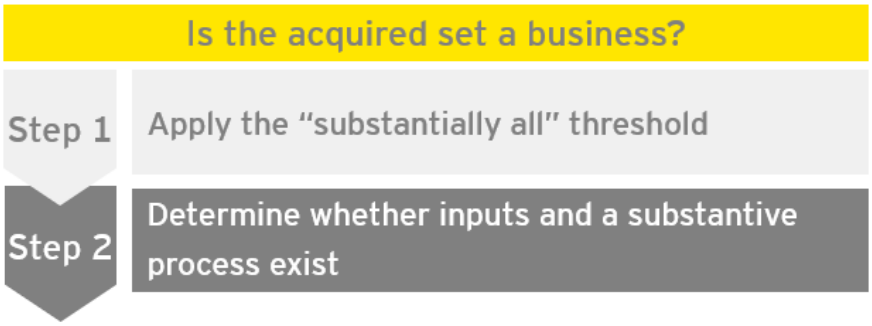
2.1.2 Variable interest entities

The initial consolidation of a VIE that is a business is considered to be a business combination and is subject to the provisions of ASC 805. The transaction is measured based on the requirements provided in the consolidation of variable interest entities guidance in ASC 810 for the initial consolidation of a VIE that was determined to be a business. As described in ASC 810-10-30-4 through 30-6, the accounting for the initial consolidation of a VIE that is not a business remains different than the accounting for a group of assets that is not a business. In the acquisition of a group of assets not considered to be a business and not subject to the requirements of the guidance in ASC 810, the difference between the fair value of the consideration paid and the fair value of the net assets acquired is assigned to the net assets acquired based on their relative fair values, as described in Appendix A. However, in the initial consolidation of a VIE that is not considered a business, the difference between (1) the sum of the total fair value of the consideration plus the reported amount of previously held interests and (2) the sum of the individual fair values of the net assets is recognized as a gain or loss. See our FRD, ***Consolidation***, for further discussion of the initial consolidation of a VIE.

2.1.3 Definition of a business

Determining whether an entity has acquired a business or an asset (or a group of assets) is critical because the accounting for a business combination differs significantly from that of an asset acquisition.

The graphic below summarizes the steps to evaluate whether an acquired set of assets and activities meets the definition of a business:



The guidance requires an entity to first evaluate whether substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or a group of similar identifiable assets (Step 1). If that threshold is met, the set of assets and activities is not a business. If it's not met, the entity evaluates whether the set meets the definition of a business (Step 2). The guidance also requires a business to include at least one substantive process in addition to an input.

2.1.3.1 Applying the 'substantially all' threshold

Excerpt from Accounting Standards Codification

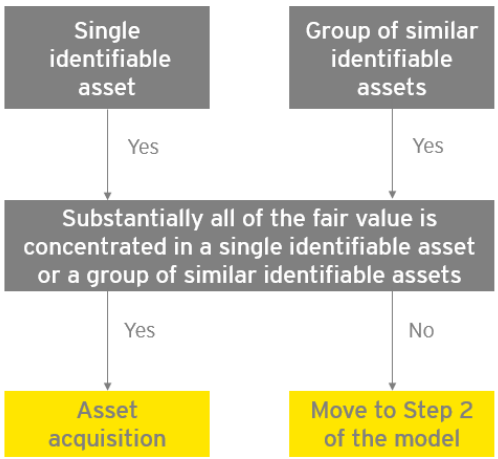
Business Combinations — Overall

Implementation Guidance and Illustrations

805-10-55-5A

If substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets, the set is not considered a business. Gross assets acquired should exclude cash and cash equivalents, deferred tax assets, and goodwill resulting from the effects of deferred tax liabilities. However, the gross assets acquired should include any consideration transferred (plus the fair value of any noncontrolling interest and previously held interest, if any) in excess of the fair value of net identifiable assets acquired.

The graphic below summarizes how to apply the "substantially all" threshold (Step 1):



The guidance requires an entity to first evaluate whether substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or a group of similar identifiable assets. If that threshold is met, the set is not a business and does not require further evaluation. We believe entities would apply ASC 805 to measure the assets in the set (including the measurement exceptions) for the purpose of applying the threshold.

The term "substantially all" is intended to be applied consistently with how it is used in other areas of US GAAP (e.g., ASC 606, ASC 810) and entities should consider how "substantially all" is applied in its existing accounting policies in such areas. Entities will need to apply judgment to determine what is considered "substantially all" because the standard does not provide a bright line for making this assessment. An entity also should consider how the inherent estimation uncertainty of its valuations of assets acquired and consideration transferred affects the evaluation of what is considered "substantially all." That is, an entity may conclude there is a range of fair value measurements for an asset in a set because of inherent estimation uncertainty that exists in fair value measurements. An entity should consider whether different measurements in that range affect whether the "substantially all" threshold is met.

The guidance does not require a quantitative evaluation of whether the threshold is met. For example, the assessment could be qualitative if an entity concludes that all of the fair value will be assigned to one element of the set. In contrast, if an entity concludes that there is clearly significant value in assets that are not similar, the entity may be able to qualitatively determine that the threshold is not met.

In many acquisitions, an entity may not need additional information to evaluate whether the threshold is met because it would need most of the information required for such an analysis, regardless of whether the acquired set is a business or a group of assets. That is, in an acquisition of a group of assets that does not constitute a business, an entity must determine the fair value of all the assets acquired to allocate consideration transferred to those assets on a relative fair value basis in accordance with ASC 805-50-30-3. In other situations, such as dispositions, quantitatively evaluating whether the threshold is met may be more challenging because an entity wouldn't otherwise be required to determine the fair value of all of the assets.

2.1.3.1.1 Determining what is part of the set

To apply the definition of a business, an entity must determine which elements are part of the set and which are part of a separate transaction. For example, if an acquirer does not assume an outsourcing arrangement from a seller but enters into a new outsourcing arrangement at the same time as the acquisition, the acquirer would have to evaluate whether the new arrangement is an element of the acquired set. Any inputs or processes provided through separate transactions are excluded from the threshold evaluation and the analysis of whether the set meets the definition of a business. That is, an entity needs to evaluate what is in the set before it evaluates whether that set is a business. Refer to section 3.4.1.2 for further information on evaluating what is part of the set.

2.1.3.1.2 Single identifiable assets

Excerpt from Accounting Standards Codification

Business Combinations — Overall

Implementation Guidance and Illustrations

805-10-55-5B

A single identifiable asset includes any individual asset or group of assets that could be recognized and measured as a single identifiable asset in a business combination. However, for purposes of this evaluation, the following should be considered a single asset:

a. A tangible asset that is attached to and cannot be physically removed and used separately from another tangible asset (or an intangible asset representing the right to use a tangible asset) without incurring significant cost or significant diminution in utility or fair value to either asset (for example, land and building)

b. In-place lease intangibles, including favorable and unfavorable intangible assets or liabilities, and the related leased assets.

To evaluate whether the threshold is met, an entity must first determine the identifiable assets in the set. In doing so, an entity will identify assets or groups of assets that could be recognized and measured as a single identifiable asset in a business combination accounted for under ASC 805.

Some single identifiable assets in a business combination may include more than one asset. For example, ASC 805-20-55-18 provides that a group of complementary assets such as a trademark and its related trade name, formulas, recipes and technological expertise may be recognized as a single brand intangible asset if those assets have similar useful lives.

It is important to remember that the threshold is used only to determine whether further evaluation of the definition of a business is necessary and does not affect recognition and measurement of the assets and liabilities in the set. Therefore, although entities must identify single identifiable assets by applying the guidance in ASC 805, they won't apply the recognition and measurement principles in that guidance if the set is determined not to be a business.

For example, assume an acquired set includes value attributed to an assembled workforce. Because an assembled workforce is not an identifiable asset in a business combination (it is subsumed into goodwill), the value attributed to it is not included in the numerator of the threshold equation. However, this value would be captured in the gross assets acquired (i.e., the denominator of the equation). If the entity concludes that the set is not a business, it would separately recognize value attributed to the assembled workforce in an asset acquisition. See section A.1.2 and section A.4.1 for considerations of other assets that may be recognized separately in an asset acquisition but not in a business combination.

2.1.3.1.2.1 Exceptions to the principle for determining single identifiable assets

The guidance also requires entities to combine the following assets that wouldn't be combined into a single identifiable asset in a business combination:

- Two tangible assets such as land and a building that are attached and cannot be used separately without incurring significant cost or significant diminution in utility or fair value to either asset (or an intangible asset representing the right to use a tangible asset that cannot be used separately from the tangible asset such as leased land and a building)
- In-place lease intangibles, including favorable and unfavorable intangible assets or liabilities (i.e., an off-market component), and the related leased assets

The FASB provided the first exception so that real estate entities and other entities that transfer assets that are effectively inseparable could practically apply the threshold. The second exception is intended to enhance consistency of conclusions reached when applying the threshold to leased assets and lease-related intangibles.

We believe that the concepts underlying the exceptions may not be applied by analogy to other circumstances. For example, leased assets and unfavorable lease intangible liabilities are explicitly addressed within the second exception and are considered a single identifiable asset when applying the threshold. It would not be appropriate to consider other assets and related liabilities a single identifiable asset, such as a fixed asset and related asset retirement obligation.

Also, it only is appropriate to combine assets and consider them a single identifiable asset under the exceptions when applying the threshold. That is, any combination of these assets would not affect recognition in either a business combination or an asset acquisition (e.g., land and building would still be recognized separately).

2.1.3.1.3 Group of similar identifiable assets

Excerpt from Accounting Standards Codification

Business Combinations — Overall

Implementation Guidance and Illustrations

805-10-55-5C

A group of similar assets includes multiple assets identified in accordance with paragraph 805-10-55-5B. When evaluating whether assets are similar, an entity should consider the nature of each single identifiable asset and the risks associated with managing and creating outputs from the assets (that is, the risk characteristics). However, the following should not be considered similar assets:

a. A tangible asset and an intangible asset

b. Identifiable intangible assets in different major **intangible asset classes** (for example, customer-related intangibles, trademarks, and in-process research and development)

c. A financial asset and a nonfinancial asset

d. Different major classes of financial assets (for example, accounts receivable and marketable securities)

e. Different major classes of tangible assets (for example, inventory, manufacturing equipment, and automobiles)

f. Identifiable assets within the same major asset class that have significantly different risk characteristics.

In evaluating whether the threshold is met, an entity also must determine whether any single identifiable assets identified by applying the guidance described in section 2.1.3.1.2 are similar. When evaluating whether assets are similar, an entity should consider the nature of each single identifiable asset and the risks associated with managing and creating outputs from the assets. This evaluation will require significant judgment.

While the guidance provides a framework for evaluating whether assets are similar, the guidance states that the following assets cannot be considered similar:

- A tangible asset and an intangible asset
- Identifiable intangible assets in different major intangible asset classes (e.g., customer-related intangibles, trademarks, in-process research and development (IPR&D))
- A financial asset and a nonfinancial asset
- Different major classes of financial assets (e.g., accounts receivable and marketable securities)
- Different major classes of tangible assets (e.g., inventory, manufacturing equipment, automobiles)
- Identifiable assets within the same major asset class that have significantly different risk characteristics

While many of these terms are clear, applying the guidance on assets in different major classes may require judgment because this term is not defined. The Master Glossary in ASC 805 defines intangible asset class as "a group of intangible assets that are similar, either by their nature or by their use in the operations of an entity" and is used in the context of required financial statement disclosures under ASC 350, *Intangibles — Goodwill and Other*. However, we believe that this definition also could be used in evaluating whether intangible, tangible or financial assets are in different "major classes" when applying the threshold. For example, tangible assets may be in different major classes if either their nature or use in the operations of an entity differ. Moreover, identifiable assets within the same major asset class cannot be considered similar if they have significantly different risk characteristics (e.g., a commercial

warehouse and a single-family home). Although the standard prohibits combining tangible and intangible assets into a group of similar assets, an entity applies this exception after combining certain tangible and intangible assets (e.g., lease-related intangibles and leased assets) into single identifiable assets as described in section 2.1.3.1.2.1 above.

2.1.3.1.4 Gross assets acquired (updated June 2023)

Gross assets acquired include any consideration transferred (plus the fair value of any noncontrolling interest and previously held interest, if any) in excess of the fair value of the net identifiable assets acquired (e.g., goodwill in a business combination). In determining consideration transferred for the purpose of applying the threshold, entities must include all forms of consideration (e.g., cash, contingent consideration) that would be recognized in a business combination. Consideration transferred would not be affected by elements that are part of a separate transaction (e.g., equity awards that represent compensation for future services).

However, any amount by which the fair value of the net identifiable assets acquired exceeds the consideration transferred (i.e., bargain purchase gain in a business combination) should be excluded from the gross assets acquired for the purpose of evaluating whether substantially all of the fair value is concentrated in a single identifiable asset or a group of similar identifiable assets. That's because a bargain purchase gain is not an asset, and including it as an adjustment to the gross assets acquired would distort the analysis and would be similar to the effect of including liabilities in the analysis.

Gross assets acquired exclude cash and cash equivalents, deferred tax assets and any goodwill that would be created in a business combination from the recognition of deferred tax liabilities.

The following illustration summarizes the example in ASC 805-10-55-65 through 55-66:

Illustration 2-1: Application of the threshold — life sciences

Pharma Co. purchases a legal entity that holds a Phase 3 (clinical research phase) compound developed to treat diabetes, an at-market clinical research organization (CRO) contract and an at-market clinical manufacturing organization (CMO) contract. No other assets or activities are transferred. No employees are transferred.

Application of the 'substantially all' threshold

Pharma Co. concludes that the IPR&D related to the compound (including the historical know-how, formula protocols, designs and related procedures) is a single identifiable intangible asset. Pharma Co. concludes there is no value to assign to the at-market CRO and CMO contracts and that all of the fair value of the gross assets acquired is concentrated in the IPR&D asset. Therefore, the acquired set is not a business, and no further analysis is required.

2.1.3.2 The elements of a business

Excerpt from Accounting Standards Codification

Business Combinations — Overall

Implementation Guidance and Illustrations

805-10-55-3A

A business is 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. To be considered a business, an integrated set must meet the requirements in paragraphs 805-10-55-4 through 55-6 and 805-10-55-8 through 55-9.

805-10-55-4

A business consists of inputs and processes applied to those inputs that have the ability to contribute to the creation of outputs. Although businesses usually have outputs, outputs are not required for an integrated set to qualify as a business. The three elements of a business are defined as follows:

a. Input. Any economic resource that creates, or has the ability to contribute to the creation of, outputs when one or more processes are applied to it. Examples include long-lived assets (including **intangible assets** or rights to use long-lived assets), intellectual property, the ability to obtain access to necessary materials or rights, and employees.

b. Process. Any system, standard, protocol, convention, or rule that when applied to an input or inputs, creates or has the ability to contribute to the creation of outputs. Examples include strategic management processes, operational processes, and resource management processes. These processes typically are documented, but the intellectual capacity of an organized workforce having the necessary skills and experience following rules and conventions may provide the necessary processes that are capable of being applied to inputs to create outputs. Accounting, billing, payroll, and other administrative systems typically are not processes used to create outputs.

c. Output. The result of inputs and processes applied to those inputs that provide goods or services to customers, investment income (such as dividends or interest), or other revenues.

805-10-55-6

The nature of the elements of a business varies by industry and by the structure of an entity's operations (activities), including the entity's stage of development. Established businesses often have many different types of inputs, processes, and outputs, whereas new businesses often have few inputs and processes and sometimes only a single output (product). Nearly all businesses also have liabilities, but a business need not have liabilities. In addition, some transferred sets of assets and activities that are not a business may have liabilities.

A business is an integrated set of assets and activities that is capable of being conducted and managed for the purpose of providing a return to investors or other owners, members or participants. A business typically has inputs, processes applied to those inputs and outputs that are used to generate a return to investors, but outputs are not required for a set to be a business.

While processes are typically documented, that isn't a requirement. In fact, the guidance clarifies that a process can be provided by the intellectual capacity of an organized workforce with the necessary skills and experience to use inputs to create outputs. For example, a group of software engineers may be capable of performing the necessary process to develop acquired technology into a product that can be sold to customers.

The guidance defines an output as "the result of inputs and processes applied to those inputs that provide goods or services to customers, investment income (such as dividends or interest), or other revenues." The focus is on revenue-generating activities, which is closely aligned with how outputs are described in the revenue guidance in ASC 606.

However, a set that does not generate revenue could still contain outputs. For example, a set could provide goods or services that are used internally and don't generate revenue (or intercompany revenue). The goods or services provided, in this case, would be considered outputs.

2.1.3.2.1 Minimum requirements to be a business

Excerpt from Accounting Standards Codification

Business Combinations — Overall

Implementation Guidance and Illustrations

805-10-55-5

To be capable of being conducted and managed for the purposes described in paragraph 805-10-55-3A, an integrated set of activities and assets requires two essential elements—inputs and processes applied to those inputs. A business need not include all the inputs or processes that the seller used in operating that business. However, to be considered a business, the set must include, at a minimum, an input and a substantive process that together significantly contribute to the ability to create output. Paragraphs 805-10-55-5A through 55-5C provide a practical screen to determine when a set would not be considered a business. If the screen is not met, further assessment is necessary to determine whether the set is a business. Paragraphs 805-10-55-5D through 55-6 and 805-10-55-8 through 55-9 provide a framework to assist an entity in evaluating whether the set includes both an input and a substantive process.

805-10-55-8

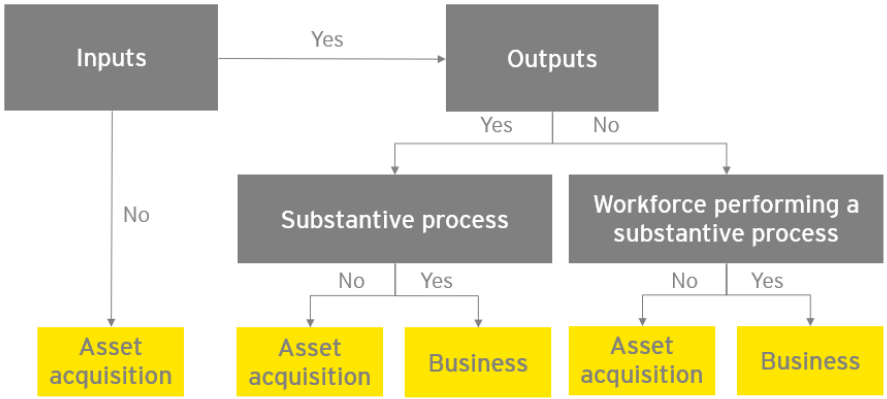
Determining whether a particular set of assets and activities is a business should be based on whether the integrated set is capable of being conducted and managed as a business by a **market participant**. Thus, in evaluating whether a particular set is a business, it is not relevant whether a seller operated the set as a business or whether the acquirer intends to operate the set as a business.

The guidance establishes minimum requirements for what is considered a business and focuses the analysis on the substance of what is acquired (in contrast to the legacy guidance, which included an evaluation of whether a market participant could replace any missing elements). A business must include, at a minimum, an input and a substantive process that together significantly contribute to the ability to create outputs. Therefore, a business need not include all the inputs and processes that the seller used in operating the set. Judgment will be required to evaluate when an input and substantive process together significantly contribute to the ability to create outputs.

The overall evaluation of whether a set is a business is performed from the perspective of a market participant. That is, how a seller operated the set or how the buyer intends to operate the set does not affect the analysis.

2.1.3.3 Determining whether inputs and a substantive process exist

If the "substantially all" threshold is not met, entities must evaluate whether the set is a business (Step 2), which is summarized in the graphic below:



The guidance requires that, to be a business, a set must include, at a minimum, an input and a substantive process that together significantly contribute to the ability to create outputs. Because all asset acquisitions include inputs, the existence of a substantive process is what distinguishes an asset or group of assets from a business. Entities cannot presume that a set contains a process if the set generates revenues before and after the transaction. Further analysis is required to determine whether the set contains a substantive process.

The guidance provides different criteria for determining whether sets with outputs and those without outputs include a substantive process. Because outputs are a key element of a business, entities have to meet a higher standard to conclude that a substantive process is present when outputs are missing.

2.1.3.3.1 When the set is not generating outputs

Excerpt from Accounting Standards Codification

Business Combinations — Overall

Implementation Guidance and Illustrations

805-10-55-5D

When a set does not have outputs (for example, an early stage company that has not generated revenues), the set will have both an input and a substantive process that together significantly contribute to the ability to create outputs only if it includes employees that form an organized workforce and an input that the workforce could develop or convert into output. The organized workforce must have the necessary skills, knowledge, or experience to perform an acquired process (or group of processes) that when applied to another acquired input or inputs is critical to the ability to develop or convert that acquired input or inputs into outputs. An entity should consider the following in evaluating whether the acquired workforce is performing a substantive process:

a. A process (or group of processes) is not critical if, for example, it is considered ancillary or minor in the context of all the processes required to create outputs.

b. Inputs that employees who form an organized workforce could develop (or are developing) or convert into outputs could include the following:

    1. Intellectual property that could be used to develop a good or service

    2. Resources that could be developed to create outputs

    3. Access to necessary materials or rights that enable the creation of future outputs.

Examples of inputs that could be developed include technology, mineral interests, real estate, and in-process research and development.

When there are no outputs, an acquired process (or group of processes) will be considered substantive if the set includes employees with the necessary skills, knowledge or experience to perform an acquired process that is critical to the ability to develop or convert an acquired input or inputs into outputs. Entities must consider the facts and circumstances to determine whether employees perform or are capable of performing a substantive process.

If there are no outputs, an entity cannot consider an organized workforce provided by an acquired contract (i.e., an outsourced workforce) in its assessment of whether the set includes a substantive process. The Board concluded that a contractual arrangement that is not directly involved in creating outputs is not considered substantive enough for the set to be considered a business. Rather, the Board concluded that the acquired set needs to include a workforce that is actively contributing to the development of outputs. Without an employee to manage the performance of a vendor, there are inherent limitations on the processes that can be performed in a development capacity without further

decision making or actions from an employee. If a set without outputs includes both employees and an outsourced workforce, entities will have to apply judgment to determine whether the employees are an organized workforce that provides a substantive process.

Entities also must evaluate the nature of inputs included in a set that is not generating outputs. The guidance defines an input as "any economic resource that creates, or has the ability to contribute to the creation of, outputs when one or more processes are applied to it." A set might include elements that don't create or have the ability to contribute to the creation of outputs. For example, while office furniture may be acquired as part of a set, it would likely not be considered an input in the analysis of whether a set that focuses on the development of technology is a business.

Question 2.1 **How should an entity determine which set of criteria to apply (i.e., guidance for set with outputs or without outputs) if the acquired set produces an insignificant amount of outputs?**

It depends. Determining which set of criteria to apply may require judgment. In certain cases, a set may produce an insignificant amount of outputs relative to the fair value of the gross assets acquired in the set. We believe that, depending on the facts and circumstances, entities could conclude that, because the outputs are so insignificant, it would be appropriate to evaluate whether a substantive process exists using the guidance for sets not generating outputs.

2.1.3.3.2 When the set is generating outputs

Excerpt from Accounting Standards Codification

Business Combinations — Overall

Implementation Guidance and Illustrations

805-10-55-5E

When the set has outputs (that is, there is a continuation of revenue before and after the transaction), the set will have both an input and a substantive process that together significantly contribute to the ability to create outputs when any of the following are present:

a. Employees that form an organized workforce that has the necessary skills, knowledge, or experience to perform an acquired process (or group of processes) that when applied to an acquired input or inputs is critical to the ability to continue producing outputs. A process (or group of processes) is not critical if, for example, it is considered ancillary or minor in the context of all of the processes required to continue producing outputs.

b. An acquired contract that provides access to an organized workforce that has the necessary skills, knowledge, or experience to perform an acquired process (or group of processes) that when applied to an acquired input or inputs is critical to the ability to continue producing outputs. An entity should assess the substance of an acquired contract and whether it has effectively acquired an organized workforce that performs a substantive process (for example, considering the duration and the renewal terms of the contract).

c. The acquired process (or group of processes) when applied to an acquired input or inputs significantly contributes to the ability to continue producing outputs and cannot be replaced without significant cost, effort, or delay in the ability to continue producing outputs.

d. The acquired process (or group of processes) when applied to an acquired input or inputs significantly contributes to the ability to continue producing outputs and is considered unique or scarce.

> ***805-10-55-5F***
>
> If a set has outputs, continuation of revenues does not on its own indicate that both an input and a substantive process have been acquired. Accordingly, assumed contractual arrangements that provide for the continuation of revenues (for example, customer contracts, customer lists, and leases [when the set is the lessor]) should be excluded from the analysis in paragraph 805-10-55-5E of whether a process has been acquired.

An acquired process (or group of processes) will be considered substantive when the set has outputs and includes any of the following:

- Employees that form an organized workforce or an acquired contract that provides access to an organized workforce that has the necessary skills, knowledge or experience to perform an acquired process (or group of processes) that, when applied to an acquired input, is critical to the ability to continue producing outputs
- A process (or group of processes) that, when applied to an acquired input, significantly contributes to the ability to continue producing outputs and cannot be replaced without significant cost, effort or delay in the ability to continue producing outputs
- A process (or group of processes) that, when applied to an acquired input, significantly contributes to the ability to continue producing outputs and is considered unique or scarce

The Board concluded that a set that generates outputs before and after a transaction is more likely to include an input and substantive process than a set that is not generating outputs. Therefore, the criteria are less stringent than those for a set that isn't producing outputs, and a substantive process can exist if any one of the above criteria are met. For example, a set that includes an automated production line could have a substantive process, even if it doesn't include an organized workforce.

An organized workforce provided by an acquired contract also may perform a substantive process, which differs significantly from the criteria for sets without outputs. Determining whether an organized workforce provided by an acquired contract (i.e., an outsourced workforce) performs a substantive process will require judgment. Entities should consider the substance of the arrangement, including the nature and terms of the activities performed by the outsourced workforce (i.e., whether it is performing a critical process).

Assumed contractual arrangements that are part of the set and provide for the continuation of revenue cannot provide a substantive process. The Board made this determination to emphasize that a set is not a business solely because there is a continuation of revenues.

2.1.3.3.3 Groups of processes

The criteria entities must apply to determine whether a substantive process exists refer to "groups of processes." This reference emphasizes that a group of processes could be a substantive process. That is, a set could include numerous processes that are insignificant (i.e., not substantive) individually but are substantive in the aggregate.

2.1.3.3.4 Presence of goodwill

Excerpt from Accounting Standards Codification

Business Combinations — Overall

Implementation Guidance and Illustrations

805-10-55-9

When evaluating whether a set meets the criteria in paragraphs 805-10-55-5D through 55-5E, the presence of more than an insignificant amount of **goodwill** may be an indicator that the acquired process is substantive and, therefore, the acquired set is a business. However, a business need not have goodwill.

The guidance states that the existence of more than an insignificant amount of goodwill may indicate that a process included in the set is substantive. For example, the presence of more than an insignificant amount of goodwill in a set that includes scientists and a drug compound may help an entity conclude that the process performed by those scientists is critical to the ability to create outputs.

2.1.3.4 Application of the definition of a business

The following examples illustrate the application of the "substantially all" threshold and the evaluation of whether a set is a business. The following illustration summarizes the example in ASC 805-10-55-67 through 55-69:

Illustration 2-2: Application of the definition of a business — life sciences

Pharma Co. purchases a legal entity that holds a Phase 3 compound (i.e., a compound in the clinical research phase) developed to treat diabetes, a Phase 3 compound to treat Alzheimer's disease and the related at-market CRO and CMO contracts for each compound. Included with each project are the historical know-how, formula protocols, designs and procedures expected to be needed to complete the related phase of testing. No employees, other assets or other activities are transferred. Assume both Phase 3 compounds have equal fair value.

Application of 'substantially all' threshold

Pharma Co. concludes that, while the compounds are separate IPR&D assets in the same major asset class, the assets are not similar because the risks associated with creating outputs from each asset differ significantly. This is because the compounds (1) are intended to treat significantly different medical conditions, (2) have significantly different potential customer bases and (3) have significantly different expected markets and regulatory risks. Therefore, substantially all of the fair value of the gross assets acquired is not concentrated in a single identifiable asset or group of similar identifiable assets. Pharma Co. must then evaluate whether the set includes an input and a substantive process that together significantly contribute to the ability to create outputs.

Determination of whether an input and substantive process exist

Pharma Co. concludes the set does not contain a substantive process because the set is not generating outputs and does not include employees that form an organized workforce. Therefore, the set does not include a substantive process and is not a business.

The following illustration summarizes the example in ASC 805-10-55-70 through 55-72:

Illustration 2-3: Application of the definition of a business — life sciences

Pharma Co. buys 100% of Biotech. Biotech's operations include IPR&D on several drug compounds that are in different stages of development and would treat significantly different diseases, scientists and long-lived tangible assets, such as a corporate headquarters, a research lab and testing equipment. Biotech does not yet generate revenues. Each IPR&D asset has a significant amount of fair value. There is fair value associated with the acquired workforce because of the scientists' knowledge of and experience with Biotech's ongoing development projects and their potential to develop new products.

Application of the 'substantially all' threshold

Pharma Co. concludes that, while the IPR&D assets are in the same major asset class, the assets are not similar because the risks associated with creating outputs from each asset differ significantly. This is because the compounds (1) have significantly different development risks, (2) have significantly different potential customer bases and (3) have significantly different potential markets. Pharma Co. applies the threshold and determines that substantially all of the fair value of the gross assets acquired is not concentrated in a single identifiable asset or a group of similar identifiable assets. Pharma Co. must then evaluate whether the set includes an input and a substantive process that together significantly contribute to the ability to create outputs.

Determination of whether an input and substantive process exist

Pharma Co. concludes that the scientists make up an organized workforce that has the necessary skills, knowledge or experience to perform a process that is critical to the ability to develop the acquired IPR&D into products that can be sold to customers. Pharma Co. also concludes that there is a more-than-insignificant amount of goodwill (including the fair value associated with the workforce), which is another indicator that the workforce is performing a critical process. Therefore, the acquired set includes inputs and a substantive process and is a business.

Note that even if Pharma Co. had concluded that the IPR&D assets were similar in the example above, the fair value associated with the other assets acquired may have prevented substantially all of the fair value from being concentrated in a single identifiable asset or group of similar identifiable assets.

The following illustration summarizes the example in in ASC 805-10-55-52 through 55-54:

Illustration 2-4: Application of the definition of a business — real estate

ABC acquires a portfolio of 10 single-family homes that all have in-place leases. Each single-family home includes the land, building and other property improvements. The homes have different floor plans, square footage, lot sizes and interior design, but they have a similar class of customers. No other elements (e.g., assets, employees) are included in the acquired set.

Application of the 'substantially all' threshold

ABC concludes that the land, building, property improvements and in-place lease at each property can be considered a single identifiable asset because the building and property improvements are attached to the land and cannot be removed without significant cost. Additionally, the in-place lease is an intangible asset that should be combined with the related real estate and considered a single identifiable asset.

ABC also concludes that the 10 single identifiable assets (i.e., the combined land, building, property improvements and in-place lease intangibles) are a group of similar identifiable assets. While the location and dimensions of each home are different, the nature of the assets (i.e., income-producing, single-family homes) is similar. ABC also concludes that the risks associated with operating the properties are not significantly different because the properties have a similar class of customers and the risks associated with operating in the same real estate market are similar.

ABC concludes that substantially all of the fair value of the gross assets acquired is concentrated in the group of similar identifiable assets (i.e., the real estate assets comprise substantially all of the gross assets acquired). Therefore, the acquired portfolio of 10 single-family homes is not a business, and no further analysis is required.

The following illustration summarizes the example in ASC 805-10-55-55 through 55-61:

Illustration 2-5: Application of the definition of a business — real estate

Assume the same facts as in Illustration 2-4 except that ABC also acquires an office park with six 10-story office buildings leased to maximum occupancy that all have significant fair value. ABC also assumes the existing outsourced cleaning, security and maintenance contracts for the properties. Seller's employees who perform leasing (e.g., sales, underwriting), tenant management, financing and other management processes are not included in the set. ABC plans to replace the property management and employees with its own internal resources.

Application of the 'substantially all' threshold

ABC concludes that the single-family homes and the office park are not similar identifiable assets. ABC considers that the single-family homes and the office buildings have significantly different risks associated with operating the assets, obtaining tenants and tenant management because the scale of operations and risks associated with the class of customers are significantly different. Therefore, substantially all of the fair value of the gross assets acquired is not concentrated in a single identifiable asset or group of similar identifiable assets. ABC must then evaluate whether the set includes an input and a substantive process that together significantly contribute to the ability to create outputs.

Determination of whether an input and substantive process exist

ABC determines that the processes performed through the cleaning and security contracts are not critical in the context of all of the processes required to create outputs. ABC also determines that the cleaning and security processes could be easily replaced with little cost, effort or delay in the set's ability to continue producing outputs and are not unique or scarce. Therefore, ABC concludes that the set does not include a substantive process (individually or in the aggregate) and is not a business.

Conversely, consider the following illustration:

Illustration 2-6: Application of the definition of a business — real estate

Assume the same facts as in Illustration 2-5 except ABC acquires the employees responsible for leasing, tenant management, and managing and supervising all operational processes.

Application of the 'substantially all' threshold

For the same reasons described in Illustration 2-5, ABC concludes that substantially all of the fair value of the gross assets acquired is not concentrated in a single identifiable asset or group of similar identifiable assets. ABC must then evaluate whether the set includes an input and a substantive process that together significantly contribute to the ability to create outputs.

Determination of whether an input and substantive process exist

ABC concludes that the leasing, tenant management and operational supervision personnel represent an organized workforce that has the skills, knowledge or experience to perform processes that when applied to the acquired inputs in the set are critical to the ability to continue to produce outputs. Therefore, ABC has acquired a substantive process, and the set is considered a business.

The following illustration summarizes the example in ASC 805-10-55-88 through 55-89:

Illustration 2-7: Application of the definition of a business — asset management

Bank A purchases a loan portfolio from Bank Z. The portfolio of loans consists of residential mortgages with terms, sizes and risk ratings that are not significantly different. No other elements (e.g., assets, employees) are included in the acquired set. The loan portfolio is generating interest income before and after the transaction.

Application of the 'substantially all' threshold

Bank A concludes that the nature of the assets (residential mortgage loans) is similar. Bank A also concludes that the risks associated with managing those loans and creating outputs are not significantly different. Bank A concludes that substantially all of the fair value of the gross assets acquired is concentrated in the portfolio of loans. Therefore, the acquired set is not a business, and no further analysis is required.

The following illustration summarizes the example in ASC 805-10-55-90 through 55-92:

Illustration 2-8: Application of the definition of a business — asset management

Assume the same facts as in Illustration 2-7 except that the portfolio of loans consists of commercial loans with terms, sizes and risk ratings that are significantly different.

Application of the 'substantially all' threshold

Bank A concludes that the nature of the assets (commercial loans) is similar; however, because the terms, sizes and risk ratings of the loans are significantly different, Bank A concludes that the risks associated with managing and creating outputs are significantly different. Therefore, substantially all of the fair value of the gross assets acquired is not concentrated in a single identifiable asset or group of similar identifiable assets. Bank A must then evaluate whether the set includes an input and a substantive process that together significantly contribute to the ability to create outputs.

Determination of whether an input and substantive process exist

Bank A concludes that the set does not contain employees who form an organized workforce, an organized workforce provided through an acquired contract or an acquired process. Therefore, the set does not include a substantive process and is not a business.

The following illustration summarizes the example in ASC 805-10-55-93 through 55-96:

Illustration 2-9: Application of the definition of a business — asset management

Assume the same facts as in Illustration 2-8 except that the acquisition includes employees of Bank Z who manage the credit risk of the portfolio and the relationship with the borrowers (such as brokers and risk managers). The consideration transferred is significantly higher than Bank A's estimate of the fair value of the loan portfolio.

Application of the 'substantially all' threshold

Bank A concludes that the nature of the assets (commercial loans) is similar; however, because the terms, sizes and risk ratings of the loans are significantly different, Bank A concludes that the risks associated with managing and creating outputs are significantly different. Therefore, substantially all of the fair value of the gross assets acquired is not concentrated in a single identifiable asset or group of similar identifiable assets. Bank A must then evaluate whether the set includes an input and a substantive process that together significantly contribute to the ability to create outputs.

Determination of whether an input and substantive process exist

Bank A determines the employees are an organized workforce that performs processes critical to the ability to continue producing outputs (customer relationships management and credit risk management). Therefore, the set includes inputs and a substantive process and is considered a business.

Note that the presence of more than an insignificant amount of goodwill in the example above also indicates that the process performed by the organized workforce is a substantive process.

The following example illustrates how to apply the definition of a business in the oil and gas industry:

Illustration 2-10: Application of the definition of a business — oil and gas

Upstream Co. acquires a set of assets, and the fair value of these assets is allocated as follows:

- 60% proved developed producing (PDP) properties
- 10% proved undeveloped (PUD) properties
- 10% probable properties
- 20% possible properties

All properties are located in a single onshore geological formation. However, the formation is considered higher risk, and unproved development in the area has a high rate of exploratory dry holes.

Application of the 'substantially all' threshold

Upstream Co. concludes that each property represents a single identifiable asset and that each of the PDP and PUD properties is similar because they are proved oil and gas properties in the same major asset class and have similar risk characteristics.

Upstream Co. then evaluates whether the risk characteristics of the unproved (probable and possible) properties differ significantly from the risk characteristics of the proved properties. Due to the high rate of dry holes in the formation for probable and possible properties, there is significantly greater risk associated with successfully extracting hydrocarbons from these properties than from the proved properties. In addition, because the rate of dry holes is higher for the possible properties than for the probable properties, these two categories of properties have significantly different risk characteristics too.

However, Upstream Co. concludes that each of the probable properties is similar and each of the possible properties is similar because they are in the same major asset class and have similar risk characteristics (i.e., they are in the same reserve category, the likelihood of successfully extracting hydrocarbons is the same and the development risk is the same). As a result, Upstream Co. concludes that there are three groups of similar assets: (1) the PDP and PUD properties, (2) the probable properties and (3) the possible properties.

Upstream Co. concludes that substantially all of the fair value of the gross assets acquired is not concentrated in a single identifiable asset or group of similar assets.

Determination of whether an input and substantive process exist

Because 60% of the set includes PDPs, the set is generating outputs. Therefore, Upstream Co. evaluates whether the set includes an input and substantive process by applying the guidance for sets generating outputs.

Upstream Co. determines that the set includes inputs (the properties, which include well equipment) and substantive processes. The equipment associated with the PDPs, while an input, also performs an automated process that significantly contributes to the production of outputs and cannot be replaced without significant cost, effort and delay in the ability to continue producing outputs. Therefore, the set is a business.

2.1.4 Effect of the definition of a business on other US GAAP

The definition of a business in ASC 805 affects several areas of US GAAP, including:

- As described in ASC 810-10-15-17(d), certain qualifying businesses are excluded from the scope of ASC 810, which provides guidance on the consolidation of variable interest entities. If an entity meets the definition of a business under ASC 805, it may not be subject to the guidance on variable interest entities in ASC 810 when certain other conditions are met. See section 4.4 of our FRD, ***Consolidation***, for further discussion.
- As described in ASC 810-10-40-3A, an entity should deconsolidate a subsidiary or derecognize a group of assets that meets the definition of a business under ASC 805 if it loses control of that subsidiary or group of assets. See section 19.1 of our FRD, ***Consolidation***, for further discussion.
- A component of an operating segment is a reporting unit (as defined in ASC 350) if, among other things, the component meets the definition of a business under ASC 805. See section 3.8 before the adoption of Accounting Standards Update (ASU) 2017-04 and section 3A.8 after the adoption of ASU 2017-04 of our FRD, ***Intangibles — goodwill and other***, for further discussion.
- When a portion of a reporting unit that meets the definition of a business under ASC 805 is disposed of, some of the goodwill of the reporting unit should be assigned to the portion of the reporting unit being disposed. See section 3.14 before the adoption of ASU 2017-04 and section 3A.14 after the adoption of ASU 2017-04 of our FRD, ***Intangibles — goodwill and other***, for further discussion.

2.2 Limitations in the scope of ASC 805

Excerpt from Accounting Standards Codification

Business Combinations — Overall

Scope and Scope Exceptions

805-10-15-2

The guidance in the Business Combinations Topic applies to all entities, with specific qualifications and exceptions in paragraph 805-10-15-4.

805-10-15-3

The guidance in the Business Combinations Topic applies to all transactions or other events that meet the definition of a **business combination** or an **acquisition by a not-for-profit entity**.

805-10-15-4

The guidance in the Business Combinations Topic does not apply to any of the following:

a. The formation of a joint venture

b. The acquisition of an asset or a group of assets that does not constitute a **business** or a **nonprofit activity**

c. A combination between entities, businesses, or nonprofit activities under common **control** (see paragraph 805-50-15-6 for examples)

d. An acquisition by a not-for-profit entity for which the acquisition date is before December 15, 2009 or a **merger of not-for-profit entities** (NFPs)

e. A transaction or other event in which an NFP obtains **control of a not-for-profit entity** but does not consolidate that entity, as described in paragraph 958-810-25-4. The Business Combinations Topic also does not apply if an NFP that obtained control in a transaction or other event in which consolidation was permitted but not required decides in a subsequent annual reporting period to begin consolidating a controlled entity that it initially chose not to consolidate.

f. Financial assets and financial liabilities of a consolidated variable interest entity that is a **collateralized financing entity** within the scope of the guidance on collateralized financing entities in Subtopic 810-10.

The guidance in ASC 805 applies to all transactions in which control is obtained over a business, without regard to the legal form of the acquirer or the acquired entity. Accordingly, the guidance in ASC 805 applies to acquisitions of or by corporate and non-corporate entities such as partnerships, limited partnerships, limited liability partnerships and limited liability corporations. However, as discussed in section 2.2.5, mergers of not-for-profit entities are not within the scope of ASC 805. Further, financial assets and financial liabilities of a consolidated variable interest entity that is a collateralized financing entity within the scope of the guidance on collateralized financing entities in ASC 810-10 are not within the scope of ASC 805. However, the acquisition of a collection of assets without the acquisition of a legal entity is within the scope of ASC 805 if the collection of assets meets the definition of a business discussed in section 2.1.3.

2.2.1 Joint ventures (updated June 2023)

Proposed amendment to the standard

In October 2022, the FASB issued an exposure draft that would require a joint venture to apply a new basis of accounting upon formation. By applying a new basis of accounting, a joint venture, upon formation, would recognize and initially measure its assets and liabilities at fair value (with certain exceptions that are consistent with ASC 805). The scope of this project focuses on joint ventures that meet the definition in ASC 323, as discussed in section 4.2 of our FRD, ***Equity method investments and joint ventures***. The proposed guidance is expected to be codified in ASC 805.

Readers should monitor developments.

The formation of a joint venture is not considered a business combination. A joint venture is defined by ASC 323 as a corporation owned and operated by a small group of entities (the joint venturers) as a separate and specific business or project for the mutual benefit of the members of the group. A government may also be a member of the group. The purpose of a corporate joint venture frequently is to share risks and rewards in developing a new market, product or technology; to combine complementary technological knowledge; or to pool resources in developing production or other facilities. A corporate joint venture also usually provides an arrangement under which each joint venturer may participate, directly or indirectly, in the overall management of the joint venture. Joint venturers thus have an interest or relationship other than as passive investors. An entity that is a subsidiary of one of the joint venturers is not a corporate joint venture. The ownership of a corporate joint venture seldom changes, and its stock is usually not traded publicly. However, a noncontrolling interest held by public ownership does not preclude a corporation from being a corporate joint venture.

2.2.2 The acquisition of an asset or group of assets that does not constitute a business or a nonprofit activity

Acquisitions of an asset or group of activities and assets (referred to as "asset acquisitions") that do not meet the definition of a business or a nonprofit activity, as defined in ASC 805 and discussed in sections 2.1.3 and 2.2.5, respectively, are not within the scope of ASC 805. There are significant differences in the accounting for business combinations and the accounting for asset acquisitions. A more detailed discussion of the accounting for asset acquisitions, including how the accounting for an asset acquisition differs from that of a business combination, is included in Appendix A.

2.2.3 A combination between entities, businesses or nonprofit activities under common control

Combinations between entities that are under common control are excluded from the scope of the guidance in ASC 805. However, guidance on the accounting for common control transactions is included in the subsections of ASC 805-50. A more detailed discussion of the accounting for combinations between entities under common control is included in Appendix C. Note that the guidance on the accounting for combinations between entities under common control included in ASC 805 and described in Appendix C is not included in IFRS 3(R). Accordingly, the accounting for combinations of entities under common control may differ under IFRS from that described in Appendix C.

2.2.4 Change of accounting basis in master limited partnerships

Excerpt from Accounting Standards Codification

Business Combinations — Related Issues

Overview and Background

805-50-05-7

Master limited partnerships are partnerships in which interests are publicly traded. Most master limited partnerships are formed from assets in existing businesses. Typically, the general partner of the master limited partnership is affiliated with the existing **business** (that is, the master limited partnership is usually operated as an extension of or complementary to the business of the general partner). The purposes for forming a master limited partnership vary. They can be formed to realize the value of undervalued assets, to pass income and tax-deductible losses directly through to owners, to raise capital, to combine several existing partnerships, or as a vehicle to enable entities to sell, spin off, or liquidate existing operations. A master limited partnership may be created in a variety of ways. Whether a particular transaction is a **business combination** that should be accounted for using the acquisition method or a transaction between entities under common control can be determined only after a careful analysis of all facts and circumstances. The Formation of a Master Limited Partnership Subsections identify specific transactions involving master limited partnerships and provide guidance on whether a new basis of accounting is appropriate.

Scope and Scope Exceptions

805-50-15-7

The guidance in the Formation of a Master Limited Partnership Subsections applies to a publicly traded master limited partnership formed from assets of existing **businesses**. Paragraph 805-50-05-7 explains that, typically, the general partner of the master limited partnership is affiliated with the existing business.

Initial Measurement

805-50-30-7

Because of such factors as the consideration of common ownership and changes in control, a new basis of accounting is not appropriate for any of the following transactions that create a master limited partnership:

a. A **rollup** in which the general partner of the new master limited partnership was also the general partner in some or all of the predecessor limited partnerships and no cash is involved in the transaction. Transaction costs in a rollup shall be charged to expense.

b. A **dropdown** in which the sponsor receives 1 percent of the units in the master limited partnership as the general partner and 24 percent of the units as a limited partner, the remaining 75 percent of the units are sold to the public, and a two-thirds vote of the limited partners is required to replace the general partner.

c. A **rollout**.

d. A **reorganization**.

805-50-30-8

In other situations, it is possible that a new basis of accounting would be appropriate.

805-50-30-9

The issuance of master limited partnership units to a general partner of a predecessor limited partnership who will not be the general partner of the new master limited partnership in settlement of management contracts or for other services that will not carry over to the new master limited partnership has characteristics of compensation rather than of equity and shall be accounted for accordingly by the new master limited partnership.

Transactions involving master limited partnerships, in which entities transfer net assets or the owners of those entities transfer their equity interests to a newly formed entity (some of which are referred to as roll-up or put-together transactions), are in the scope of ASC 805. However, as noted previously, transactions between entities under common control (including transfers of net assets or exchanges of equity interests) are excluded from the scope of ASC 805. Whether a particular transaction involving a master limited partnership is a business combination that should be accounted for under the guidance in ASC 805 or a transaction between entities under common control can be determined only after a careful analysis of all facts and circumstances, particularly the timing of when the entity is created and when the net assets are transferred.

2.2.5 Not-for-profit organizations

ASC 958-805 provides guidance for acquisitions by a not-for-profit entity that is incremental to the guidance in ASC 805. ASC 958-805 also provides guidance for transactions or other events that meet the definition of a merger of not-for-profit entities. The guidance in ASC 958-805 establishes principles and requirements for how a not-for-profit entity:

- Determines whether a combination is a merger or an acquisition
- Applies the carryover method in accounting for a merger
- Applies the acquisition method in accounting for an acquisition, including determining which of the combining entities is the acquirer
- Determines what information to disclose to enable users of financial statements to evaluate the nature and financial effects of a merger or an acquisition

The accounting for a for-profit enterprise's acquisition of a not-for-profit entity is within the scope of ASC 805.

Further, a transaction or other event in which a not-for-profit entity obtains control of another not-for-profit entity but does not consolidate that entity, as described in paragraph 958-810-25-4, is not within the scope of ASC 805 or ASC 958-805. That guidance also does not apply if a not-for-profit entity that obtained control in a transaction or other event in which consolidation was permitted but not required decides in a subsequent annual reporting period to begin consolidating a controlled entity that it initially chose not to consolidate.

2.2.6 Mutual entities

Combinations involving only mutual entities (e.g., credit unions, cooperatives, etc.) should be accounted for using the acquisition method of accounting.

2.2.7 Other scope considerations

Pursuant to the guidance in ASC 805, the acquisition of a consolidated business in exchange for nonmonetary assets, including equity method investments, is considered a business combination.

In addition, the acquisition of noncontrolling interests, subsequent to obtaining control, will be accounted for as an equity transaction and will not result in the application of the acquisition method of accounting. See our FRD, ***Consolidation***, for additional guidance on the "day 2" accounting for noncontrolling interests.

3 The acquisition method

3.1 Overview

Excerpt from Accounting Standards Codification

Business Combinations — Overall

Overview and Background

805-10-05-4

Paragraph 805-10-25-1 requires that a business combination be accounted for by applying what is referred to as the acquisition method. The acquisition method requires all of the following steps:

a. Identifying the acquirer

b. Determining the acquisition date

c. Recognizing and measuring the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree

d. Recognizing and measuring goodwill or a gain from a bargain purchase.

Recognition

805-10-25-1

An entity shall determine whether a transaction or other event is a **business combination** by applying the definition in this Subtopic, which requires that the assets acquired and liabilities assumed constitute a **business**. If the assets acquired are not a business, the reporting entity shall account for the transaction or other event as an asset acquisition. An entity shall account for each business combination by applying the acquisition method.

The FASB replaced the term "purchase method," which previously was used to describe the method of accounting for business combinations, with the term "acquisition method." This change resulted from the FASB's conclusion that a business combination could occur in the absence of a purchase of net assets or equity interests. It also is consistent with the FASB's conclusion that a change in control triggers a new basis in all of the acquired net assets.

The FASB concluded that all acquisitions include four steps:

- Identifying the acquirer (section 3.2)
- Determining the acquisition date (section 3.3)
- Recognizing and measuring the identifiable assets acquired, the liabilities assumed and any noncontrolling interest in the acquiree (section 3.4)
- Recognizing and measuring goodwill or a gain from a bargain purchase (section 3.5)

3.2 Identifying the acquirer (updated June 2022)

Excerpt from Accounting Standards Codification

Business Combinations — Overall

Recognition

805-10-25-4

For each business combination, one of the combining entities shall be identified as the acquirer.

805-10-25-5

The guidance in the General Subsections of Subtopic 810-10 related to determining the existence of a controlling financial interest shall be used to identify the acquirer—the entity that obtains **control** of the **acquiree**. If a business combination has occurred but applying that guidance does not clearly indicate which of the combining entities is the acquirer, the factors in paragraphs 805-10-55-11 through 55-15 shall be considered in making that determination. However, in a business combination in which a variable interest entity (VIE) is acquired, the primary beneficiary of that entity always is the acquirer. The determination of which party, if any, is the primary beneficiary of a VIE shall be made in accordance with the guidance in the Variable Interest Entities Subsections of Subtopic 810-10, not by applying either the guidance in the General Subsections of that Subtopic, relating to a controlling financial interest, or in paragraphs 805-10-55-11 through 55-15.

Implementation Guidance and Illustrations

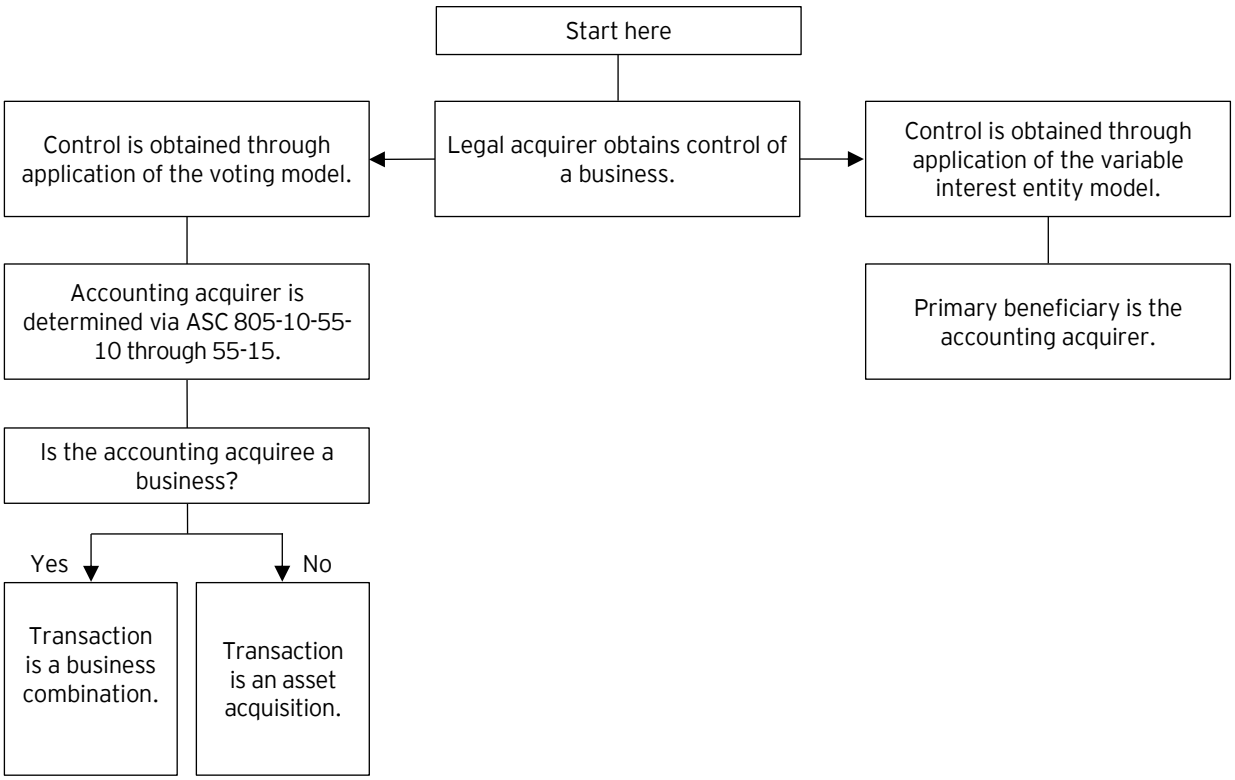
805-10-55-10

Paragraph 805-10-25-5 provides that the guidance in the General Subsections of Subtopic 810-10 related to determining the existence of a controlling financial interest should be used to identify the acquirer in a business combination, except when a variable interest entity (VIE) is acquired. If a business combination has occurred but applying that guidance does not clearly indicate which of the combining entities is the acquirer, paragraph 805-10-25-5 requires the factors in paragraphs 805-10-55-11 through 55-15 to be considered in making that determination.

All business combinations require the identification of the acquiring entity, which is the entity that obtains control of the acquiree. As control is a prerequisite to determining the accounting acquirer, the first step in determining if a business combination has occurred is to determine if control of another entity has been obtained.

Although focused on the determination of whether or not another entity should be consolidated, ASC 810-10 contains guidance on the concept of control that should be applied in determining if one entity has obtained control of another entity and, thus, consummated a business combination. However, the FASB stated that if the determination of the acquiring entity (the controlling entity) is not clearly indicated (i.e., the acquirer is not "obvious") then the guidance in ASC 805-10-55-11 through 55-15 must be considered in order to determine the accounting acquirer.

The flowchart below provides a roadmap for entities to follow as they determine the accounting acquirer.



3.2.1 Identifying the acquirer if the acquiree is a VIE

The determination of whether control has been obtained begins with the evaluation of whether or not control should be evaluated based on variable interests or voting interests. Accordingly, it must first be determined whether the entity is a VIE pursuant to the guidance in the variable interest entities subsections of ASC 810-10. If the entity is a VIE, the primary beneficiary is always considered the acquirer. The determination of the primary beneficiary is solely based on the guidance provided in the variable interest entities subsections of ASC 810-10. See our FRD, ***Consolidation***, for guidance on the determination of the primary beneficiary. ASC 805-10-25-5 states that the guidance in the general subsections of ASC 810-10 related to determining the existence of a controlling financial interest is used to identify the acquirer in a business combination, except when a VIE is acquired.

3.2.2 Identifying the acquirer if the acquiree is a voting interest entity

Excerpt from Accounting Standards Codification

Business Combinations — Overall

Implementation Guidance and Illustrations

805-10-55-11

In a business combination effected primarily by transferring cash or other assets or by incurring liabilities, the acquirer usually is the entity that transfers the cash or other assets or incurs the liabilities.

805-10-55-12

In a business combination effected primarily by exchanging equity interests, the acquirer usually is the entity that issues its equity interests. However, in some business combinations, commonly called **reverse acquisitions**, the issuing entity is the acquiree. Subtopic 805-40 provides guidance on accounting for reverse acquisitions. Other pertinent facts and circumstances also shall be considered in identifying the acquirer in a business combination effected by exchanging equity interests ...

If the acquiree is determined to be a voting interest entity, determining the acquirer starts with an evaluation of the consideration transferred in the exchange. In business combinations that involve consideration other than common stock, the company that pays cash, distributes assets or incurs debt is likely the acquirer. In a business combination involving the exchange of equity interests, the entity that issues the equity interests generally is the acquirer. However, ASC 805 provides that in a business combination involving the exchange of equity interests all pertinent facts and circumstances should be considered. In particular, consideration should be given to which combining company's shareholders obtain, in the aggregate, a controlling interest in the combined company.

Excerpt from Accounting Standards Codification

Consolidation — Overall

Scope and Scope Exceptions

810-10-15-8

For legal entities other than limited partnerships, the usual condition for a controlling financial interest is ownership of a majority voting interest, and, therefore, as a general rule ownership by one reporting entity, directly or indirectly, of more than 50 percent of the outstanding voting shares of another entity is a condition pointing toward consolidation. The power to control may also exist with a lesser percentage of ownership, for example, by contract, lease, agreement with other stockholders, or by court decree.

810-10-15-8A

Given the purpose and design of limited partnerships, **kick-out rights** through voting interests are analogous to voting rights held by shareholders of a corporation. For limited partnerships, the usual condition for a controlling financial interest, as a general rule, is ownership by one limited partner, directly or indirectly, of more than 50 percent of the limited partnership's kick-out rights through voting interests. The power to control also may exist with a lesser percentage of ownership, for example, by contract, lease, agreement with partners, or by court decree.

As a general rule, ownership by one entity, directly or indirectly, of over 50% of the outstanding voting shares (or kick-out rights) of another entity is a condition indicating control and, in a business combination, towards the identity of the accounting acquirer. However, in any case, ownership of more than 50% of the voting rights in the combined entity should not be considered a presumptive factor in determining the accounting acquirer.

Determining the accounting acquirer can be difficult when the combining entities are of nearly equal value or the shareholders of one entity do not clearly control the combined entity based on voting interests. In these circumstances, judgment will be required.

Illustration 3-1: Identifying the acquirer if the acquiree is a voting interest entity

Company A and Company B enter into a merger agreement. Company A issues shares to the shareholders of Company B in exchange for all of the outstanding shares of Company B. The original shareholders of Company A will have 51% of the voting interests of the combined entity and the original shareholders of Company B will have 49% of the voting interests of the combined entity.

Analysis

Because the voting interests of each shareholder group in the combined company are so similar, we do not believe that the difference in voting interests necessarily leads to a presumption that Company A is the acquirer and, as a result, all the pertinent factors discussed in ASC 805-10-55-11 through 55-15 should be considered.

3.2.2.1 Identifying the acquirer when the acquirer is not 'obvious'

The guidance in ASC 805 states that if an acquirer cannot be identified based solely on the outstanding voting interests, the guidance in ASC 805-10-55-11 through 55-13 is considered in determining the acquirer, unless the business combination involves more than two entities (see section 3.2.2.3) or the formation of a new entity to issue equity interests (see section 3.2.2.4), in which cases the additional guidance in ASC 805-10-55-14 and 55-15 is considered.

The FASB did not provide a hierarchy to explain how to assess factors that influence the identification of the acquirer in a business combination, effectively concluding that no single criterion is more significant than any other. Therefore, the determination of the accounting acquirer will require the exercise of professional judgment based on an evaluation of all factors in aggregate. This may be particularly challenging in situations where the factors are mixed (that is, some of the factors may point to one of the combining entities as the accounting acquirer whereas other factors may point to the other combining entity as the accounting acquirer).

In addition to the factors from ASC 805 discussed below, we believe that a company may consider other relevant factors (e.g., the combined entity's name, the location of the combined entity's corporate headquarters or the combined entity's ticker symbol) that would influence the determination of the accounting acquirer.

We also believe companies should be cautious about approaching the factors as a checklist. For example, the combining entity with the most checks (or factors) may not necessarily be the accounting acquirer.

3.2.2.1.1 Relative voting rights

Excerpt from Accounting Standards Codification

Business Combinations — Overall

Implementation Guidance and Illustrations

805-10-55-12(a)

The relative voting rights in the combined entity after the business combination. The acquirer usually is the combining entity whose owners as a group retain or receive the largest portion of the voting rights in the combined entity. In determining which group of owners retains or receives the largest portion of the voting rights, an entity shall consider the existence of any unusual or special voting arrangements and options, warrants, or convertible securities.

All else being equal (that is, when all other relevant factors are neutral and do not favor either party as the accounting acquirer), the acquirer usually is the combining entity whose owners as a group retain or receive the largest portion of the voting rights in the combined entity. We generally believe the more significant the differential in the voting interest of the combining entities, the more difficult it is to conclude that the entity with the largest voting interest is not the acquirer absent other compelling evidence from the other relevant factors.

Based on an assessment of all relevant facts and circumstances, judgment must be applied when evaluating how options, warrants, or convertible instruments, including convertible debt with attributes similar to common stock, are considered. For example, entities should consider the extent to which the instruments are in-the-money, vested and exercisable or convertible. We believe that in-the-money options, warrants and convertible instruments that are vested and exercisable or convertible into voting shares as of the date of consummation (or become so as a result of consummation) generally are considered outstanding shares for purposes of this test.

Greater judgment must be applied when assessing whether options, convertible instruments and other similar instruments that are out-of-the-money and exercisable or convertible into voting shares are considered to represent outstanding shares for the relative voting rights assessment. Factors to consider include the extent by which the instruments are out-of-the-money, the volatility of the underlying shares, expectations that the instruments will become in-the-money before the exercisability or conversion features expire, and the attributes of the holders of the instruments (e.g., board members, executive management or a large minority voting interest holder in one of the combining companies).

We believe that instruments that are not vested or exercisable or convertible until after the consummation date generally should not be considered outstanding shares for purposes of the voting rights assessment unless it is apparent that a sufficient number of instruments will be vested or exercisable or convertible in the near-term, and it can be reasonably concluded that those instruments would be exercised or converted.

3.2.2.1.2 Size of single minority voting interest

Excerpt from Accounting Standards Codification

Business Combinations — Overall

Implementation Guidance and Illustrations

805-10-55-12(b)

The existence of a large minority voting interest in the combined entity if no other owner or organized group of owners has a significant voting interest. The acquirer usually is the combining entity whose single owner or organized group of owners holds the largest minority voting interest in the combined entity.

All else being equal (that is, when all other relevant factors are neutral and do not favor either party as the accounting acquirer), the combining entity with a large minority voting interest concentrated in one individual or entity, or a group of individuals or entities considered under common control, as described in Appendix C, that has an ability to significantly influence the combined entity would be the accounting acquirer. For example, assume Company A and Company B merge, resulting in the former shareholders of each combining company owning approximately 50% of the outstanding shares of the combined company. If a former shareholder of Company A received 30% of the outstanding shares of the combined company (with no other shareholders owning a significant interest), then that would favor Company A as the accounting acquirer.

3.2.2.1.3 Composition of the governing body

Excerpt from Accounting Standards Codification

Business Combinations — Overall

Implementation Guidance and Illustrations

805-10-55-12(c)

The composition of the governing body of the combined entity. The acquirer usually is the combining entity whose owners have the ability to elect or appoint or to remove a majority of the members of the governing body of the combined entity.

All else being equal (that is, when all other relevant factors are neutral and do not favor either party as the accounting acquirer), the combining entity whose continuing shareholders have the ability to elect or appoint a voting majority of the governing body generally would be the accounting acquirer. We believe that when applying this criterion, entities should consider the election schedule of directors and whether the ability to elect or appoint a voting majority of the governing body could change in the near-term. For example, entities should consider the effect of scheduled member retirements or elections over the year

or two following the combination when assessing the governing body of the combined entity. In addition, entities should consider whether the governing body has the ability to make significant decisions affecting the operations of the combined entity for a sufficient period of time.

3.2.2.1.4 Composition of management

Excerpt from Accounting Standards Codification

Business Combinations — Overall

Implementation Guidance and Illustrations

805-10-55-12(d)

The composition of the senior management of the combined entity. The acquirer usually is the combining entity whose former management dominates the management of the combined entity.

All else being equal (that is, when all other relevant factors are neutral and do not favor either party as the accounting acquirer), the entity whose management is able to dominate the management of the combined entity generally is the accounting acquirer. Mandatory retirement dates that could shift management domination in the near-term should be considered. The SEC staff has stated that consideration should be given to the relative number of executive positions taken by the combining entities' former management teams and to the roles, responsibilities, and seniority of those positions.

3.2.2.1.5 Terms of the exchange of equity interests

Excerpt from Accounting Standards Codification

Business Combinations — Overall

Implementation Guidance and Illustrations

805-10-55-12(e)

The terms of the exchange of equity interests. The acquirer usually is the combining entity that pays a premium over the precombination **fair value** of the equity interests of the other combining entity or entities.

All else being equal (that is, when all other relevant factors are neutral and do not favor either party as the accounting acquirer), the acquirer is the combining entity that pays a premium over the precombination fair value of the equity securities of the other combining entity or entities. This factor is considered in any circumstance in which equity instruments are exchanged. However, the reliability of the fair value measurement should be taken into consideration in establishing whether a premium has been paid for equity securities exchanged in a business combination. For example, this factor may be considered less significant in a situation in which the combining companies are not public entities and the fair value of the equity instruments is less objectively determinable.

3.2.2.1.6 Size

Excerpt from Accounting Standards Codification

Business Combinations — Overall

Implementation Guidance and Illustrations

805-10-55-13

The acquirer usually is the combining entity whose relative size (measured in, for example, assets, revenues, or earnings), is significantly larger than that of the other combining entity or entities.

All else being equal (that is, when all other relevant factors are neutral and do not favor either party as the accounting acquirer), if one of the combining companies is significantly larger than the other, that entity generally is the acquirer. The relative size is measured in terms of assets, revenues, earnings, market capitalization, etc.

Illustration 3-2: Identifying the accounting acquirer when the acquirer is not "obvious"

Company A issues shares to the shareholders of Company B in exchange for all of the outstanding shares of Company B. The original shareholders of Company A will have 51% of the voting interests of the combined entity (there are no other equity instruments outstanding at Company A or B).

The Board of Directors will consist of 5 directors from Company B and 4 from Company A, all with 5-year terms. A two-thirds vote of the ownership interests is required for removal of Board members.

Senior management will consist of one member from Company A (Chairman) and two members from Company B (CEO and CFO).

All other relevant factors to consider in the transaction are neutral (i.e., they do not favor either party as the accounting acquirer).

Analysis

In this transaction, although Company A shareholders will have the largest portion of the voting rights, Company B shareholders appear to have the most influence over the combined entity, dominating the Board of Directors and senior management. As such, Company B would be considered the accounting acquirer. Note that as Company A is the legal acquirer (i.e., the issuer of shares), this transaction would be considered a reverse acquisition. See section 3.2.2.2 for a further discussion of the accounting for reverse acquisitions.

Illustration 3-3: Identifying the accounting acquirer when the acquirer is not "obvious"

Assume the same facts as Illustration 3-2, except that:

- One preexisting Company A shareholder owns 30% of the outstanding shares of the combined entity. This shareholder was given veto rights over the composition of the combined entity's Board of Directors.

Analysis

In this transaction, a Company A shareholder owns a significant minority voting interest. Although Company B dominates the Board of Directors and senior management, the shareholder has direct veto rights over the composition of the Board and effectively over the appointment of senior management. As such, Company A shareholders would appear to have the most influence over the combined entity and Company A would be considered the accounting acquirer.

3.2.2.2 Reverse acquisitions

Excerpt from Accounting Standards Codification

Business Combinations — Reverse Acquisitions

Overview and Background

805-40-05-2

As one example of a reverse acquisition, a private operating entity may want to become a public entity but not want to register its equity shares. To become a public entity, the private entity will arrange for a public entity to acquire its equity interests in exchange for the equity interests of the public entity. In

this situation, the public entity is the legal acquirer because it issued its equity interests, and the private entity is the legal acquiree because its equity interests were acquired. However, application of the guidance in paragraphs 805-10-55-11 through 55-15 results in identifying:

a. The public entity as the **acquiree** for accounting purposes (the accounting acquiree)

b. The private entity as the **acquirer** for accounting purposes (the accounting acquirer).

Recognition

805-40-25-1

For a **business combination** transaction to be accounted for as a **reverse acquisition**, the accounting acquiree must meet the definition of a **business**. All of the recognition principles in Subtopics 805-10, 805-20, and 805-30, including the requirement to recognize **goodwill**, apply to a reverse acquisition.

Initial Measurement

805-40-30-1

All of the measurement principles applicable to **business combinations** in Subtopics 805-10, 805-20, and 805-30 apply to a **reverse acquisition**.

In a business combination, the legal acquirer is the entity that issues shares or shares and cash or shares and other consideration. Based on an evaluation of the relevant factors, including those described in section 3.2.2.1, if it is determined that the acquiring company for accounting purposes is not the legal acquirer, then "reverse acquisition" accounting principles apply. That is, the accounting acquirer is the legal acquiree and the legal acquirer is the accounting acquiree. For example, assume that Company A, a legal acquirer, acquires Company B for stock or stock and cash. Based on an evaluation of all relevant factors, Company B is identified as the acquiring company for financial reporting purposes although for legal purposes, Company B is a subsidiary of Company A. Reverse acquisition accounting principles result in the recognition of the fair values (with limited exceptions) of Company A's assets acquired and liabilities assumed in the consolidated financial statements of Company A and Company B on the date of acquisition. Company B's assets and liabilities would continue to be recognized at their historical basis.

Mergers of public companies and relatively larger or more valuable private companies are often executed as reverse acquisitions so that the merged companies can retain public entity status. If the public company involved is determined to have significant precombination activities and elements, and these activities and elements meet the definition of a business, the reverse acquisition transaction constitutes a business combination. If the public company, just prior to the combination does not meet the definition of a business, the transaction is accounted for as the acquisition of an asset or group of assets (see section 3.2.2.2.5 for a discussion of public shell companies).

Question 3.1 **Can a business combination be a reverse acquisition if the legal acquirer pays cash consideration for the legal acquiree?**

Yes. Business combination effected only with cash consideration may still qualify as a "reverse acquisition" if the facts support this conclusion. Normally the entity issuing cash consideration is considered the accounting acquirer. However, despite the form of the consideration, the key determinant in identifying an accounting acquirer remains the power of one party to control the other. Therefore, if there is clear evidence demonstrating that the legal acquiree has obtained control over the legal acquirer, this will overcome the presumption that the legal acquirer is the accounting acquirer and the combination is accounted for as a reverse acquisition.

3.2.2.2.1 *Measuring the consideration transferred in a reverse acquisition*

Excerpt from Accounting Standards Codification

Business Combinations — Reverse Acquisitions

Initial Measurement

805-40-30-2

In a reverse acquisition, the accounting acquirer usually issues no consideration for the **acquiree**. Instead, the accounting acquiree usually issues its equity shares to the owners of the accounting acquirer. Accordingly, the **acquisition-date fair value** of the consideration transferred by the accounting acquirer for its interest in the accounting acquiree is based on the number of equity interests the legal subsidiary would have had to issue to give the owners of the legal parent the same percentage equity interest in the combined entity that results from the reverse acquisition. Example 1, Case A (see paragraph 805-40-55-8) illustrates that calculation. The fair value of the number of equity interests calculated in that way can be used as the fair value of consideration transferred in exchange for the acquiree.

In a reverse acquisition, generally the legal acquirer (accounting acquiree) issues consideration in the transaction. As such, the fair value of the consideration transferred is determined based on the number of equity interests the accounting acquirer (legal acquiree) would have had to issue to the owners of the legal acquirer (accounting acquiree) in order to provide the same ratio of ownership of equity interests in the combined entity as a result of the reverse acquisition. This amount (i.e., the fair value of the consideration transferred) generally will be equal to the fair value of the legal acquirer.

For reverse acquisitions that occur between a public company (as the legal acquirer) and a private company (as the accounting acquirer), the fair value of the legal acquirer's public stock generally is more reliably determinable than the fair value of the accounting acquirer's private stock. As such, the determination of the consideration transferred might be based on the fair value of the legal acquirer's stock rather than the fair value of the accounting acquirer's stock.

If, prior to a reverse acquisition, an accounting acquirer (legal acquiree) owns shares of legal acquirer (accounting acquiree), the acquisition-date fair value of the accounting acquirer's noncontrolling interest in the legal acquirer (accounting acquiree) should be remeasured at fair value and added to the consideration transferred in the exchange. See section 7.4.2 for a discussion of the acquisition-date accounting for an investment held in a newly-controlled entity prior to obtaining control.

Illustration 3-4: Measuring the consideration transferred in a reverse acquisition

Legal Acquirer (accounting acquiree) is a public company with 100 shares outstanding and a fair value of $1,000 per share (total fair value of $100,000). Accounting Acquirer (legal acquiree) is a public company with 500 shares outstanding and a fair value of $800 per share (total fair value of $400,000). Legal Acquirer (accounting acquiree) issues 400 shares of common stock to acquire all of the outstanding common shares of Accounting Acquirer (legal acquiree). After the consummation of the transaction, former Accounting Acquirer (legal acquiree) shareholders will own 80% of the combined entity (400 shares issued/500 shares outstanding) and the shareholders of Legal Acquirer will own 20% of the combined entity.

Analysis

As both entities are public, there is a market value for the stock of both entities. At the acquisition date, the fair value of the consideration transferred is determined based on the number of shares the Accounting Acquirer would have had to issue to the shareholders of the Legal Acquirer for the ownership ratio in the combined entity to be the same. If Accounting Acquirer issued 125 shares to the Legal Acquirer, the shareholders of the Legal Acquirer would own 125 shares out of a total of 625 shares (20%), which is the same ratio the shareholders of Legal Acquirer own after the reverse acquisition. As such, the fair value of the consideration transferred is $100,000 (125 shares x $800 per share).

If Accounting Acquirer were a private company, the fair value of Legal Acquirer (100 shares x $1,000 per share) would be used to determine the consideration transferred as it is likely this amount would be the most reliably determinable fair value.

3.2.2.2.2 Share-based payments in a reverse acquisition

In a business combination the acquirer often exchanges its share-based payment awards for awards held by grantees of the target entity. Reverse acquisitions are no different, except that the accounting for such exchanges might appear counterintuitive because of the legal form of the transaction. From a legal perspective, the form of an outstanding share-based payment award held by the grantees of the legal acquirer has not changed; however, from an accounting perspective, the award has been exchanged for a share-based payment award of the accounting acquirer. As such, all or a portion of the acquisition-date fair value of the legal acquirer's (accounting acquiree's) share-based payment awards are included as part of the consideration transferred by the accounting acquirer. Section 6.3 discusses how to determine which portion of the fair value of the share-based payment awards are included in consideration transferred and which portion, if any, should be considered compensation cost recognized in the financial statements of the accounting acquirer. Generally, the portion of the award that is part of the consideration transferred is determined by multiplying the fair value of the award by the portion of the requisite service period that elapsed prior to the business combination divided by the total service period.

For share-based payment awards held by the grantees of the accounting acquirer (legal acquiree), the legal exchange of accounting acquirer awards for legal acquirer awards is considered, from an accounting perspective, to be a modification of the accounting acquirer's outstanding awards. This modification should be accounted for pursuant to ASC 718. See section 8 of our FRD, ***Share-based payment***, for further guidance on the accounting for modifications.

3.2.2.2.3 Noncontrolling interests in a reverse acquisition

Excerpt from Accounting Standards Codification

Business Combinations — Reverse Acquisitions

Recognition

805-40-25-2

In a reverse acquisition, some of the owners of the legal acquiree (the accounting acquirer) might not exchange their equity interests for equity interests of the legal parent (the accounting acquiree). Those owners are treated as a **noncontrolling interest** in the consolidated financial statements after the reverse acquisition. That is because the owners of the legal acquiree that do not exchange their equity interests for equity interests of the legal acquirer have an interest in only the results and net assets of the legal acquiree—not in the results and net assets of the combined entity. Conversely, even though the legal acquirer is the **acquiree** for accounting purposes, the owners of the legal acquirer have an interest in the results and net assets of the combined entity.

Initial Measurement

805-40-30-3

The assets and liabilities of the legal acquiree are measured and recognized in the consolidated financial statements at their precombination carrying amounts (see paragraph 805-40-45-2(a)). Therefore, in a reverse acquisition the noncontrolling interest reflects the noncontrolling shareholders' proportionate interest in the precombination carrying amounts of the legal acquiree's net assets even though the noncontrolling interests in other acquisitions are measured at their fair values at the acquisition date.

Because of the nature of a reverse acquisition, all shareholders of the legal acquirer/accounting acquiree participate in the transactions and, therefore, there are no noncontrolling interests in the legal acquirer/accounting acquiree after consummation of the reverse acquisition.

Shareholders of the accounting acquirer that do not participate in the reverse acquisition would continue to have a legal interest in the accounting acquirer; however, such shareholders would not have a legal interest in the legal acquirer. Thus, in a legal sense, noncontrolling interests might exist in the accounting acquirer/legal acquiree after a reverse acquisition is executed. In the consolidated financial statements of the combined entity after the acquisition, that legal noncontrolling interest is presented as such. As illustrated in section 3.2.2.2.4, the assets and liabilities of the accounting acquirer/legal acquiree are recognized at their precombination historical carrying value. Consequently, any remaining noncontrolling interest in the accounting acquirer/legal acquiree is recognized based on its legal status as noncontrolling interest in the net assets of the accounting acquirer/legal acquiree. Any such noncontrolling interest is effectively reclassified within the historical capital accounts of the accounting acquirer/legal acquiree upon consummation of the reverse acquisition and measured based on its proportionate interest in the carrying value of the predecessor's (now legal subsidiary's) net assets. Generally, in a business combination that is not a reverse acquisition, noncontrolling interests in the acquired company are recognized at fair value under ASC 805; thus, the recognition of noncontrolling interests in the legal acquiree at historical cost is unique to reverse acquisition accounting.

Any changes to the outstanding noncontrolling interests after the acquisition date are accounted for pursuant to the guidance in ASC 810. See our FRD, ***Consolidation***, for additional guidance on the "day 2" accounting for noncontrolling interests.

3.2.2.2.4 Financial statement presentation

Excerpt from Accounting Standards Codification

Business Combinations — Reverse Acquisitions

Other Presentation Matters

805-40-45-1

Consolidated financial statements prepared following a **reverse acquisition** are issued under the name of the legal parent (accounting acquiree) but described in the notes as a continuation of the financial statements of the legal subsidiary (accounting acquirer), with one adjustment, which is to retroactively adjust the accounting acquirer's legal capital to reflect the legal capital of the accounting acquiree. That adjustment is required to reflect the capital of the legal parent (the accounting acquiree). Comparative information presented in those consolidated financial statements also is retroactively adjusted to reflect the legal capital of the legal parent (accounting acquiree).

805-40-45-2

Because the consolidated financial statements represent the continuation of the financial statements of the legal subsidiary except for its capital structure, the consolidated financial statements reflect all of the following:

a. The assets and liabilities of the legal subsidiary (the accounting acquirer) recognized and measured at their precombination carrying amounts.

b. The assets and liabilities of the legal parent (the accounting acquiree) recognized and measured in accordance with the guidance in this Topic applicable to **business combinations**.

c. The retained earnings and other equity balances of the legal subsidiary (accounting acquirer) before the business combination.

d. The amount recognized as issued equity interests in the consolidated financial statements determined by adding the issued equity interest of the legal subsidiary (the accounting acquirer) outstanding immediately before the business combination to the **fair value** of the legal parent (accounting acquiree) determined in accordance with the guidance in this Topic applicable to business combinations. However, the equity structure (that is, the number and type of equity interests issued) reflects the equity structure of the legal parent (the accounting acquiree), including the equity interests the legal parent issued to effect the combination. Accordingly, the equity structure of the legal subsidiary (the accounting acquirer) is restated using the exchange ratio established in the acquisition agreement to reflect the number of shares of the legal parent (the accounting acquiree) issued in the reverse acquisition.

e. The **noncontrolling interest's** proportionate share of the legal subsidiary's (accounting acquirer's) precombination carrying amounts of retained earnings and other equity interests as discussed in paragraphs 805-40-25-2 and 805-40-30-3 and illustrated in Example 1, Case B (see paragraph 805-40-55-18).

In a business combination, the fair value (with limited exceptions) of the assets acquired and liabilities assumed are recognized by the acquirer on the acquisition date. That guidance also applies to the accounting for a reverse acquisition. From an accounting perspective, the financial statements of the combined entity represent a continuation of the financial statements of the accounting acquirer/legal acquiree. As such, the historical cost bases of assets and liabilities of the acquiring entity (the accounting acquirer/legal acquiree) are maintained in the consolidated financial statements of the merged company and the assets and liabilities of the acquired entity (the legal acquirer) are accounted for under the acquisition method. Results of operations of the acquired entity (the legal acquirer) are included in the financial statements of the combined company only from the acquisition date.

Stockholders' equity of the accounting acquirer is presented as the equity of the combined company as follows:

- Capital Stock: The historical capital stock account of the accounting acquirer immediately prior to the reverse acquisition is carried forward. However, the balance is adjusted to reflect the par value of the outstanding stock of the legal acquirer, including the number of shares issued in the business combination as the legal acquirer is the surviving legal entity. Any necessary, corresponding offset is added to the additional paid-in capital account.
- Additional paid-in capital (APIC): The historical APIC account of the accounting acquirer immediately prior to the acquisition is carried forward and is increased to reflect the additional fair value of the legal acquirer less the par value of the shares held by the legal acquirer's preacquisition shareholders.
- Retained Earnings: Retained earnings of the accounting acquirer are carried forward after the acquisition.
- Prior Period Presentation: For periods prior to the business combination, shareholders' equity of the combined enterprise is presented based on the historical equity of the accounting acquirer prior to the merger retroactively restated to reflect the number of shares received in the business combination.

3.2.2.2.4.1 *Earnings per share (EPS)*

Excerpt from Accounting Standards Codification

Business Combinations — Reverse Acquisitions

Other Presentation Matters

805-40-45-3

As noted in (d) in the preceding paragraph, the equity structure in the consolidated financial statements following a reverse acquisition reflects the equity structure of the legal acquirer (the accounting acquiree), including the equity interests issued by the legal acquirer to effect the business combination.

805-40-45-4

In calculating the weighted-average number of common shares outstanding (the denominator of the earnings-per-share [EPS] calculation) during the period in which the reverse acquisition occurs:

a. The number of common shares outstanding from the beginning of that period to the **acquisition date** shall be computed on the basis of the weighted-average number of common shares of the legal acquiree (accounting acquirer) outstanding during the period multiplied by the exchange ratio established in the merger agreement.

b. The number of common shares outstanding from the acquisition date to the end of that period shall be the actual number of common shares of the legal acquirer (the accounting acquiree) outstanding during that period.

805-40-45-5

The basic EPS for each comparative period before the acquisition date presented in the consolidated financial statements following a reverse acquisition shall be calculated by dividing (a) by (b):

a. The income of the legal acquiree attributable to common shareholders in each of those periods

b. The legal acquiree's historical weighted-average number of common shares outstanding multiplied by the exchange ratio established in the acquisition agreement.

As discussed above, EPS for periods prior to the acquisition date for a reverse acquisition is restated. The retroactive restatement is based on the same number of weighted-average shares outstanding that the accounting acquirer presents as outstanding in each historic period pursuant to the guidance in the preceding section. The denominator of the historical, restated EPS calculation is adjusted by multiplying (or possibly dividing) the weighted-average shares used in each historically reported EPS calculation by the agreed-upon exchange ratio. For reverse acquisitions that result in accounting acquirer noncontrolling interest as described in section 3.2.2.2.3, the historical EPS would not consider any noncontrolling shares that remained outstanding but, rather, would be presented in the same manner as if all the shares of the accounting acquirer were exchanged (i.e., including noncontrolling shares).

Illustration 3-5: Reverse acquisition accounting[8]

Balance sheets of Legal Acquirer and Accounting Acquirer just prior to a reverse acquisition are as follows:

	Legal Acquirer (Accounting Acquiree)	Accounting Acquirer (Legal Acquiree)
Net current assets	$ 20,000	$ 50,000
Common shares outstanding	100	500
Capital stock (par value)	$ 10	$ 100
APIC	990	4,900
Retained earnings	19,000	45,000
Total shareholders' equity	$ 20,000	$ 50,000

Legal Acquirer is a public company with a fair value of $1,000 per share (total fair value of $100,000). Accounting Acquirer is a public company with a fair value of $800 per share (total fair value of $400,000).

Legal Acquirer issues 400 shares of common stock to acquire all of the outstanding 500 common shares of Accounting Acquirer. After the consummation of the transaction, former Accounting Acquirer shareholders will own 80% of the combined entity. All factors (i.e., the criteria discussed in ASC 805-10-55-11 through 55-15) indicate that for accounting purposes, Accounting Acquirer is the acquiring entity. As such, under the acquisition method, the assets acquired and liabilities assumed from Legal Acquirer will be recognized at 100% of their fair values (with limited exceptions) and consolidated with the historical carrying values of Accounting Acquirer's net assets.

At the acquisition date, the fair value of the consideration transferred is determined based on the number of shares Accounting Acquirer would have had to issue to the shareholders of Legal Acquirer for the ownership ratio in the combined entity to be the same. If Accounting Acquirer issued 125 shares to the shareholders of Legal Acquirer, the shareholders of Legal Acquirer would own 125 shares out of a total of 625 shares (20%), which is the same ratio the shareholders of Legal Acquirer own after the reverse acquisition. As such, the fair value of the consideration transferred is $100,000 (125 shares x $800 per share), which is also the fair value of Legal Acquirer (100 shares x $1,000 per share).

For purposes of simplicity, this example assumes that Legal Acquirer has no identifiable intangible assets and that the fair value of its net current assets equals $20,000 (the historical cost basis of the net current assets). As such, the fair value assigned to Legal Acquirer's net assets is as follows:

Fair value of consideration transferred	$ 100,000
Fair value of net current assets	(20,000)
Goodwill	$ 80,000

[8] Note that ASC 805-40-55-3 through 55-23 also include a comprehensive example of the accounting for a reverse acquisition.

The accounting required to effect the reverse acquisition is summarized below:

	Accounting Acquirer Historical Value	Legal Acquirer Fair Value	Reverse Acquisition Equity Adjustments	Consolidated Accounting Acquirer
Net current assets	$ 50,000	$ 20,000		$ 70,000
Goodwill		80,000		80,000
Total assets	$ 50,000	$ 100,000		$ 150,000
Capital stock	$ 100	$ –	(50)	$ 50
APIC	4,900	100,000	50	104,950
Retained earnings	45,000	–		45,000
Total shareholders' equity	$ 50,000	$ 100,000		$ 150,000

After the reverse acquisition, there are 500 shares outstanding (100 initially outstanding plus 400 issued in the business combination) of Legal Acquirer at a par value of $0.10, or $50. As such, Accounting Acquirer reduces its historical capital stock account to reflect the par value of Legal Acquirer's outstanding capital stock.

Historical Capital Accounts and Earnings per Share

Assume that the reverse acquisition was completed on 30 June 20X8. For the six-month period from 1 January 20X8 through 30 June 20X8 (the Pre-acquisition Period), Accounting Acquirer (Legal Acquiree) had net income of $1,000 and for the six-month period from 1 July 20X8 through 31 December 20X8 (the Post-acquisition Period), the combined entity had net income of $1,000. In the Pre-acquisition Period, Accounting Acquirer had 300 shares outstanding for three months and 500 shares outstanding for three months, resulting in weighted-average shares outstanding of Accounting Acquirer prior to the reverse acquisition of 400 shares [(300 shares x (3 months/6 months)) plus (500 shares x (3 months/6 months))]. In the Post-acquisition Period, Legal Acquirer had no changes to the number of outstanding shares.

The combined entity's EPS for 20X8 is $4.88 (net income of $2,000/410 weighted-average shares). The weighted-average shares are calculated as follows:

Accounting Acquirer weighted-average shares	400 shares	
Exchange ratio (% of ownership)	x 0.8	
Accounting Acquirer Pre-acquisition Period weighted average shares	320 shares	
	x 6/12	160 shares
Legal Acquirer Post-acquisition Period weighted average shares	500 shares	
	x 6/12	250 shares
Total weighted-average shares		410 shares

In Accounting Acquirer's 31 December 20X7 statement of financial position (presented comparatively in the 31 December 20X8 financial statements), its capital accounts will reflect 240 outstanding shares (300 shares outstanding as of 31 December 20X7 multiplied by the exchange ratio of 0.8).

Illustration 3-6: Reverse acquisition accounting with noncontrolling interest

Assume the same facts as in Illustration 3-5, except that instead of purchasing all of Accounting Acquirer's outstanding common stock, Legal Acquirer purchases only 80% or 400 shares of Accounting Acquirer, leaving a legal minority interest in Accounting Acquirer of 100 shares outstanding. To acquire the 400 shares of Accounting Acquirer, Legal Acquirer issues 320 shares, which results in the former shareholders of Accounting Acquirer owning 76% of the merged entity.

At the acquisition date, the fair value of the consideration transferred is the same as Illustration 3-5. This is determined based on the number of shares Accounting Acquirer would have had to issue to the shareholders of Legal Acquirer for the ownership ratio in the combined entity to be the same. This calculation ignores the noncontrolling interest because they have an interest only in Accounting Acquirer and not the combined entity. Ignoring the noncontrolling interests (100 shares), if Accounting Acquirer issued 125 shares to Legal Acquirer, the shareholders of Legal Acquirer would own 125 shares out of a total of 525 shares (24%), which is the same ratio the shareholders of Legal Acquirer own after the reverse acquisition. As such, the fair value of the consideration transferred is $100,000 (125 shares x $800 per share), which is also the fair value of Legal Acquirer (100 shares x $1,000 per share). The fact that the noncontrolling interest remains in the accounting acquirer after the business combination should not affect the determination of the consideration transferred.

The accounting required to effect Accounting Acquirer's reverse acquisition is summarized below:

	Accounting Acquirer historical value	Legal Acquirer fair value	Reverse acquisition equity adjustments	Consolidated Accounting Acquirer
Net current assets	$ 50,000	$ 20,000		$ 70,000
Goodwill	–	80,000		80,000
Total assets	$ 50,000	$100,000		$ 150,000
Noncontrolling interest	$ –	$ –	10,000	$ 10,000
Capital stock	100	–	(58)	42
APIC	4,900	100,000	(9,942)	94,958
Retained earnings	45,000	–		45,000
Total liabilities and shareholders' equity	$ 50,000	$100,000		$ 150,000

The noncontrolling interest is measured at the historical carrying value of Accounting Acquirer's remaining outstanding shares (100 x ($50,000/500 shares) or $10,000) with the corresponding offsetting entry reducing the combined entity's APIC. Further, as the number of shares issued by Legal Acquirer is less than if all Accounting Acquirer's shareholders participated in the exchange, the adjusted capital stock account is lower than in Illustration 3-5. After the reverse acquisition, there are 420 shares outstanding (100 initially outstanding plus 320 issued in the business combination) of Legal Acquirer at a par value of $0.10, or $42. As such, Accounting Acquirer reduces its historical capital stock account to reflect the par value of Legal Acquirer's outstanding capital stock.

The calculation of the pre-acquisition period weighted-average shares for EPS purposes would be as described in the preceding illustration. The calculation of post-acquisition shares will exclude the shares characterized as noncontrolling interest in Accounting Acquirer. Accordingly, the weighted-average shares are calculated as follows:

Accounting Acquirer weighted-average shares	400 shares	
Exchange ratio (% of ownership)	x 0.8	
Pre-acquisition Period weighted average shares	320 shares	
	x 6/12	160 shares
Post-acquisition Period weighted average shares	420 shares	
	x 6/12	210 shares
Total weighted-average shares		370 shares

The earnings attributable to the noncontrolling interest would be deducted from the consolidated net income for the year and divided by 370 to derive basic EPS.

3.2.2.2.5 Transactions involving public shell companies

One way for a private company to gain access to the public markets and increase liquidity is through the acquisition of a public shell company. A shell company is a dormant, non-operating entity. A public shell company might exist as the result of the failure or liquidation of a public company for which the legal entity has not been dissolved. A public shell company would not meet the definition of a business under ASC 805. The SEC staff believes that the merger of a private operating company into a public shell corporation with nominal net assets typically results in the owners and management of the private company having actual or effective operating control of the combined company after the transaction, with shareholders of the former public shell continuing only as passive investors. As such, for accounting purposes, mergers of operating private companies into public shell companies are considered to be capital transactions rather than business combinations. These transactions are equivalent to the issuance of stock by the private company for the net monetary assets, if any, of the shell corporation, accompanied by a recapitalization. The accounting for the transaction is identical to that resulting from a reverse acquisition, except that goodwill or other intangibles should not be recognized.

In addition, a transaction where a private company merges into a public company that has net assets that are not assessed as "nominal" may be accounted for as a recapitalization. For this to be the case, in addition to the former private company owners having actual or effective control of the merged entities after the transaction, with shareholders of the former public shell continuing only as passive investors, the pre-transaction net assets of the public company should be non-operating assets. Refer to section 3.2.2.5 for additional information on recapitalizations.

3.2.2.2.5.1 Special purpose acquisition companies (updated June 2023)

A special purpose acquisition company (SPAC) has no operations but is established as a public investment vehicle that has the expressed purpose of making an investment in an operating company. These operating companies are usually privately held companies that use the SPAC merger to become publicly traded companies. Generally, a SPAC is initially capitalized by sponsors, who contribute nominal capital or fund formation and offering costs in exchange for founder shares and warrants, which become exercisable shortly after the SPAC acquires an operating company. The warrants are issued with a strike price that is out-of-the-money and are intended to compensate holders for investing their capital in the SPAC before it acquires an operating company. Proceeds from the initial public offering (IPO) are placed in a trust account for use in an acquisition. A SPAC has a defined term (generally 18 to 24 months from the date of its IPO) during which it must identify a target and consummate an acquisition; otherwise, the SPAC is liquidated, and the IPO proceeds are returned to investors. A SPAC also may be referred to as a "blank check" company.

In contrast, as described above, a public shell company is a dormant, non-operating entity that typically exists as the result of the failure or liquidation of a public company for which the legal entity has not been dissolved. A SPAC is not a public shell; a SPAC has significant precombination activities in that it has a strategy of pursuing investment opportunities. Therefore, the merger of an operating company into a SPAC is not automatically considered a reverse merger of the operating company into a public shell company.

Entities in a SPAC transaction, like entities involved in a business combination, need to first consider the variable interest model in ASC 810-10, which requires the primary beneficiary of a VIE to consolidate the VIE in all instances. That is, if the acquiree is a VIE, the primary beneficiary will be the accounting acquirer. The factors in ASC 805-10-55-11 through 55-15 are not considered when applying the VIE model to determine the accounting acquirer. If the VIE model doesn't apply, an accounting acquirer must be identified pursuant to the criteria in ASC 805-10-55-11 through 55-15, and the SPAC may be considered the accounting acquirer. When a SPAC acquires a business for all cash consideration, the SPAC is usually the accounting acquirer. If the consideration is equity or a mix of cash and equity, determining the accounting acquirer will require further evaluation and may involve significant judgment. See our Technical Line, ***Navigating the requirements for merging with a special purpose acquisition company***, for further information.

If an operating company is determined to be the accounting acquirer in a merger with a SPAC, the accounting for the transaction will be similar to that of a capital infusion as it is likely that the only precombination asset of the SPAC is cash obtained from the SPAC's investors. If a SPAC is determined to be the accounting acquirer in a merger with an operating company, the fair value of the operating company and, with limited exceptions, its assets acquired and liabilities assumed, are recognized in accordance with the guidance in ASC 805.

3.2.2.3 Combinations of more than two entities

Excerpt from Accounting Standards Codification

Business Combinations — Overall

Implementation Guidance and Illustrations

805-10-55-14

In a business combination involving more than two entities, determining the acquirer shall include a consideration of, among other things, which of the combining entities initiated the combination, as well as the relative size of the combining entities, as discussed in the preceding paragraph.

The transactions described in ASC 805-10-55-14 often are referred to as "roll-up" or "put-together" transactions. These transactions are business combinations and one of the combining companies should be identified as the acquirer. In addition to the criteria established in paragraphs ASC 805-10-55-11 and 55-12, identifying the entity that initiated the combination, the relative size of the combining enterprises, and other pertinent information might indicate the party that ultimately will have the most influence on the combined enterprise. When considering whether one of the combining companies' assets, revenues, and earnings significantly exceed those of the others, the relative asset sizes should be assessed on the basis of precombination carrying amounts. In some situations, evaluating the combining entities' relative asset sizes on the basis of their fair values may be appropriate (e.g., if that analysis would provide more meaningful information).

Illustration 3-7: "Roll-up" transaction

Company A, Company B and Company C are distributors operating in a competitive, low margin industry. Company A initiates discussions that result in the three entities merging their operations into a new entity to reduce their operating costs and generate economies of scale through increased purchasing volume. Companies B and C are of similar size, but Company A's net assets (at fair value), revenues, and earnings significantly exceed those of Companies B and C. Ownership of the combined entity will be as follows: Company A-44%, Company B-28% and Company C-28%. The Board of Directors and senior management are equally divided among the three entities and a majority vote is required to remove members from the Board. No other factors are present that would be relevant to determining the acquirer.

Analysis

Company A initiated the merger discussions and has assets, revenues, and earnings that significantly exceed those of either Company B or C. Thus, Company A would be considered the acquirer in this roll-up transaction.

3.2.2.4 Combinations involving a 'Newco'

Excerpt from Accounting Standards Codification

Business Combinations — Overall

Implementation Guidance and Illustrations

805-10-55-15

A new entity formed to effect a business combination is not necessarily the acquirer. If a new entity is formed to issue equity interests to effect a business combination, one of the combining entities that existed before the business combination shall be identified as the acquirer by applying the guidance in paragraphs 805-10-55-10 through 55-14. In contrast, a new entity that transfers cash or other assets or incurs liabilities as consideration may be the acquirer.

A business combination may be consummated by forming a new entity (commonly characterized as a "Newco") that has no significant precombination activities other than to issue shares to the shareholders of the combining companies. In such situations, regardless of the number of entities involved in the combination, ASC 805-10-55-15 precludes Newco from being identified as the acquirer. For example, Company A and Company B agree to merge and form a new entity in order to accomplish the merger of the two companies (assume the new entity is not a joint venture as defined in ASC 323). In this case, either Company A or Company B should be identified as the acquirer in a purchase business combination based on application of the guidance in section 3.2. This is consistent with paragraph B100 of the Basis for Conclusions to Statement 141(R), which states:

> The IASB also considered whether treating a new entity formed to issue equity instruments to effect a business combination as the acquirer would place the form of the transaction over its substance, because the new entity may have no economic substance. The formation of such entities is often related to legal, tax, or other business considerations that do not affect the identification of the acquirer. For example, a combination between two entities that is structured so that one entity directs the formation of a new entity to issue equity instruments to the owners of both of the combining entities is, in substance, no different from a transaction in which one of the combining entities directly acquires the other. Therefore, the transaction should be accounted for in the same way as a transaction in which one of the combining entities directly acquires the other. To do otherwise would impair both the comparability and the reliability of the information.

However, the Newco may be the accounting acquirer if it is determined to be substantive. If the new entity has been involved in significant precombination activities (e.g., raising capital, identifying acquisition targets, negotiating transactions, and promoting the business combination) then it would be considered substantive and could be the accounting acquirer. In a 16 August 2001 letter to the FASB, the SEC staff

described its continued belief that a newly-formed entity with significant precombination activities cannot be viewed as an entity formed solely to issue equity interests to effect a business combination. In such cases, Newco would be considered substantive and therefore could be deemed the accounting acquirer. This view is consistent with views previously expressed in SEC staff speeches.[9,10] The FASB staff has previously indicated that the SEC staff's interpretation was not inconsistent with the guidance in ASC 805.

Whether a newly-formed entity is involved in "significant precombination activities" is a matter of judgment. We believe that the establishment of and capitalization of a new entity by equity investment would not, in and of itself, be considered a significant precombination activity. However, if the new company raises debt financing for use as consideration in an acquisition transaction, that financing activity would qualify as a significant precombination activity. Significant precombination activities might also be indicated by the newly-formed entity having assets other than cash related to the initial equity investment, including previous stock ownership in the target. Generally, it should not matter which entity formed the Newco (i.e., the buyer or the seller) in the analysis of whether or not Newco is substantive.

In addition, if a Newco survives the transaction (i.e., the Newco is not transitory), we believe that is an indicator that a Newco may be substantive (and therefore the accounting acquirer). All facts and circumstances should be considered in the analysis, and significant judgment will be required.

Illustration 3-8 below summarizes the circumstances that entities may consider when evaluating whether a Newco is substantive for purposes of identifying an accounting acquirer. The indicators should be evaluated holistically when making this determination.

Illustration 3-8: Identifying the accounting acquirer when an acquisition involves a Newco

Indicators that Newco does not have substance	Indicators that Newco has substance
Newco is transitory and does not survive the transaction.	Newco survives the transaction.
No changes in control when considering the ownership structure of Newco compared to the ownership structure of the target prior to the merger.	Changes in control when considering the ownership structure of Newco compared to the ownership structure of the target prior to the merger.
Newco only issues equity in exchange for its interest in the target.	Newco issues debt and/or pays cash in exchange for its interest in the target.
The reason a Newco was used to effect the business combination lacks substance.	The reason a Newco was used to effect the business combination has substance.
Newco is not involved in significant precombination activities, such as: ▸ Raising capital ▸ Identifying acquisition targets ▸ Negotiating transactions ▸ Promoting the business combination	Newco is involved in significant precombination activities, such as: ▸ Raising capital ▸ Identifying acquisition targets ▸ Negotiating transactions ▸ Promoting the business combination
No change in the governance structure (e.g., board composition) and/or composition of management of Newco (compared to that of the target).	Significant change in governance structure (e.g., board composition) and/or composition of management of Newco (compared to that of the target).

[9] Douglas T. Parker, Professional Accounting Fellow, Office of the Chief Accountant, *Remarks before the 2009 AICPA National Conference on Current SEC and PCAOB Developments*, 7 December 2009.

[10] Pamela R. Schlosser, Professional Accounting Fellow, Office of the Chief Accountant, *Remarks before the 2005 AICPA National Conference on Current SEC and PCAOB Developments*, December 5, 2005.

If the newly formed entity is determined to be the acquiring entity, each entity that merges into the newly formed entity would be considered an acquiree in a business combination. Accordingly, the acquisition method would apply to each of the entities merged into the newly-formed entity. That is, a new basis would be measured and recognized for the assets and liabilities of each entity merged into Newco.

Because the accounting for a business combination involving a Newco is largely based on SEC interpretations, greater diversity in practice may exist when this guidance is applied by private companies.

3.2.2.4.1 Examples: combinations involving a Newco

Illustration 3-9: Combination involving a non-substantive Newco — example 1

Company A forms a Newco to facilitate a merger between Company A and Company B. Newco issues 100% of its equity interests to the owners of Company A and Company B in exchange for their ownership interests. Newco has not performed any other activities.

Analysis

In substance, the transaction is no different from a transaction in which one of the combining entities (i.e., Company A or Company B) directly acquires the other. Accordingly, Newco is not considered substantive in this situation and the transaction should be accounted for in the same way as a transaction in which one of the combining entities directly acquires the other. Company A and Company B must be evaluated to determine which entity is the accounting acquirer.

Illustration 3-10: Combination involving a non-substantive Newco — example 2

A private equity firm (PE) has been negotiating to acquire Target and to raise the necessary capital from financial institutions to complete the transaction. PE forms Newco, which is capitalized with cash from PE. The purpose of forming Newco is to force all the shareholders of Target to participate in the exchange rather than completing a tender offer, through which PE cannot compel complete participation.

Target is owned 90% by the public and 10% by management (who will continue with Newco). Target issues debt prior to the combination, which equates to 20% of the total expected financing of the combination. Newco merges with Target and Target is the surviving entity. Target's shareholders receive cash in exchange for all outstanding Target shares. PE controls the combined entity.

Analysis

Because Newco was formed only as a transitory entity to effect the merger with Target and has no substantive precombination activities, it is not substantive and therefore is not the accounting acquirer. In this case, PE is the accounting acquirer. Assuming that Target does not elect to apply pushdown accounting, Target's net assets in its separate financial statements would remain at its historical cost basis.

If PE issued financial statements in which Target was consolidated, the assets acquired and liabilities assumed would be recognized at their acquisition-date fair values (with limited exceptions).

Illustration 3-11: Combination involving a substantive Newco

Assume the same facts as Illustration 3-10, except that in addition to being capitalized with cash from PE, Newco (instead of Target) raises the debt financing and survives the transaction as a parent of Target.

Analysis

In this case, Newco would be considered to have significant precombination activities and would be considered the accounting acquirer. As a result, Newco's post-combination financial statements would reflect a new basis in Target's net assets. Target would have the option to elect to apply pushdown accounting (i.e., reflect Newco's new basis) in its separate financial statements.

3.2.2.5 Recapitalizations (updated June 2022)

Recapitalizations are designed to change the capitalization (between debt and equity) or change an investor's voting interest in an entity. Typically, these transactions involve debt financing, the issuance of new shares and/or the repurchase of outstanding common shares. While these transactions may result in a change in control of an entity, they may or may not result in a new basis of accounting at the entity level. Consider the following illustration.

Illustration 3-12: Recapitalization

Company A contributes cash to Company B, an SEC registrant, for newly issued voting common shares giving Company A a 35% interest in Company B. Simultaneously, Company B incurs debt. Company B then uses the new equity and debt proceeds to redeem common shares held by parties other than Company A, resulting in Company A owning 80% of the outstanding common shares of Company B.

Analysis

Company A has indirectly obtained control of Company B and thus accounts for the transaction as a business combination. Absent the election by Company B to apply pushdown accounting, a new basis of accounting is not recognized in the separate financial statements of Company B. ASC 805 defines a business combination as a transaction or other event in which an acquirer obtains control of one or more businesses. When a transaction results in a change of control of just one business and there is no new reporting entity, there can be no new basis at the acquiree level other than via pushdown accounting. Therefore, unless Company B elects to apply pushdown accounting, the separate financial statements of Company B are presented on a historical basis. Refer to Appendix B for information on pushdown accounting.

3.2.2.5.1 Transaction costs in a recapitalization

In connection with a recapitalization, the target frequently incurs fees and expenses associated with the transaction. The accounting for those fees depends on the activities to which the fees relate and the structure of the transaction. Refer to section 6.2 for guidance on the accounting for acquisition-related costs in a business combination.

3.3 Determining the acquisition date

Excerpt from Accounting Standards Codification

Business Combinations — Overall

Recognition

805-10-25-6

The acquirer shall identify the acquisition date, which is the date on which it obtains control of the acquiree.

805-10-25-7

The date on which the acquirer obtains control of the acquiree generally is the date on which the acquirer legally transfers the consideration, acquires the assets, and assumes the liabilities of the acquiree—the closing date. However, the acquirer might obtain control on a date that is either earlier or later than the closing date. For example, the acquisition date precedes the closing date if a written agreement provides that the acquirer obtains control of the acquiree on a date before the closing date. An acquirer shall consider all pertinent facts and circumstances in identifying the acquisition date.

The acquisition date is the date control is obtained and is ordinarily the date that assets are received and other assets are given, liabilities are assumed or incurred, or equity interests are issued (i.e., the closing date or consummation date). For business combinations that do not have a consummation date (i.e., business combinations that occur without the transfer of consideration, as discussed in section 2.1.1), the acquisition date is the date on which control is first obtained. For example, if control is obtained by contract, the acquisition date would be the date the contract is executed or, if control is obtained by an investor as a result of an investee share buyback, the acquisition date is the date the investor obtains a majority voting interest. However, the acquisition date may precede the closing or consummation date if control of the target has been obtained by the acquirer prior to the consummation of the acquisition.

We believe the acquisition date can precede the closing date only if a written agreement is in place as of the designated date that provides for transfer of control of the acquired entity to the acquirer on that date. The written agreement should provide the acquirer with the ability to make decisions about the operations and financing of the acquired entity without impediment. That is, the selling shareholders should not have continuing rights, as it relates to the operation of the target, other than protective rights or blocking actions. If the acquisition date occurs prior to the consummation date, a liability is recognized, at fair value, for the consideration to be transferred to the selling shareholders. That liability is accreted to the date that the consideration is transferred to an amount equal to the consideration transferred.

If the business combination requires regulatory or shareholder approval (or shareholder approval is sought) by either the acquirer or the acquiree, we do not believe that control transfers until such approval is obtained. However, in the case of shareholder approval and after considering all the relevant facts, if management and the board of directors control sufficient votes to approve the transaction, and thus shareholder approval is considered perfunctory, a transfer of control might be deemed to occur prior to the date of shareholder approval and prior to the closing date, but only if a written agreement as described above exists.

Although the "convenience" exception (i.e., the ability to designate an *effective* acquisition date) is no longer included in ASC 805, we believe that an acquirer may designate a date other than the date control of the target is obtained as the acquisition date in order to align the date of acquisition for accounting purposes to an accounting close date. However, the difference between the designated acquisition date and the actual acquisition date should be no more than a few days and the results of operations and change in financial position of the target during the intervening period must not be material to the acquirer.

3.4 Recognizing and measuring the identifiable assets acquired, the liabilities assumed and any noncontrolling interest in the acquiree

This section discusses general concepts related to the recognition and measurement of the net assets acquired, including any noncontrolling interests. See section 4 for further discussion of the recognition and measurement of specific assets, liabilities and any noncontrolling interests.

Excerpt from Accounting Standards Codification

Business Combinations — Identifiable Assets and Liabilities, and Any Noncontrolling Interest

Recognition

805-20-25-1

As of the **acquisition date**, the **acquirer** shall recognize, separately from **goodwill**, the **identifiable** assets acquired, the liabilities assumed, and any **noncontrolling interest** in the **acquiree**. Recognition of identifiable assets acquired and liabilities assumed is subject to the conditions specified in paragraphs 805-20-25-2 through 25-3 ...

As noted in section 1.3, one of the primary principles of ASC 805 is that obtaining control is a new basis recognition event. That is, the assets acquired and liabilities assumed, including any noncontrolling interests, are recognized at 100% of their fair value, with limited exceptions, regardless of the percentage of the equity interests acquired. As such, the next step in the acquisition method under ASC 805, after the identification of the acquirer and determination of the acquisition date, is the recognition and measurement of 100% of the acquired net assets, including any noncontrolling interests. The acquirer's cost of the acquisition is relevant only in the determination of the acquirer's share of the full goodwill, as discussed further in sections 3.5 and 7.1.

3.4.1 Recognition principles

In order to ensure consistency and resolve inconsistencies that existed in practice, the FASB concluded that the guidance in ASC 805 should provide guidance for applying its recognition principle. This guidance emphasizes two fundamental conditions. To recognize an asset or liability when applying the acquisition method, the item acquired or assumed must:

- Meet the definition of an asset or liability at the acquisition date
- Be part of the business combination rather than the result of a separate transaction

3.4.1.1 Meaning of 'an asset or liability at the acquisition date' (updated June 2022)

Excerpt from Accounting Standards Codification

Business Combinations — Identifiable Assets and Liabilities, and Any Noncontrolling Interest

Recognition

805-20-25-2

To qualify for recognition as part of applying the acquisition method, the identifiable assets acquired and liabilities assumed must meet the definitions of assets and liabilities in FASB Concepts Statement No. 6, Elements of Financial Statements, at the acquisition date. For example, costs the acquirer expects but is not obligated to incur in the future to effect its plan to exit an activity of an acquiree or to terminate the employment of or relocate an acquiree's employees are not liabilities at the acquisition date. Therefore, the acquirer does not recognize those costs as part of applying the acquisition method. Instead, the acquirer recognizes those costs in its postcombination financial statements in accordance with other applicable generally accepted accounting principles (GAAP).

805-20-25-4

The acquirer's application of the recognition principle and conditions may result in recognizing some assets and liabilities that the acquiree had not previously recognized as assets and liabilities in its financial statements. For example, the acquirer recognizes the acquired identifiable **intangible assets**, such as a brand name, a patent, or a customer relationship, that the acquiree did not recognize as assets in its financial statements because it developed them internally and charged the related costs to expense.

The FASB issued CON 8.4 to replace CON 6 in December 2021. CON 8.4 includes the following definitions of assets and liabilities:

Assets — A present right of an entity to an economic benefit.

Liabilities — A present obligation of an entity to transfer an economic benefit.

In a business combination accounted for under the guidance in ASC 805, the "entity" referred to in the definition of both assets and liabilities from CON 8.4 should be interpreted as the target entity. As such, when determining what assets and liabilities should be recognized in a business combination, the CON 8.4 definitions should be applied to the target entity (i.e., recognition is based solely on what exists within the target entity at the acquisition date). However, the definitions should not be interpreted to mean that assets or liabilities recognized in the business combination are required to have been recognized previously in the target entity. Often, a target will have assets (e.g., internally developed intangibles) and liabilities (e.g., contingent liabilities) that are not recognized in the predecessor financial statements, even though they meet the CON 8.4 definitions, as a result of the application of authoritative literature that applies outside of a business combination (e.g., ASC 730, ASC 450).

3.4.1.2 Meaning of 'part of the business combination'

Excerpt from Accounting Standards Codification

Business Combinations — Identifiable Assets and Liabilities, and Any Noncontrolling Interest

Recognition

805-20-25-3

In addition, to qualify for recognition as part of applying the acquisition method, the identifiable assets acquired and liabilities assumed must be part of what the acquirer and the acquiree (or its former owners) exchanged in the **business combination** transaction rather than the result of separate transactions. The acquirer shall apply the guidance in paragraphs 805-10-25-20 through 25-23 to determine which assets acquired or liabilities assumed are part of the exchange for the acquiree and which, if any, are the result of separate transactions to be accounted for in accordance with their nature and the applicable GAAP.

Business Combinations — Overall

Recognition

805-10-25-20

The acquirer and the acquiree may have a preexisting relationship or other arrangement before negotiations for the business combination began, or they may enter into an arrangement during the negotiations that is separate from the business combination. In either situation, the acquirer shall identify any amounts that are not part of what the acquirer and the acquiree (or its former **owners**) exchanged in the business combination, that is, amounts that are not part of the exchange for the acquiree. The acquirer shall recognize as part of applying the acquisition method only the consideration transferred for the acquiree and the assets acquired and liabilities assumed in the exchange for the acquiree. Separate transactions shall be accounted for in accordance with the relevant generally accepted accounting principles (GAAP).

805-10-25-21

A transaction entered into by or on behalf of the acquirer or primarily for the benefit of the acquirer or the combined entity, rather than primarily for the benefit of the acquiree (or its former owners) before the combination, is likely to be a separate transaction. The following are examples of separate transactions that are not to be included in applying the acquisition method:

a. A transaction that in effect settles preexisting relationships between the acquirer and acquiree (see paragraphs 805-10-55-20 through 55-23)

b. A transaction that compensates employees or former owners of the acquiree for future services (see paragraphs 805-10-55-24 through 55-26)

c. A transaction that reimburses the acquiree or its former owners for paying the acquirer's acquisition-related costs (see paragraph 805-10-25-23).

805-10-25-22

Paragraphs 805-10-55-18 through 55-26, 805-30-55-6 through 55-13, 805-740-25-10 through 25-11, 805-740-45-5 through 45-6, and Example 2 (see paragraph 805-10-55-30) provide additional guidance for determining whether a transaction is separate from the business combination transaction.

Parties directly involved in the negotiations of an impending business combination may take on the characteristics of related parties. Therefore, they may be willing to enter into other agreements or include as part of the business combination agreement some arrangements that are designed primarily for the benefit of the acquirer or the combined entity; for example, to achieve more favorable financial reporting outcomes after the business combination. Because of concerns that such arrangements might be accounted for as part of the business combination, the FASB developed a principle to ensure each component of the transaction is accounted for in accordance with its economic substance; that is, to determine whether a particular transaction or arrangement entered into by the parties to the combination is part of what the acquirer and acquiree exchange in the business combination or is a separate transaction.

The ASC 805 principle is based on the concept of who receives the primary benefits from the transaction. If the transaction is entered into by or on behalf of the acquirer or primarily for the benefit of the acquirer or the combined entity, rather than primarily for the benefit of the acquiree (or its former owners) before the combination, the transaction is likely a separate transaction that should be accounted for apart from the business combination based on its economic substance. As the identification of these transactions often requires judgment, ASC 805-10-55-18 provides factors that should be considered in assessing whether a transaction is part of a business combination or should be accounted for separately. There is no hierarchy to the following factors. They should not be considered all-inclusive and should be considered holistically.

The reasons for the transaction — Understanding the reasons why the parties to the combination (the acquirer, the acquiree, and their owners, directors, managers, and their agents) entered into a particular transaction or arrangement may provide insight into whether it is part of the consideration transferred and the assets acquired or liabilities assumed.

For example, assume Acquirer includes as part of the consideration transferred to Target's shareholders a contingent consideration arrangement. The former shareholders of Target become employees of the combined entity and will receive a payout of the contingent consideration if certain earnings thresholds are met and they continue to be employed by Acquirer at a specified future date. In this scenario, although the contingent consideration arrangement was negotiated in connection with the business combination, the Acquirer likely entered into the arrangement for its own benefit; that is, in order to provide incentive to the former shareholders to remain as employees of the combined entity. As such,

this contingent consideration arrangement would be accounted for separately from the business combination as a compensatory arrangement. See section 6.4 for further discussion of contingent consideration arrangements.

Who initiated the transaction — Understanding who initiated the transaction may also provide insight into whether it is part of the exchange for the acquiree.

For example, assume Acquirer, in its evaluation of a potential business combination with Target, has identified numerous facilities that would be redundant in the combined entity after the transaction. During the negotiations, Acquirer requests that Target initiate certain restructuring activities in order to eliminate the redundancy. Target agrees to restructure certain activities before the consummation date, but only after receiving shareholder approval for the business combination. In this scenario, Acquirer initiated the transaction and is the recipient of the future economic benefits of the restructuring activities. The fact that Target initiated the restructuring is not substantive because it was done at the acquirer's request and after the business combination was essentially assured of completion. As such, the restructuring activities should be accounted for separately from the business combination and will result in an expense to Acquirer pursuant to the guidance in ASC 420. See section 4.3.2 for further discussion on restructuring activities in a business combination.

In another example, assume that Acquirer enters into a noncompetition arrangement with the target company shareholders (who typically would have been employed by or involved in the management of the target but will not be employed by Acquirer). Because the noncompetition agreement was initiated by Acquirer to protect Acquirer's interests, the noncompetition agreement generally will be accounted for as a transaction separate from the business combination. See section 4.2.5.3.1.1 for additional discussion of noncompetition arrangements.

The timing of the transaction — The timing of the transaction may also provide insight into whether it is part of the exchange for the acquiree.

For example, assume concurrent with the execution of the business combination agreement, Acquirer enters into a supply agreement with Target. Target agrees to supply Acquirer with the raw materials necessary for Acquirer's manufacturing process after the transaction is complete. As this supply arrangement was agreed to concurrent with the business combination, the terms of the arrangement should be evaluated to determine if they are at market value, if the consideration transferred in the business combination was affected by the terms of the future supply arrangement, and if Acquirer is receiving future economic benefits as a result.

ASC 805-10-25-21 includes examples of transactions that require accounting apart from the business combination; however, the following examples should not be considered all inclusive:

- A transaction that in effect settles preexisting relationships between the acquirer and acquiree (see section 4.5)
- A transaction that compensates employees or former owners of the acquiree for future services (see section 6.4.5)
- A transaction that reimburses the acquiree or its former owners for paying the acquirer's acquisition-related costs (see section 6.2)

3.4.1.2.1 Allocating the consideration transferred to a transaction to be accounted for separate from the business combination

As discussed above, an acquirer must determine which assets acquired or liabilities assumed are part of the exchange for the acquiree and which, if any, are the result of separate transactions. However, ASC 805 does not provide guidance on how to allocate the consideration transferred between the various components (i.e., the business combination and the separate transaction(s)). Absent specific guidance, we believe that using a relative fair value approach to allocate the consideration transferred between the two (or more) components would be reasonable and acceptable. Other alternatives may also be acceptable.

3.4.1.3 Classification or designation of assets acquired and liabilities assumed

Excerpt from Accounting Standards Codification

Business Combinations — Identifiable Assets and Liabilities, and Any Noncontrolling Interest

Recognition

805-20-25-6

At the acquisition date, the acquirer shall classify or designate the identifiable assets acquired and liabilities assumed as necessary to subsequently apply other GAAP. The acquirer shall make those classifications or designations on the basis of the contractual terms, economic conditions, its operating or accounting policies, and other pertinent conditions as they exist at the acquisition date.

805-20-25-7

In some situations, GAAP provides for different accounting depending on how an entity classifies or designates a particular asset or liability. Examples of classifications or designations that the acquirer shall make on the basis of the pertinent conditions as they exist at the acquisition date include but are not limited to the following:

a. Classification of particular investments in securities as trading, available for sale, or held to maturity in accordance with Section 320-10-25

b. Designation of a derivative instrument as a hedging instrument in accordance with paragraph 815-10-05-4

c. Assessment of whether an embedded derivative should be separated from the host contract in accordance with Section 815-15-25 (which is a matter of classification as this Subtopic uses that term).

805-20-25-8

This Section provides the following two exceptions to the principle in paragraph 805-20-25-6:

a. Classification of a lease contract as either an operating lease or a capital lease in accordance with the guidance in paragraph 840-10-25-27

b. Classification of a contract written by an entity that is in the scope of Subtopic 944-10 as an insurance or **reinsurance** contract or a deposit contract.

The acquirer shall classify those contracts on the basis of the contractual terms and other factors at the inception of the contract (or, if the terms of the contract have been modified in a manner that would change its classification, at the date of that modification, which might be the acquisition date).

Pending Content:

Transition Date: *(P) December 16, 2018; (N) December 16, 2021* | **Transition Guidance:** 842-10-65-1

805-20-25-8

This Section provides the following two exceptions to the principle in paragraph 805-20-25-6:

a. Classification of a lease of an acquiree shall be in accordance with the guidance in paragraph 842-10-55-11

b. Classification of a contract written by an entity that is in the scope of Subtopic 944-10 as an insurance or **reinsurance** contract or a deposit contract. The acquirer shall classify that contract on the basis of the contractual terms and other factors at the inception of the contract (or, if the terms of the contract have been modified in a manner that would change its classification, at the date of that modification, which might be the acquisition date).

In a business combination, the target entity's carrying value of the assets acquired and liabilities assumed are not relevant in the measurement that results from the application of the acquisition method of accounting by the acquiring entity. Similarly, except as noted in ASC 805-20-25-8, any prior classifications or designations of assets acquired and liabilities assumed are reconsidered in connection with their remeasurement. In addition to the examples listed in ASC 805-20-25-7, classification and designation should also be reconsidered for assets held for sale. The acquirer's classification and designation should be based on all relevant factors at the acquisition date, including contractual terms, economic conditions, accounting policies of the acquirer, and any other relevant factors. See section 4 for further discussion of the recognition and measurement of specific assets, liabilities and any noncontrolling interests.

3.4.2 Measurement principles

Excerpt from Accounting Standards Codification

Business Combinations — Identifiable Assets and Liabilities, and Any Noncontrolling Interest

Initial Measurement

805-20-30-1

The **acquirer** shall measure the **identifiable** assets acquired, the liabilities assumed, and any **noncontrolling interest** in the **acquiree** at their **acquisition-date fair values**.

During its deliberations leading to the guidance in ASC 805, the FASB concluded fair value is the most relevant attribute for assets acquired and liabilities assumed in a business combination and provides information that is more complete, relevant and understandable to financial statement users. As such, the guidance in ASC 805 requires all assets acquired, liabilities assumed and any noncontrolling interests to be recorded at their acquisition-date fair values, with the limited exceptions discussed in ASC 805-20-25-16. As defined in the Glossary at Appendix J, fair value is 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. That is, fair value is a market-participant concept and not an entity-specific concept.

3.4.3 Exceptions to the recognition and measurement principles (updated June 2022)

Excerpt from Accounting Standards Codification

Business Combinations — Identifiable Assets and Liabilities, and Any Noncontrolling Interest

Recognition

805-20-25-16

This Topic provides limited exceptions to the recognition and measurement principles applicable to business combinations. Paragraphs 805-20-25-17 through 25-28 specify the types of identifiable assets and liabilities that include items for which this Subtopic provides limited exceptions to the recognition principle in paragraph 805-20-25-1. The acquirer shall apply the specified GAAP or the specified requirements rather than that recognition principle to determine when to recognize the assets or liabilities identified in paragraphs 805-20-25-17 through 25-28. That will result in some items being recognized either by applying recognition conditions in addition to those in paragraphs 805-20-25-2 through 25-3 or by applying the requirements of other GAAP, with results that differ from applying the recognition principle and conditions in paragraphs 805-20-25-1 through 25-3.

Pending Content:

Transition Date: *(P) December 16, 2018; (N) December 16, 2021* | **Transition Guidance:** 842-10-65-1

805-20-25-16

This Topic provides limited exceptions to the recognition and measurement principles applicable to business combinations. Paragraphs 805-20-25-17 through 25-28B specify the types of identifiable assets and liabilities that include items for which this Subtopic provides limited exceptions to the recognition principle in paragraph 805-20-25-1. The acquirer shall apply the specified GAAP or the specified requirements rather than that recognition principle to determine when to recognize the assets or liabilities identified in paragraphs 805-20-25-17 through 25-28B. That will result in some items being recognized either by applying recognition conditions in addition to those in paragraphs 805-20-25-2 through 25-3 or by applying the requirements of other GAAP, with results that differ from applying the recognition principle and conditions in paragraphs 805-20-25-1 through 25-3.

Transition Date: *(P) December 16, 2022; (N) December 16, 2023* | **Transition Guidance:** 805-20-65-3

805-20-25-16

This Topic provides limited exceptions to the recognition and measurement principles applicable to business combinations. Paragraphs 805-20-25-17 through 25-28C specify the types of identifiable assets and liabilities that include items for which this Subtopic provides limited exceptions to the recognition principle in paragraph 805-20-25-1. The acquirer shall apply the specified GAAP or the specified requirements rather than that recognition principle to determine when to recognize the assets or liabilities identified in paragraphs 805-20-25-17 through 25-28C. That will result in some items being recognized either by applying recognition conditions in addition to those in paragraphs 805-20-25-2 through 25-3 or by applying the requirements of other GAAP, with results that differ from applying the recognition principle and conditions in paragraphs 805-20-25-1 through 25-3.

Initial Measurement

805-20-30-10

Paragraph 805-20-25-16 notes that the Business Combinations Topic provides limited exceptions to the recognition and measurement principles applicable to business combinations. Paragraphs 805-20-30-12 through 30-23 specify the types of identifiable assets and liabilities that include items for which this Subtopic provides limited exceptions to the paragraph 805-20-30-1 measurement principle. The acquirer shall apply the specified GAAP or the specified requirements rather than that measurement principle to determine how to measure the assets or liabilities identified in paragraphs 805-20-30-12 through 30-23. That will result in some items being measured at an amount other than their acquisition-date fair values.

Pending Content:

Transition Date: *(P) December 16, 2018; (N) December 16, 2021* | **Transition Guidance:** 842-10-65-1

805-20-30-10

Paragraph 805-20-25-16 notes that the Business Combinations Topic provides limited exceptions to the recognition and measurement principles applicable to business combinations. Paragraphs 805-20-30-12 through 30-25 specify the types of identifiable assets and liabilities that include items for which this Subtopic provides limited exceptions to the paragraph 805-20-30-1 measurement principle. The acquirer shall apply the specified GAAP or the specified requirements rather than that measurement principle to determine how to measure the assets or liabilities identified in paragraphs 805-20-30-12 through 30-25. That will result in some items being measured at an amount other than their acquisition-date fair values.

Transition Date: *(P) December 16, 2019; (N) December 16, 2022* | **Transition Guidance:** 326-10-65-1

805-20-30-10

Paragraph 805-20-25-16 notes that the Business Combinations Topic provides limited exceptions to the recognition and measurement principles applicable to business combinations. Paragraphs 805-20-30-12 through 30-26 specify the types of identifiable assets and liabilities that include items for which this Subtopic provides limited exceptions to the paragraph 805-20-30-1 measurement principle. The acquirer shall apply the specified GAAP or the specified requirements rather than that measurement principle to determine how to measure the assets or liabilities identified in paragraphs 805-20-30-12 through 30-26. That will result in some items being measured at an amount other than their acquisition-date fair values.

Transition Date: *(P) December 16, 2022; (N) December 16, 2023* | **Transition Guidance:** 805-20-65-3

805-20-30-10

Paragraph 805-20-25-16 notes that the Business Combinations Topic provides limited exceptions to the recognition and measurement principles applicable to business combinations. Paragraphs 805-20-30-12 through 30-30 specify the types of identifiable assets and liabilities that include items for which this Subtopic provides limited exceptions to the paragraph 805-20-30-1 measurement principle. The acquirer shall apply the specified GAAP or the specified requirements rather than that measurement principle to determine how to measure the assets or liabilities identified in paragraphs 805-20-30-12 through 30-30. That will result in some items being measured at an amount other than their acquisition-date fair values.

As discussed above, the guidance in ASC 805 includes certain recognition and measurement exceptions. The exceptions are discussed in the respective sections noted below and include the following:

Asset/liability	Recognition exception	Measurement exception	Authoritative guidance	Section of FRD
Preacquisition contingencies	X	X	ASC 450, 805	4.4.1
Income taxes	X	X	ASC 740	FRD, *Income taxes*
Employee benefit obligations	X	X	ASC 710, 712, 715	4.3.1
Indemnification assets	X	X	ASC 805	4.2.7
Leases[11]	X	X	ASC 842, 805	4.4.4.4
Contract assets and contract liabilities[12]	X	X	ASC 606, 805	4.4.3A
Assets held for sale		X	ASC 360	4.2.4.2
Reacquired rights		X	ASC 805	4.2.5.3.7
Share-based payment awards		X	ASC 718	6.3
Purchased financial assets with credit deterioration[13]		X	ASC 326	4.2.2
Goodwill/bargain purchase		X	ASC 805	3.5, 7.1 and 7.2

3.5 Recognizing and measuring goodwill or a gain from a bargain purchase

3.5.1 Goodwill

Excerpt from Accounting Standards Codification

Business Combinations — Goodwill or Gain from Bargain Purchase, Including Consideration Transferred

Initial Measurement

805-30-30-1

The **acquirer** shall recognize **goodwill** as of the **acquisition date**, measured as the excess of (a) over (b):

a. The aggregate of the following:

   1. The consideration transferred measured in accordance with this Section, which generally requires acquisition-date **fair value** (see paragraph 805-30-30-7)

   2. The fair value of any **noncontrolling interest** in the **acquiree**

   3. In a **business combination** achieved in stages, the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree.

b. The net of the acquisition-date amounts of the **identifiable** assets acquired and the liabilities assumed measured in accordance with this Topic.

[11] Accounting for leases in a business combination is an exception to the recognition and measurement principles of ASC 805 only following the adoption of ASU 2016-02. Refer to section 4.4.4.4 for further discussion.

[12] Accounting for contract assets and contract liabilities in a business combination is an exception to the recognition and measurement principles of ASC 805 only following the adoption of ASU 2021-08. Refer to section 4.4.3A for further discussion.

[13] Accounting for purchased financial assets with credit deterioration is an exception to the measurement principle of ASC 805 only after the adoption of ASU 2016-13. Refer to section 4.2.2 for further discussion.

805-30-30-2

In a business combination in which the acquirer and the acquiree (or its former owners) exchange only equity interests, the acquisition-date fair value of the acquiree's equity interests may be more reliably measurable than the acquisition-date fair value of the acquirer's equity interests. If so, the acquirer shall determine the amount of goodwill by using the acquisition-date fair value of the acquiree's equity interests instead of the acquisition-date fair value of the equity interests transferred.

805-30-30-3

To determine the amount of goodwill in a business combination in which no consideration is transferred, the acquirer shall use the acquisition-date fair value of the acquirer's interest in the acquiree determined using a valuation technique in place of the acquisition-date fair value of the consideration transferred (see paragraph 805-30-30-1(a)(1)). Paragraphs 805-30-55-3 through 55-5 provide additional guidance on applying the acquisition method to combinations of **mutual entities**, including measuring the acquisition-date fair value of the acquiree's equity interests using a valuation technique.

Goodwill is an asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognized. Goodwill is also affected by assets and liabilities that are not recognized at their fair values (e.g., deferred income taxes).

Under ASC 805, an acquirer in a business combination recognizes 100% of the fair value of the business acquired (i.e., the full fair value of the assets acquired, liabilities assumed and any noncontrolling interests, with certain exceptions) as of the acquisition date. This is referred to as the "full-goodwill" approach and is applicable without regard to the actual controlling ownership interest acquired. This principle applies whether control is obtained by purchasing an acquiree's net assets, purchasing some (or all) of the acquiree's equity interests, by contract alone, or by other means. The result is that recognized goodwill will represent all of the goodwill of the acquired business, not just the acquirer's share.

While the full goodwill of an acquired business is recognized under the acquisition method of accounting, goodwill is the residual amount (i.e., the "leftover" after the recognition and measurement of all assets acquired, liabilities assumed, and any noncontrolling interests). Because limited exceptions to fair value recognition exist, goodwill is affected by these measurement differences and will not reflect the "true" goodwill of the acquired entity. Under ASC 805, goodwill is calculated as the difference between the aggregate of the following:

- The acquisition-date fair value of the consideration transferred[14] (i.e., the "purchase price")
- The acquisition-date fair value of any noncontrolling interest in the acquiree
- In a business combination achieved in stages, the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree[15]

Less

- The amount of acquisition-date identifiable assets acquired net of liabilities assumed, both measured in accordance with the guidance in ASC 805

In other words, goodwill is the difference between the full fair value of the acquiree and the recognized bases of the identifiable net assets acquired. See section 7.1 for further discussion of the accounting for goodwill in a business combination.

---

[14] See section 6.1 for a discussion of measuring consideration transferred in a business combination.

[15] See section 7.4.2 for a discussion of the acquisition-date accounting for a noncontrolling investment in the acquiree immediately before obtaining control.

3.5.2 Bargain purchase

Excerpt from Accounting Standards Codification

Business Combinations — Goodwill or Gain from Bargain Purchase, Including Consideration Transferred

Recognition

805-30-25-2

Occasionally, an acquirer will make a bargain purchase, which is a **business combination** in which the amount in paragraph 805-30-30-1(b) exceeds the aggregate of the amounts specified in (a) in that paragraph. If that excess remains after applying the requirements in paragraph 805-30-25-4, the acquirer shall recognize the resulting gain in earnings on the acquisition date. The gain shall be attributed to the acquirer. Example 1 (see paragraph 805-30-55-14) provides an illustration of this guidance.

In rare circumstances (e.g., distress sales), the acquirer's interest in the acquiree (i.e., the fair value of consideration transferred, the fair value of any noncontrolling interest in the acquiree and the fair value of any previously held equity interest in the acquiree) is less than the fair value (or other recognized value for the exceptions to fair value recognition) of the identifiable net assets acquired. Such a transaction results in an economic gain to the acquiring entity and is referred to as a bargain purchase. Any such gain is recognized in earnings only after a thorough reassessment of all elements of the accounting for the acquisition.

See section 7.2 for further discussion of the accounting for a bargain purchase in a business combination.

4 Recognizing assets acquired, liabilities assumed and any noncontrolling interest

4.1 Overview

As stated in section 3.4.1, generally, an asset or liability is recognized in a business combination if the applicable definition in CON 8.4 is met as of the acquisition date, and the asset or liability is determined to be part of the business combination, as discussed in section 3.4.1.2. Once it has been determined that recognition in the business combination is appropriate, the asset or liability generally is measured at fair value in accordance with the principles of ASC 820. As such, any references in this section to fair value mean 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. Additional guidance about measuring fair value is included in our FRD, ***Fair value measurement***.

This section discusses the specific exceptions to the ASC 805 recognition and fair value measurement criteria, subsequent accounting for certain assets and liabilities recognized in a business combination, and certain other recognition and measurement issues.

4.2 Assets acquired

4.2.1 Assets the acquirer does not intend to use to their highest and best use

Excerpt from Accounting Standards Codification

Business Combinations — Identifiable Assets and Liabilities, and Any Noncontrolling Interest

Initial Measurement

805-20-30-6

To protect its competitive position, or for other reasons, the acquirer may intend not to use an acquired nonfinancial asset actively, or it may not intend to use the asset according to its highest and best use. For example, that might be the case for an acquired research and development intangible asset that the acquirer plans to use defensively by preventing others from using it. Nevertheless, the acquirer shall measure the fair value of the nonfinancial asset in accordance with Subtopic 820-10 assuming its highest and best use by market participants in accordance with the appropriate valuation premise, both initially and for purposes of subsequent impairment testing.

The guidance in ASC 805 requires all tangible and intangible assets for which the guidance does not otherwise provide a specific exception to be measured at fair value, as defined in ASC 820, even if the acquirer does not intend to use the asset to its highest and best use (e.g., defensive assets).

For example, assume that an acquiree has a trademark that the acquirer does not intend to support and utilize after acquisition, as the acquirer's primary intention in the acquisition was to remove a competitor from the marketplace. Under the guidance in ASC 805, the acquirer would determine the fair value of the trademark based on the highest and best use by a market participant, both initially and for purposes of subsequent impairment testing. The requirement to apply the concepts of ASC 820 to assets that an acquirer does not intend to fully utilize raises questions regarding the "day 2" accounting for the assets, including the determination of the useful life of the asset and, for intangible assets, whether or not the intangible asset is an indefinite-lived intangible asset. See section 4.2.1.1 below and our FRD, ***Intangibles — goodwill and other***, for further discussion of the "day 2" accounting.

4.2.1.1 Subsequent accounting for assets the acquirer does not intend to use to their highest and best use

An issue arises in determining the appropriate unit of account and the appropriate useful life for defensive intangible assets. ASC 350-30 provides guidance on the subsequent accounting for defensive intangible assets and requires an entity to assign a useful life in accordance with ASC 350-30-35-1 through 35-5.

In reaching a consensus on EITF 08-7 (codified primarily in ASC 350-30), the EITF concluded that intangible assets that an acquirer intends to use as defensive assets are a separate unit of account from the existing intangible assets of the acquirer. The EITF also concluded that a defensive intangible asset should be amortized over the period it is expected to contribute directly or indirectly to the entity's future cash flows. That period is the period that the asset provides significant value to the reporting entity but would not extend beyond the date the reporting entity effectively waives its rights to the intangible asset (i.e., is not using the asset either directly or defensively). This does not preclude the acquirer from assigning an indefinite life to the defensive intangible asset (see section 4.2.6.2.6); however, the EITF concluded that the assignment of an indefinite life to a defensive intangible asset likely would be rare. In reaching this conclusion, the EITF stated that the acquirer's intention to not actively use the intangible asset, but instead to maintain it for defensive purposes, is a form of use of the intangible asset. Additionally, if an acquired intangible asset meets the definition of a defensive intangible asset, it cannot be considered immediately abandoned.

We believe that, in practice, it may prove difficult to estimate not only the initial fair value of the asset (because of the indirect nature of the benefit arising from the defensive asset) but also the period over which the fair value of the defensive intangible asset diminishes. The process of estimating the useful life of defensive intangible assets will require close collaboration with valuation professionals.

4.2.2 Assets with uncertain cash flows (valuation allowances) (updated June 2023)

FASB update

As part of the post-implementation review of ASC 326, the FASB added a project to its technical agenda on expanding the scope of the PCD model in ASC 326 to include all assets acquired in a business combination and renaming it the purchased financial assets model.

We encourage readers to monitor developments.

Excerpt from Accounting Standards Codification

Business Combinations — Identifiable Assets and Liabilities, and Any Noncontrolling Interest

Initial Measurement

805-20-30-4

The acquirer shall not recognize a separate valuation allowance as of the **acquisition date** for assets acquired in a business combination that are measured at their acquisition-date fair values because the effects of uncertainty about future cash flows are included in the fair value measure. For example, because this Subtopic requires the acquirer to measure acquired receivables, including loans, at their acquisition-date fair values, the acquirer does not recognize a separate valuation allowance for the contractual cash flows that are deemed to be uncollectible at that date.

Pending Content:

Transition Date: *(P)* December 16, 2019; *(N)* December 16, 2022 | **Transition Guidance:** 326-10-65-1

805-20-30-4

The acquirer shall not recognize a separate valuation allowance as of the **acquisition date** for assets acquired in a business combination that are measured at their acquisition-date fair values because the effects of uncertainty about future cash flows are included in the fair value measure, unless the assets acquired are financial assets for which the acquirer shall refer to the guidance in paragraphs 805-20-30-4A through 30-4B.

805-20-30-4A

For acquired financial assets that are not **purchased financial assets with credit deterioration**, the acquirer shall record the purchased financial assets at the acquisition-date fair value. Additionally, for these financial assets within the scope of Topic 326, an allowance shall be recorded with a corresponding charge to credit loss expense as of the reporting date.

805-20-30-4B

For assets accounted for as purchased financial assets with credit deterioration (which includes beneficial interests that meet the criteria in paragraph 325-40-30-1A), an acquirer shall recognize an allowance in accordance with Topic 326 with a corresponding increase to the amortized cost basis of the financial asset(s) as of the acquisition date.

805-20-30-26

An acquirer shall recognize **purchased financial assets with credit deterioration** (including beneficial interests meeting the conditions in paragraph 325-40-30-1A) in accordance with Section 326-20-30 for financial instruments measured at amortized cost or Section 326-30-30 for available-for-sale debt securities. Paragraphs 326-20-55-57 through 55-78 illustrate how the guidance is applied for purchased financial assets with credit deterioration measured at amortized cost. Paragraphs 326-30-55-5 through 55-7 illustrate how the guidance is applied to available-for-sale debt securities. An acquirer shall not accrete into interest income the credit losses embedded in the purchase price for purchased financial assets with credit deterioration.

Under ASC 805, an acquirer that has not yet adopted ASU 2016-13 may not recognize a valuation allowance as of the acquisition date for assets acquired in a business combination that are initially recognized at fair value. For example, since contract assets (before the adoption of ASU 2021-08), accounts and loans receivable acquired in a business combination are recognized and measured at fair value at the acquisition date, any uncertainty about collections and future cash flows is included in the fair value measure. Accordingly, the acquiring entity does not recognize a valuation allowance for estimated uncollectible amounts at the acquisition date. We believe that the subsequent accounting for loans and receivables acquired in a business combination can be similar to the accounting for acquired loans and receivables that are required to be accounted for under the guidance in ASC 310-30. That is, the loans or other receivables will be recognized at fair value and, assuming they are not measured at fair value through earnings pursuant to ASC 825, accreted to the amount of expected cash flows to be received as interest income on a level-yield basis over the estimated life of the loan. If the loan is not accounted for as a debt security, subsequent reductions in the estimated cash flows would be assessed under the loss contingency guidance in ASC 450, or, if applicable, the impairment guidance in ASC 310-10, which may result in the recognition of an allowance for loan losses.

Separate valuation allowances are permitted to be recognized for assets that are not required to be measured at their acquisition-date fair values. For example, valuation allowances are permitted for certain indemnification assets (section 4.2.7) and deferred income tax assets (section 5).

In June 2016, the FASB issued ASU 2016-13 to amend the guidance on recognizing credit losses on financial assets held at amortized cost and available-for-sale debt securities. After an entity adopts this new guidance, the way it measures financial assets in the scope of ASC 326 acquired in a business combination will depend on whether the assets have experienced more-than-insignificant deterioration in credit quality since origination.

Financial assets that have experienced more-than-insignificant deterioration in credit quality since origination are subject to special accounting at initial recognition that is intended to make their subsequent measurement consistent with other purchased financial assets and with financial assets the entity originates. The standard refers to these assets as "purchased credit deteriorated" (PCD) financial assets (PCD assets).

An entity initially measures the amortized cost of a PCD asset by determining the acquisition date estimate of expected credit losses under the applicable impairment model (e.g., ASC 326-20) and adding that amount to the asset's fair value. Because a valuation allowance for expected credit losses is recognized separate and apart from the PCD asset to establish its amortized cost on the acquisition date, there is no credit loss expense recognized upon acquisition. If the contractual amount due (i.e., the face or stated principal amount of the loan or accounts receivable) is more (or less) than the asset's amortized cost, the acquirer will also recognize a noncredit discount (or premium) on the acquisition date equal to that difference. The sum of the amortized cost of the PCD asset (inclusive of any noncredit discount or premium) and the allowance for expected credit losses will be equal to its acquisition date fair value.

PCD accounting is commonly referred to as a "gross-up" approach. See section 5 of our FRD, ***Credit impairment under ASC 326***, for further guidance, including how to determine whether purchased financial assets have experienced more-than-insignificant deterioration in credit quality.

Conversely, under the new guidance, purchased financial assets that have *not* experienced more-than-insignificant deterioration in credit quality since origination (i.e., non-PCD assets) are initially recognized at their acquisition date fair value and a separate valuation allowance is *not* recognized under business combination accounting. Rather, expected credit losses are measured under the credit impairment model that applies to that type of financial asset with a corresponding credit loss expense recognized in the income statement.

Before the adoption of ASU 2021-08, entities account for contract assets acquired in a business combination similar to how they account for acquired non-PCD assets because contract assets do not meet the definition of a financial asset under ASC 860 and, therefore, are not subject to the initial measurement requirements in ASC 805-20-30-4A and ASC 805-20-30-4B. An entity measures an acquired contract asset at fair value (before the adoption of ASU 2021-08) and does not recognize a separate valuation allowance on the acquisition date.

While ASU 2021-08 provides an exception to fair value measurement, we believe that an entity would continue to not recognize a separate valuation allowance on the acquisition date related to an acquired contract asset after the adoption of ASU 2021-08. Rather, expected credit losses are measured under the credit impairment model with a corresponding credit loss expense recognized in the income statement.

Refer to section 2.11.2 of our FRD, ***Credit impairment under ASC 326***, for further guidance on applying the new credit impairment standard to acquired contract assets after the business combination.

In November 2019, the FASB issued ASU 2019-10 to amend the effective dates of the credit impairment standard for all entities except SEC filers that are not smaller reporting companies (SRCs). This standard is currently effective for public business entities (PBEs) that meet the definition of an SEC filer that are not SRCs. For all other entities, the standard is effective for annual periods beginning after 15 December 2022, and interim periods therein. Early adoption is permitted. See our FRD, ***Credit impairment under ASC 326***, for further information.

4.2.3 Inventories

The guidance in ASC 805 requires that inventories be recognized at fair value pursuant to the guidance in ASC 820. Because of ASC 820's exit price and highest and best use concepts for determining fair value, there was some concern that an acquirer would not recognize any profit on acquired finished goods inventories. The FASB's Valuation Resource Group[16] deliberated the issue and concluded that the fair value of acquired finished goods inventory results in the acquirer recognizing a profit from the selling effort. The VRG believes this conclusion is supported by the guidance in ASC 820-10-55-21(f), which states:

Excerpt from Accounting Standards Codification

Fair Value Measurements and Disclosures — Overall

Implementation Guidance and Illustrations

820-10-55-21(f)

Finished goods inventory at a retail outlet. For finished goods inventory that is acquired in a business combination, a Level 2 input would be either a price to customers in a retail market or a price to retailers in a wholesale market, adjusted for differences between the condition and location of the inventory item and the comparable (that is, similar) inventory items so that the fair value measurement reflects the price that would be received in a transaction to sell the inventory to another retailer that would complete the requisite selling efforts. Conceptually, the fair value measurement will be the same, whether adjustments are made to a retail price (downward) or to a wholesale price (upward). Generally, the price that requires the least amount of subjective adjustments should be used for the fair value measurement.

Based on the VRG's observation and the above guidance from ASC 820, the fair value of acquired inventory is a function of its stage of production. Inventory values are established separately for finished goods, work-in-process, and raw materials such that the acquirer should not be expected to generate a profit or loss on the ultimate disposition of the inventory based on value-added in manufacturing processes completed by the acquired company before its acquisition. Also, as the objective of accounting for acquired inventories in a business combination is to recognize the acquired inventories at their fair values on the date of acquisition, the inventory accounting method (first-in, first-out (FIFO), last-in, first-out (LIFO), weighted-average cost, etc.) of the acquired company is not relevant to the determination of the fair value of inventory of an acquired company.

The principles for valuing inventory acquired in a business combination should be followed even if the target company's inventories include amounts purchased from the acquirer; however, consideration should also be given as to whether the transaction involves the settlement of a preexisting relationship as discussed in section 4.5.

4.2.3.1 Finished goods

Acquired finished goods inventories should be recognized at their fair value, which we believe in many cases approximates a market participant's estimated selling price (as discussed above, either a retail or wholesale price) adjusted for (1) costs of the selling effort and (2) a reasonable profit allowance for the selling effort of the acquiring entity, both estimated from the viewpoint of a market participant. The acquiring entity's results of operations after the acquisition should reflect the costs and outcome of the selling activities that occur after the date of acquisition.

[16] The Valuation Resource Group (VRG) was established by the FASB staff to assist in the evaluation of fair value measurement implementation issues. Any decisions made by the VRG are not authoritative and are the opinions of only the VRG members. However, in certain instances, the recommendation of the VRG may result in additional standard setting by the FASB.

Costs of the selling effort should be incremental and directly related to the product and based on the assumptions of a market participant. Such costs might include packaging, transportation, and direct selling costs such as sales commissions or bonuses based directly on the sale of the particular inventory. Costs of the selling effort should not include general costs incurred by a market participant that are allocated across all products, such as costs incurred to maintain a sales office, although indirect costs may affect the required profit margin discussed in the following paragraph.

A reasonable profit allowance for the selling effort ("selling profit") should be based on the assumptions of a market participant. That margin on finished goods should be less than the normal profit margin achieved on products manufactured and sold in the ordinary course of business, as it relates only to the selling effort after the acquisition. Essentially, valued added from the manufacturing activities of the acquired company is already included in the fair value of the finished goods inventory. While the determination of a "reasonable profit allowance" ultimately might require judgment, it might be useful in some cases to reference profit margin information of companies that only distribute comparable products as an indication of a normal profit margin related to the selling effort.

4.2.3.2 Work-in-process

Work-in-process inventories are recognized at fair value, which we believe in most cases will approximate a market participant's estimated selling price of the eventual finished inventories adjusted for a market participant's expected (1) costs to complete the manufacturing process, (2) costs of the selling effort and (3) a reasonable profit allowance for the remaining manufacturing and selling effort. We believe that the value best approximates the price a market participant would pay to purchase unfinished inventory. Estimated costs to complete the manufacture of work-in-process inventories should consider all inventoriable costs, as discussed in ASC 330, and should be reconcilable with manufacturing cost estimates that would be incurred by a market participant. Costs of the selling effort should be estimated as discussed in section 4.2.3.1 above. A market participant's reasonable profit allowance for acquired work-in-process inventories should be greater than the profit allowance associated with comparable acquired finished inventories since the profit allowance for work-in-process inventories includes the value-added portion of manufacturing profit related to the effort to complete the inventory production, in addition to the selling profit allowance associated with acquired finished inventories.

4.2.3.3 Raw materials

Acquired raw material inventories should be recognized at fair value, which we believe generally would be the price a market participant could achieve in a current sale, without regard to whether that sale price is greater or less than a target's historical carrying cost.

Illustration 4-1: Recognition of raw materials

Assume that Acquirer acquires Target. Target has raw material inventories that include 100 pounds of aluminum used in the production process with an historical cost of $1.00 per pound ($100). At the date of acquisition, the current fair value of 100 pounds of raw material aluminum is $1.10 per pound, which is based on the price that a market participant could sell the aluminum in its most advantageous market. Acquirer would recognize the acquired aluminum inventories at $1.10 per pound ($110). Similarly, if at the date of acquisition the current fair value for aluminum is $0.90 per pound, Acquirer would recognize the acquired aluminum inventories at $0.90 per pound ($90).

4.2.3.4 Supply inventories

Acquired supplies or stores inventories, generally consisting of miscellaneous items used or consumed in a company's manufacturing process, should be valued in a manner similar to raw materials, at fair value, which we generally believe would approximate current replacement cost.

4.2.3.5 Acquired LIFO inventories

As with most other acquired identifiable assets, acquired inventories that were accounted for by the acquiree under the LIFO method and will be accounted for by the acquirer under the LIFO method by the acquiring company are recognized in a business combination at fair value (which, as it relates to acquired inventory, generally will consider a market participant's estimate of the costs of the selling and/or manufacturing effort and reasonable profit on any remaining selling or manufacturing effort). Generally, this will result in a significant increase to the carrying value of the acquired inventories compared with their predecessor basis in the financial statements of the acquired company.

ASC 330-10-S99-1 (codified primarily from SAB Topic 5.L) supports the conclusions reached in the AICPA Issues Paper, *Identification and Discussion of Certain Financial Accounting and Reporting Issues Concerning LIFO Inventories* (LIFO Issues Paper), and indicates that the LIFO Issues Paper should be considered as the primary guidance in determining what constitutes acceptable LIFO accounting practice. The LIFO Issues Paper states that when an acquiring entity has an existing LIFO pool and the acquired inventory is combined into this pool, the fair value of the acquired inventory is included in the current period's purchases for purposes of the acquirer's calculations of inventory increments or decrements in the period. If the acquiring entity establishes a new pool, or the LIFO method is initially adopted for the acquired inventory, the fair value of the acquired inventory should be considered the LIFO base period inventory layer.

4.2.3.5.1 Effect on purchase accounting of LIFO election for income tax purposes

Some business combinations are executed as nontaxable transactions (e.g., a stock acquisition versus an asset acquisition). In these transactions, the acquired company's tax basis in inventory generally is carried over. If the acquired entity accounted for inventories using the LIFO method for tax purposes, and the acquirer continues to apply the LIFO method for income tax reporting purposes, amounts recognized for those LIFO inventories in purchase accounting likely will differ from the acquired inventory's tax basis both in the period of the acquisition and in subsequent periods. These differences are temporary differences for which deferred income taxes should be calculated by the acquiring entity in accordance with ASC 740.

Some business combinations are executed as taxable transactions. In these transactions, the financial reporting and tax bases of acquired LIFO inventories generally are equivalent on the date of acquisition. As such, deferred income taxes would not be recognized at the acquisition date for these LIFO inventories.

Differences in the bases of LIFO inventories for financial and tax reporting purposes could indicate LIFO conformity issues, which are beyond the scope of this publication. We recommend discussing the implications of the LIFO conformity rules with a tax specialist.

4.2.3.6 Subsequent measurement considerations

Inventory measured using any method other than LIFO or the retail inventory method (RIM) (e.g., FIFO, average cost) is subsequently measured at the lower of cost or net realizable value. The Master Glossary in ASC 330 defines net realizable value as "estimated selling prices in the ordinary course of business, less reasonably predictable costs of completion, disposal and transportation."

Finished goods and work-in-process inventories acquired in a business combination are measured at fair value. The lower of cost or net realizable value test is applied in periods after the acquisition date. We would expect the fair value of these inventories at the acquisition date to be lower than the net realizable value because the determination of both the fair value and net realizable value of inventory generally is based on the estimated selling price less costs to sell, but the fair value of inventory is further reduced to allow for a profit on those selling efforts as described above.

Inventory measured using LIFO and RIM is measured at the lower of cost or market in periods after the acquisition date. ASC 330 equates current market price with current replacement cost (by purchase or by reproduction, as the case may be) with the following exceptions:

1. Market should not exceed the net realizable value (i.e., estimated selling price in the ordinary course of business, less reasonably predictable costs of completion, disposal and transportation).
2. Market should not be less than net realizable value reduced by an allowance for an approximately normal profit margin.

Generally, upon measurement of finished goods and work-in-process inventories in a business combination, the fair value will exceed current replacement cost at the acquisition date, as the market participant's estimated selling price (as discussed in section 4.2.3) used to determine the fair value would include the acquired entity's manufacturing profit associated with acquired inventories.[17] As discussed in the subsequent measurement guidance in ASC 330, when evidence indicates that carrying value will be recovered with an approximately normal profit margin upon sale in the ordinary course of business, inventory write-downs should not be recognized even when replacement or reproduction costs are lower. The term "normal profit margin" as applied to acquired inventories should include only the profit that was considered in the acquisition method. For finished goods, this would be the selling profit and for work-in-process this would include the selling profit plus the portion of the manufacturing profit associated with converting the work-in-process to finished goods.

Raw materials acquired in a business combination are measured at fair value as of the acquisition date, typically at current replacement cost. We would generally expect the fair value of the raw materials to approximate net realizable value after the acquisition date.

4.2.4 Plant and equipment

The measurement of plant and equipment depends on whether the acquired entity intends to use or sell the acquired assets. Acquired plant and equipment to be used by the acquirer is recognized at fair value, which would represent the estimated price that would be realized upon sale to a market participant. Acquired plant and equipment to be sold by the acquirer is valued at fair value less costs to sell, as discussed in section 4.2.4.2.

4.2.4.1 Plant and equipment to be used

The determination of fair value of plant and equipment to be used is based on the value that a market participant would ascribe for comparable used plant and equipment. If a comparable used asset market is not available, an estimate of fair value could be based on the value of comparable new plant and equipment, less depreciation and obsolescence (i.e., decreases in value due to physical depreciation or functional or economic obsolescence). The recorded carrying amount of the asset is the net value. Thus, neither the accumulated depreciation of the acquired entity that existed prior to the acquisition nor, as applicable, the economic depreciation used to estimate replacement value is carried forward or recorded.

For depreciation purposes, estimated useful lives of acquired plant and equipment should be established based on the expected remaining useful life to the acquiring entity. This useful life is an entity-specific estimate that would not necessarily be consistent with the useful life of other market participants or the life previously assigned by the acquired entity.

[17] Although the inventories initially are recognized under the acquisition method at fair value as defined in ASC 820, the application of the subsequent measurement guidance in ASC 330 is not in the scope of ASC 820.

Illustration 4-2: Plant and equipment to be used

Acquirer purchases Target in a business combination. At the acquisition date, Acquirer determines that a market participant would pay $1,500,000 for similar capacity new equipment and depreciation and obsolescence is estimated to be $750,000. The asset would be recognized at $750,000, which represents the $1,500,000 new replacement cost of the equipment less $750,000 of depreciation and obsolescence.

Acquirer assigns new useful lives to the equipment based on its intended use. Neither the useful lives previously assigned by Target nor a market participant's assumptions regarding the useful lives of the equipment are determinative.

4.2.4.2 Property and equipment to be sold

Excerpt from Accounting Standards Codification

Business Combinations — Identifiable Assets and Liabilities, and Any Noncontrolling Interest

Initial Measurement

805-20-30-22

The acquirer shall measure an acquired long-lived asset (or disposal group) that is classified as held for sale at the acquisition date in accordance with Subtopic 360-10, at fair value less cost to sell in accordance with paragraphs 360-10-35-38 and 360-10-35-43.

An acquirer might buy a company with an intention of selling one or more of the underlying acquired assets, asset groups or acquired businesses. The guidance in ASC 805 requires that acquired assets to be sold be measured at fair value less costs to sell, pursuant to ASC 360. The principles in ASC 360 relating to recognition and measurement of acquired assets held for sale should be applied to assets acquired in a business combination that are intended to be disposed of. Therefore, if the "held for sale" criteria of ASC 360 are not met, the acquired asset should be measured and recognized at fair value as described in section 4.2.4.1.

ASC 360-10-45-12 requires that a newly acquired long-lived asset or disposal group to be sold be classified as "held-for-sale" at the acquisition date if the sale of the asset or disposal group is probable and expected to qualify for recognition as a completed sale within one year and the other "held-for-sale" criteria outlined in ASC 360-10-45-9 that are not met at the acquisition date are probable of being met within a short time following the acquisition (usually within three months). To classify an acquired long-lived asset or disposal group as held for sale as of the acquisition date, we would expect that entities would have commenced the formulation of a plan to sell the asset or group on the acquisition date and that it would be probable that the "held-for-sale" criteria other than ASC 360-10-45-9(d) will be met within three months. The criteria to classify an acquired long-lived asset or disposal group as "held-for-sale" are discussed further in our FRD, ***Impairment or disposal of long-lived assets***.

ASC 360-10 defines costs to sell as "the incremental direct costs to transact a sale, that is, the costs that result directly from and are essential to a sale transaction and that would not have been incurred by the entity had the decision to sell not been made." Examples of costs to sell include broker commissions, legal fees, title transfer fees and closing costs that must be incurred before legal title can be transferred. Examples of costs that generally do not qualify as selling costs include insurance, security services, utility expenses and other costs of protecting or maintaining the assets during the holding period.

See our FRD, ***Impairment or disposal of long-lived assets***, for further discussion and illustrative examples of accounting for newly acquired long-lived assets to be sold.

4.2.4.3 Spare parts inventories

Acquired companies might own an inventory of spare or replacement parts, generally parts that are critical to the continuing operation of manufacturing machinery and equipment. Practice supports the consistent application of a policy to classify spare parts inventories either in property and equipment or other assets. Whether the spare parts relate to property and equipment to be used or sold affects the method of measuring and recognizing the asset's value in the acquisition method. See sections 4.2.4.1 and 4.2.4.2 above for further discussion of measuring property and equipment to be held and property and equipment to be sold, respectively.

4.2.4.4 Mineral rights

ASC 805 states that mineral rights, which are defined as the legal right to explore, extract and retain at least a portion of the benefits from mineral deposits, are tangible assets that should be recognized as a separate component of property, plant, and equipment.

Mining assets[18] acquired in a business combination are recognized at fair value pursuant to ASC 820. In practice, questions had arisen as to the appropriateness of including in the estimate of fair value (a) cash flows for a mining right's potential reserves beyond "proven and probable" reserves and (b) estimates of future market price changes. The guidance in ASC 930 states that in estimating the fair value of mineral assets, an entity includes both the cash flows for a mining asset's potential reserves beyond proven and probable reserves and estimates of future market price changes. Anticipated fluctuations in market prices should be consistent with those contemplated by market participants and should be estimated based on all available information including current prices, historical averages, and forward pricing curves.

4.2.4.5 Acquired assets to be abandoned

As a result of the requirement to apply the ASC 820 definition of fair value, the use of entity-specific assumptions in valuing acquired assets that will not be fully utilized is no longer acceptable after the guidance in ASC 805 is adopted. See section 4.2.1 for further guidance.

4.2.4.6 Plant and equipment subject to retirement obligations

Acquired tangible long-lived assets may be subject to legal obligations associated with their retirement, as defined in ASC 410-20, resulting from the acquisition, construction, development, and/or normal operation of a long-lived asset. For example, upon retirement, a long-lived asset may have to be dismantled or removed and the location of the asset restored. If an asset retirement obligation (ARO) exists, pursuant to ASC 410-20, the obligation should be recognized as a separate liability and measured at its acquisition-date fair value. That is, the long-lived asset and ARO are considered to be separate units of account.

Further information on establishing and accounting for ARO liabilities is included in our FRD, ***Asset retirement obligations***.

[18] Mining assets include mineral properties and rights.

4.2.5 Intangible assets

Excerpt from Accounting Standards Codification

Business Combinations — Identifiable Assets and Liabilities, and Any Noncontrolling Interest

Recognition

805-20-25-10

The acquirer shall recognize separately from goodwill the identifiable intangible assets acquired in a business combination. An intangible asset is identifiable if it meets either the separability criterion or the contractual-legal criterion described in the definition of identifiable. Additional guidance on applying that definition is provided in paragraphs 805-20-25-14 through 25-15, 805-20-55-2 through 55-45, and Example 1 (see paragraph 805-20-55-52). For guidance on the recognition and subsequent measurement of a **defensive intangible asset**, see Subtopic 350-30.

ASC 805 requires acquired identifiable intangible assets to be recognized separately from goodwill if the subject intangible asset is either contractual or separable.

Intangible assets are assets, other than financial instruments, that lack physical substance. The guidance in ASC 805 provides specific criteria to apply in recognizing intangible assets separately from goodwill in a business combination. Because of the different accounting treatment after the completion of purchase accounting between (1) goodwill and other indefinite-lived identifiable intangible assets, which under the provisions of ASC 350 are not amortized and (2) finite-lived identifiable intangible assets, which under the provisions of ASC 350 are amortized over their estimated useful lives (in each case subject to unique impairment recognition requirements), the FASB and the SEC staff expect companies to undertake complete and thorough efforts to identify, appropriately value and recognize intangible assets acquired in a business combination.

In contrast, financial assets include contracts that convey to one entity a right to receive cash from a second entity. An entity should carefully consider the nature of an acquired asset to determine whether to recognize a financial asset or an intangible asset. See section 4.2.9 for additional guidance.

4.2.5.1 Recognition of identifiable intangible assets

An identified intangible asset must be recognized as a separate asset from goodwill if either or both of the following criteria are met:

- The intangible asset arises from contractual or other legal rights, regardless of whether those rights are in fact transferable or separable from the acquired entity or from other rights and obligations.
- The intangible asset is separable; that is, it is capable of being separated or divided from the acquired entity and sold, transferred, licensed, rented or exchanged (regardless of whether there is an intent to do so). An intangible asset that cannot be sold, transferred, licensed, rented or exchanged individually is considered separable if it can be sold, transferred, licensed, rented, or exchanged in combination with a related contract, asset or liability (e.g., core deposit intangibles and the related deposit base of a financial institution).

4.2.5.1.1 Contractual-legal criterion

In deliberating the recognition criteria, the FASB noted that in contrast to goodwill, the value of many intangible assets arise from rights conveyed by contract, statute or other means. For example, (i) franchises are granted to auto dealers, fast food outlets, and professional sports teams, (ii) trademarks and service marks may be registered with a government, (iii) contracts are negotiated with customers or suppliers and (iv) technological innovations are often protected by patents. On the other hand, goodwill arises from the collection of assembled assets that make up an acquired entity or the value created by assembling a collection of assets through a business combination, such as synergies that are expected to result from combining one or more businesses. The FASB therefore decided that the fact that an intangible asset arises

from a contractual or other legal right is an important characteristic that distinguishes it from goodwill. If an intangible asset arises from legal or contractual rights, the asset must be recognized separately from goodwill even if the acquirer is legally or contractually restricted from transferring or otherwise exchanging the asset. Accordingly, separate recognition of intangible assets that arise from legal or contractual rights is required even if they are never exchanged, and therefore may be difficult to value.

4.2.5.1.1.1 Examples: contractual-legal criterion

ASC 805-20-55-2 provides the following examples of intangible assets that meet the contractual-legal criterion:

Excerpt from Accounting Standards Codification

Business Combinations — Identifiable Assets and Liabilities, and Any Noncontrolling Interest

Implementation Guidance and Illustrations

805-20-55-2

Paragraph 805-20-25-10 establishes that an intangible asset is identifiable if it meets either the separability criterion or the contractual-legal criterion described in the definition of identifiable. An **intangible asset** that meets the contractual-legal criterion is identifiable even if the asset is not transferable or separable from the **acquiree** or from other rights and obligations. For example:

a. An acquiree leases a manufacturing facility under an operating lease that has terms that are favorable relative to market terms. The lease terms explicitly prohibit transfer of the lease (through either sale or sublease). The amount by which the lease terms are favorable compared with the pricing of current market transactions for the same or similar items is an intangible asset that meets the contractual-legal criterion for recognition separately from **goodwill**, even though the **acquirer** cannot sell or otherwise transfer the lease contract. See also paragraphs 805-20-25-12 through 25-13.

b. An acquiree owns and operates a nuclear power plant. The license to operate that power plant is an intangible asset that meets the contractual-legal criterion for recognition separately from goodwill, even if the acquirer cannot sell or transfer it separately from the acquired power plant. An acquirer may recognize the **fair value** of the operating license and the fair value of the power plant as a single asset for financial reporting purposes if the useful lives of those assets are similar.

c. An acquiree owns a technology patent. It has licensed that patent to others for their exclusive use outside the domestic market, receiving a specified percentage of future foreign revenue in exchange. Both the technology patent and the related license agreement meet the contractual-legal criterion for recognition separately from goodwill even if selling or exchanging the patent and the related license agreement separately from one another would not be practical.

Pending Content:

Transition Date: *(P) December 16, 2018; (N) December 16, 2021* | **Transition Guidance:** 842-10-65-1

805-20-55-2

Paragraph 805-20-25-10 establishes that an intangible asset is identifiable if it meets either the separability criterion or the contractual-legal criterion described in the definition of identifiable. An **intangible asset** that meets the contractual-legal criterion is identifiable even if the asset is not transferable or separable from the **acquiree** or from other rights and obligations. For example:

a. An acquiree leases a manufacturing facility to a **lessee** under an **operating lease** that has terms that are favorable relative to market terms. The lease terms explicitly prohibit transfer of the **lease** (through either sale or **sublease**). The amount by which the lease terms are favorable compared with the pricing of current market transactions for the same or similar items is an intangible asset that meets the contractual-legal criterion for recognition separately from **goodwill**, even though the **acquirer** cannot sell or otherwise transfer the lease contract. See also paragraph 805-20-25-12.

b. An acquiree owns and operates a nuclear power plant. The license to operate that power plant is an intangible asset that meets the contractual-legal criterion for recognition separately from goodwill, even if the acquirer cannot sell or transfer it separately from the acquired power plant. An acquirer may recognize the **fair value** of the operating license and the fair value of the power plant as a single asset for financial reporting purposes if the useful lives of those assets are similar.

c. An acquiree owns a technology patent. It has licensed that patent to others for their exclusive use outside the domestic market, receiving a specified percentage of future foreign revenue in exchange. Both the technology patent and the related license agreement meet the contractual-legal criterion for recognition separately from goodwill even if selling or exchanging the patent and the related license agreement separately from one another would not be practical.

805-20-55-3

The separability criterion means that an acquired intangible asset is capable of being separated or divided from the acquiree and sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract, identifiable asset, or liability. An intangible asset that the acquirer would be able to sell, license, or otherwise exchange for something else of value meets the separability criterion even if the acquirer does not intend to sell, license, or otherwise exchange it.

4.2.5.1.2 Separability criterion

Although some intangible assets do not arise from contractual or other legal rights, they are capable of being separated from the acquired company and sold or exchanged for value. Goodwill cannot be separated from a business and sold or otherwise transferred. The FASB therefore decided that separability is another characteristic distinguishing identifiable intangible assets from goodwill. Exchange transactions provide evidence of separability and might provide information for determining fair value. An acquired intangible asset meets the separability criterion if there is evidence of exchange transactions for that type of asset or an asset of a similar type, even if those exchanges are infrequent and regardless of whether the acquiring company has been involved in them. Further, if the acquired intangible asset is capable of being separated from the acquired business, the intangible asset still meets the criterion for separate recognition regardless of whether management has the intent to separate it. Even if the acquiring company believes that separating the intangible asset would be uneconomical, it is the capability of being separated, rather than the probability of being separated, that is determinative.

If agreements (e.g., confidentiality agreements) or laws or statutes (e.g., privacy laws) legally prohibit the sale, transfer, license, rent or exchange of an intangible asset, then that asset would not meet the separability criterion. To conclude that such transfer prohibitions preclude the separate recognition of the intangible asset, we believe that the transfer prohibitions must be in effect for the full useful life of the intangible asset and, of course, that the intangible asset does not otherwise meet the contractual-legal criterion. If this is not the case, the intangible asset is separately recognized. In such cases, transfer prohibitions would be expected to adversely affect the intangible asset's fair value. (See section 4.2.5.4 for further discussion of measuring the value of identifiable intangible assets).

ASC 805-20-55-4 provides the following example illustrating customer-related intangible assets that meet the separability criterion (see further discussion of customer-related intangible assets in section 4.2.5.3.2):

Excerpt from Accounting Standards Codification

Business Combinations — Identifiable Assets and Liabilities, and Any Noncontrolling Interest

Implementation Guidance and Illustrations

805-20-55-4

An acquired intangible asset meets the separability criterion if there is evidence of exchange transactions for that type of asset or an asset of a similar type, even if those transactions are infrequent and regardless of whether the acquirer is involved in them. For example, customer and subscriber lists are frequently licensed and thus meet the separability criterion. Even if an acquiree believes its customer lists have characteristics different from other customer lists, the fact that customer lists are frequently licensed generally means that the acquired customer list meets the separability criterion. However, a customer list acquired in a **business combination** would not meet the separability criterion if the terms of confidentiality or other agreements prohibit an entity from selling, leasing, or otherwise exchanging information about its customers.

Some intangible assets that might not be separable on their own are so closely related to another asset or liability that they are usually sold as a "package." Citing concerns that if the value of those intangible assets were included in the balance of goodwill, gains might be inappropriately recognized if the related asset or liability was later sold or extinguished, the FASB concluded that the separability criterion is met even if the asset can be separated only with a group of related assets. As such, an intangible asset that is not separable individually still meets the separability criterion if it can be separated or divided and sold, transferred, licensed, rented, or exchanged in combination with a related contract or other asset or liability. However, the intangible asset being evaluated for separability must otherwise meet the definition of an intangible asset. For example, if the intangible asset is not capable of being sold, transferred, licensed, rented or exchanged independent of the related contract, asset or liability, then the separability criterion would not be met. In this situation, any value associated with the intangible asset is embedded in the related contract, asset or liability.

The following examples illustrate intangible assets that, while not individually separable, are separable when segregated with other assets or liabilities:

Excerpt from Accounting Standards Codification

Business Combinations — Identifiable Assets and Liabilities, and Any Noncontrolling Interest

Implementation Guidance and Illustrations

805-20-55-5

An intangible asset that is not individually separable from the acquiree or combined entity meets the separability criterion if it is separable in combination with a related contract, identifiable asset, or liability. For example:

a. Market participants exchange deposit liabilities and related depositor relationship **intangible assets** in observable exchange transactions. Therefore, the acquirer should recognize the depositor relationship intangible asset separately from goodwill.

b. An acquiree owns a registered trademark and documented but unpatented technical expertise used to manufacture the trademarked product. To transfer ownership of a trademark, the owner is also required to transfer everything else necessary for the new owner to produce a product or service indistinguishable from that produced by the former owner. Because the unpatented technical expertise must be separated from the acquiree or combined entity and sold if the related trademark is sold, it meets the separability criterion.

The guidance in ASC 805 does not preclude accounting for acquired complimentary assets together if the assets have similar useful lives. Therefore, the value of acquired unpatented technical expertise may be aggregated with the value recognized for an associated trademark if both are acquired in the business combination. However, if technological or other expertise is separable only when grouped and transferred in conjunction with an assembled workforce, it would not be considered separable for purposes of recognition in a business combination as an identifiable intangible asset. This is because, as discussed in section 4.2.5.3.6, an assembled workforce is not in and of itself considered to be an identifiable asset in business combination accounting. Thus, in this case, the value attributed to technological expertise and assembled workforce would be subsumed into goodwill in a business combination.

The guidance in ASC 805 provides that the contractual-legal and separable criteria are not applicable to recognition of intangible assets in accounting for an asset acquisition. We believe, therefore, that in circumstances where technological expertise is embedded in an assembled workforce that is acquired in an asset acquisition (i.e., an acquisition that does not constitute a business combination), the value attributed to an assembled workforce intangible asset includes the value of the embedded technological expertise.

4.2.5.2 Intangible assets accounting alternative

US GAAP includes an accounting alternative (the intangible assets accounting alternative) that allows a private company or an NFP to limit the customer-related intangibles it recognizes in a business combination or acquisition by an NFP to those that are capable of being sold or licensed independently from the other assets of the business. As a result, private companies and NFPs that elect the alternative will subsume many of the types of customer-related intangible assets that they recognize separately under ASC 805 into goodwill. Under this alternative, private companies and NFPs also wouldn't separately recognize noncompetition agreements acquired as part of the transaction. See Appendix D for further discussion of this accounting alternative.

4.2.5.3 Examples of intangible assets that meet the recognition criteria

The implementation guidance in ASC 805 includes a listing of examples of intangible assets that the FASB believes meet the criteria for recognition apart from goodwill and provides guidance in applying the recognition criteria; the listing is reprinted below. We understand that the FASB and the SEC staff expect this list to be used effectively as a checklist such that, if an intangible asset that appears on the list exists among the assets acquired in a business combination and is material, it is measured and recognized apart from goodwill. We believe that the list is useful in identifying intangible assets of acquired entities. However, the list is not intended to be all-inclusive.

Assets designated by the symbol "**#**" are those that would be recognized apart from goodwill because they meet the contractual-legal criterion. Assets designated by the symbol "*****" do not arise from contractual or other legal rights, but nonetheless are recognized apart from goodwill because they meet the separability criterion. Note also that intangible assets designated by the symbol # meet the contractual-legal criterion but also might meet the separability criterion; however, separability is not a necessary condition for an asset to meet the contractual-legal criterion. The determination of whether or not a specific acquired intangible asset meets the criteria in ASC 805 for recognition apart from goodwill is based on the facts and circumstances of each individual business combination.

Marketing-related intangible assets

- Trademarks, trade names, service marks, collective marks, certification marks **#**
- Trade dress (unique color, shape, or package design) **#**
- Newspaper mastheads **#**
- Internet domain names **#**
- Noncompetition agreements **#**

Customer-related intangible assets

- Customer lists *
- Order or production backlog #
- Customer contracts and related customer relationships #
- Noncontractual customer relationships *

Artistic-related intangible assets

- Plays, operas, ballets #
- Books, magazines, newspapers, other literary works #
- Musical works such as compositions, song lyrics, advertising jingles #
- Pictures, photographs #
- Video and audiovisual material, including motion pictures, music videos, television programs #

Contract-based intangible assets

- Licensing, royalty, standstill agreements #
- Advertising, construction, management, service, or supply contracts #
- Lease agreements #
- Construction permits #
- Franchise agreements #
- Operating and broadcast rights #
- Servicing contracts such as mortgage servicing contracts #
- Employment contracts #
- Use rights such as drilling, water, air, timber cutting, and route authorities #

Technology-based intangible assets

- Patented technology #
- Computer software and mask works #
- Unpatented technology *
- Databases, including title plants *
- Trade secrets, such as secret formulas, processes, recipes #

A discussion of each category of intangible assets is included in the following sections 4.2.5.3.1 through 4.2.5.6.

4.2.5.3.1 Marketing-related intangible assets

Marketing-related intangible assets provide value to the marketing or promotion of products or services. Trademarks, service marks, collective marks and certification marks might be protected legally through registration, continuous use in commerce or other means. If they are registered or are otherwise providing legal protection, those assets meet the contractual-legal criterion for recognition apart from goodwill. Otherwise, a trademark or other mark is recognized apart from goodwill if the separability criterion is met, which the FASB believes normally would be the case.

The terms "brand" and "brand name" are general marketing terms that typically refer to a group of complimentary assets such as a trademark and its related trade name, formulas, recipes, and technological expertise, which might or might not be patented. The guidance in ASC 805 does not preclude recognition, as a single asset apart from goodwill, of the value of a group of complimentary intangible assets, commonly referred to as a brand, if the assets that make up the group have similar useful lives.

4.2.5.3.1.1 Noncompetition agreements

Noncompetition agreements are legal arrangements that limit a person's or entity's ability to compete with another entity in a specific market for a period of time. If a target in a business combination has preexisting noncompetition arrangements in place at the acquisition date, these typically would meet the contractual-legal criterion for recognition as intangible assets in a business combination. Such a noncompetition agreement is recognized as an intangible asset as of the acquisition date at its fair value, which might or might not be equal to a value assigned to the noncompetition agreement in the purchase agreement. The recognized asset is amortized over the useful life of the noncompetition agreement under a method that reflects the economic benefits to the acquirer or based on a straight-line method if another method is not reliably determinable. This accounting contrasts with accounting for noncompetition agreements included in employee compensation arrangements, which generally are not recognized as separate assets but are considered in the accounting for the compensation arrangement. As discussed further in section 4.4.4.6, we generally believe that a noncompetition agreement with continuing employees would not have significant value in a business combination, as the employee's decision on whether or not to compete is influenced by the terms of the existing employment agreement and many other factors. A discussion of noncompetition agreements in employee equity-based compensation arrangements is included in our FRD, ***Share-based payment***.

In contrast, an acquirer may enter a noncompetition agreement with the target company shareholders (who typically would have been employed by or involved in the management of the target but will not be employed by the acquirer) in connection with a business combination. Because noncompetition agreements typically are initiated by the acquirer to protect the acquirer's interests, they generally will be accounted for as transactions separate from the business combination. See section 3.4.1.2 for additional consideration of determining what is a part of the business combination.

4.2.5.3.1.2 Internet domain names

An Internet domain name is a unique alphanumeric name that is used to identify a particular numeric Internet address. Registration of a domain name creates an association between that name and a designated computer on the Internet for the period of the registration. Those registrations are renewable. A registered domain name acquired in a business combination meets the contractual-legal criterion and is measured at fair value.

An acquirer may purchase internet domain names that are similar to a primary domain name that the acquirer is already using with the intention to redirect traffic to the primary domain name rather than use the acquired name. For example, an acquirer many own a particular domain name ending in ".com" but there may also be a similar domain name ending in ".net." In such a situation, and as discussed in section 4.2.1, the acquired internet domain name must be recognized at fair value (as defined in ASC 820) to a market participant even though the acquirer may not use the asset to the extent of its highest and best use.

4.2.5.3.2 Customer-related intangible assets

4.2.5.3.2.1 Customer relationships

Excerpt from Accounting Standards Codification

Business Combinations — Identifiable Assets and Liabilities, and Any Noncontrolling Interest

Implementation Guidance and Illustrations

805-20-55-25

A customer relationship exists between an entity and its customer if the entity has information about the customer and has regular contact with the customer, and the customer has the ability to make direct contact with the entity. Customer relationships meet the contractual-legal criterion if an entity has a practice of establishing contracts with its customers, regardless of whether a contract exists at the acquisition date. Customer relationships also may arise through means other than contracts, such as through regular contact by sales or service representatives. As noted in paragraph 805-20-55-22, an order or a production backlog arises from contracts such as purchase or sales orders and therefore is considered a contractual right. Consequently, if an entity has relationships with its customers through these types of contracts, the customer relationships also arise from contractual rights and therefore meet the contractual-legal criterion.

Customer relationships can be both contractual and non-contractual. If a company has a practice of establishing customer relationships through contracts, those relationships would meet the contractual-legal criterion and would be recognized apart from goodwill regardless of whether a contract is (1) in existence at the acquisition date or (2) is cancelable. The entity's business practice of establishing relationships through contracts is determinative when evaluating whether or not a customer relationship is contractual. Thus, an intangible customer relationship asset is recognized in a business combination to the extent that the acquired business is expected to benefit from future contracts which, at the date of acquisition, do not exist but which are reasonably anticipated given the history and operating practices of the acquired business. Examples of customer relationships established by contract[19] include, without limitation, supply agreements, service contracts, purchase or sales orders, and order or production backlogs that arise from contracts. An intangible customer relationship asset that meets the contractual-legal criterion is recognized apart from goodwill even if confidentiality or other contractual terms prohibit the sale or transfer of the contract separately from the acquired company. As discussed earlier, separability is not a necessary condition for an asset to meet the contractual-legal criterion.

If a customer relationship does not arise from a contract, an intangible customer relationship asset is recognized apart from goodwill only if it meets the separability criterion. Because most non-contractual customer relationships are not separable by themselves, companies need to consider if those relationships are capable of being sold, leased, licensed, transferred or exchanged with another asset, liability or contract. Even though not separable individually, these relationships may be separable along with another asset, liability, or contract, such as with a sales representative's contract, with a brand or trademark, or with a product line, even if management has no intention of doing so. An example of such an intangible asset would be a depositor relationship, as discussed in section 4.2.5.1.2 above.

Customer relationships (both contractual and non-contractual) are recognized separately from goodwill only to the extent that they exist at the acquisition date (although as discussed above a contract need not be in place at the acquisition date for a contractual customer relationship to exist). Customer relationships that arise after the consummation date would not be recognized separately as an acquired asset.

---

[19] Note that contractual customer relationship intangible assets are distinct from contract intangible assets. Further, both the useful life and the pattern in which the economic benefits of the two assets are consumed may differ. For example, the acquisition of a contract with a customer might result in the recognition of both an in-progress contract that would be accounted for by the acquirer under ASC 606 and a separate customer relationship intangible asset that would be amortized over its expected useful life.

4.2.5.3.2.1.1 Examples of customer relationships

The following examples illustrate the establishment of customer relationships:

Excerpt from Accounting Standards Codification

Business Combinations — Identifiable Assets and Liabilities, and Any Noncontrolling Interest

Implementation Guidance and Illustrations

Example 1: Customer Contract and Customer Relationship Intangible Assets Acquired in a Business Combination

805-20-55-52

The following Cases illustrate the guidance in paragraphs 805-20-55-23 through 55-27 on recognition of customer contract and customer relationship intangible assets acquired in a business combination:

a. Five-year supply agreement (Case A)

b. One customer, contract in one of two lines of business (Case B)

c. Purchase and sales orders (Case C)

d. Cancelable contracts (Case D).

805-20-55-53

In each of the Cases, the Acquirer acquires Target in a business combination on December 31, 20X5.

Case A: Five-Year Supply Agreement

805-20-55-54

Target has a five-year agreement to supply goods to Customer. Both Target and Acquirer believe that Customer will renew the agreement at the end of the current contract. The agreement is not separable. The agreement, whether cancelable or not, meets the contractual-legal criterion. Additionally, because Target establishes its relationship with Customer through a contract, not only the agreement itself but also Target's customer relationship with Customer meet the contractual-legal criterion.

Case B: One Customer, Contract in One of Two Lines of Business

805-20-55-55

Target manufactures goods in two distinct lines of business: sporting goods and electronics. Customer purchases both sporting goods and electronics from Target. Target has a contract with Customer to be its exclusive provider of sporting goods but has no contract for the supply of electronics to Customer. Both Target and Acquirer believe that only one overall customer relationship exists between Target and Customer. The contract to be Customer's exclusive supplier of sporting goods, whether cancelable or not, meets the contractual-legal criterion. Additionally, because Target establishes its relationship with Customer through a contract, the customer relationship with Customer meets the contractual-legal criterion. Because Target has only one customer relationship with Customer, the fair value of that relationship incorporates assumptions about Target's relationship with Customer related to both sporting goods and electronics. However, if Acquirer determines that the customer relationships with Customer for sporting goods and for electronics are separate from each other, Acquirer would assess whether the customer relationship for electronics meets the separability criterion for identification as an intangible asset.

Case C: Purchase and Sales Orders

805-20-55-56

Target does business with its customers solely through purchase and sales orders. At December 31, 20X5, Target has a backlog of customer purchase orders from 60 percent of its customers, all of whom are recurring customers. The other 40 percent of Target's customers also are recurring customers. However, as of December 31, 20X5, Target has no open purchase orders or other contracts with those customers. Regardless of whether they are cancelable or not, the purchase orders from 60 percent of Target's customers meet the contractual-legal criterion. Additionally, because Target has established its relationship with 60 percent of its customers through contracts, not only the purchase orders but also Target's customer relationships meet the contractual-legal criterion. Because Target has a practice of establishing contracts with the remaining 40 percent of its customers, its relationship with those customers also arises through contractual rights and therefore meets the contractual-legal criterion even though Target does not have contracts with those customers at December 31, 20X5.

Case D: Cancelable Contracts

805-20-55-57

Target has a portfolio of one-year motor insurance contracts that are cancelable by policyholders. Because Target establishes its relationships with policyholders through insurance contracts, the customer relationship with policyholders meets the contractual-legal criterion. The guidance in Subtopic 350-30 applies to the customer relationship intangible asset.

4.2.5.3.2.2 Customer lists

A customer list consists of information about customers, such as their name and contact information. A customer list can also be in the form of a database that includes other information about a customer, such as order history and demographic information. Customer lists generally do not arise from contractual or other legal rights, but they are valuable and frequently leased or exchanged. Therefore, an acquired customer list meets the separability criterion for recognition apart from goodwill. A customer list meets the separability criterion even if the acquiring company has never sold or leased a customer list and has no intentions of doing so in the future provided that the list is capable of being sold, leased, or otherwise exchanged. However, if terms of confidentiality or other agreements prohibit a company from selling, leasing, or otherwise exchanging a non-contractual customer list, the separability criterion would not be met and an intangible asset would not be recognized apart from goodwill. See section 4.2.5.1.2 for further discussion of separability.

4.2.5.3.2.3 Customer base

A "customer base" does not meet the criteria for recognition apart from goodwill. The term "customer base" refers to a group of customers that are not known or identifiable to the company. For example, customers of fast-food franchises or movie theatres may be loyal and repeat customers; however, rarely would specific demographic data on customers be maintained such that it would meet the separability criterion. Because of the inability to separate a customer base, and the fact that the customer base relationship is not contractual, a customer base is not considered to be an asset separable from goodwill.

4.2.5.3.2.4 *Exclusivity arrangements*

Exclusivity arrangements, while not listed as an example of an intangible asset in ASC 805, are considered intangible assets that meet the contractual-legal criterion and thus are recognized separately in a business combination. The EITF reached a consensus in EITF 01-3[20] that the amortization of an intangible asset recognized in a business combination for an exclusivity arrangement under which the target of a business combination will be the exclusive supplier of a product or service to a third party, is recognized as a reduction to revenue in the acquirer's income statement if the exclusivity arrangement is negotiated in conjunction with the business combination. The EITF's consensus was based on the accounting for cash consideration given by a vendor to a customer and is similar to the guidance for consideration payable to a customer in the revenue recognition standard (see ASC 606-10-32). If the exclusivity arrangement was in place before the business combination and negotiated independently of the acquirer, amortization of the intangible asset recognized in the business combination is recognized as an expense in the acquirer's income statement. Consider the following example:

Illustration 4-3: Exclusivity arrangement

Supplier A is willing to pay an up-front fee to Company B in return for the right to be the exclusive supplier of Product A. If that arrangement were entered into directly, Supplier A would be required to recognize the up-front fee as a reduction of revenue. Supplier A has agreed to acquire Supplier Z, a much smaller entity in the same line of business that also sells Product A. Shortly before the acquisition date, Supplier Z pays an up-front fee to serve as the sole supplier of Product A to Company B on terms similar to those that would have been offered by Supplier A. As a result of its acquisition of Supplier Z, Supplier A, in effect, will become the exclusive supplier of Product A to Company B. Supplier A would recognize the fair value of that exclusivity arrangement as an intangible asset when the business combination is recorded.

Analysis

In this fact pattern, the exclusivity arrangement was not negotiated independently by the acquiree, presumably because Supplier A had an influence on the terms offered by Supplier Z, who, because of its small stature, would not have been capable of agreeing to such terms on its own. Thus, the arrangement was not negotiated independently of the business combination (even though it was negotiated prior to the acquisition date) and the exclusivity arrangement is recognized as an intangible asset separate from the business combination, with the related amortization presented as a reduction of revenue in the acquirer's consolidated income statement. If Supplier Z had entered into the exclusivity arrangement on terms that were not similar to those that would have been offered by Supplier A, and the arrangement was completed prior to the acquisition date, the arrangement might be determined to have been negotiated independently of the business combination and the amortization would be presented as an expense in the acquirer's post-acquisition income statement. See section 3.4.1.2 for additional information on identifying what is part of the business combination.

Contractual exclusivity intangible assets are distinct from the fair value of customer relationships. Further, both the useful life and the pattern in which the economic benefits of the two assets are consumed may differ.

[20] EITF 01-3 was nullified by Statement 141(R). Now codified in ASC 805, Statement 141(R) does not specifically address whether the amortization of the related intangible asset should be an expense or a reduction of revenue. As such, we believe the consensus reached in EITF 01-3 should continue to be followed in practice as it is consistent with the guidance in ASC 606-10-32.

Question 4.1 **How should the acquirer account for "overlapping" customers (i.e., the acquirer and target have an existing relationship with the same customer)?**

The SEC staff discussed this topic at the 2005 AICPA National Conference on Current SEC and PCAOB Developments.[21] The SEC staff believes that in many cases it would be difficult to support a conclusion that no value should be attributed to the acquired intangible customer relationship asset as a result of the acquirer's pre-established relationship with the target's customer. In the SEC staff's view, an acquired customer relationship that overlaps an existing customer relationship has value because the acquirer, as a result of the acquisition, has the ability to generate incremental cash flows, such as the ability to sell new products to the customer and/or to increase its "shelf space" with the customer. However, as described in a speech at the 2006 AICPA National Conference on Current SEC and PCAOB Developments,[22] that value may appropriately be reflected in the recognition of other intangible assets, such as trade names or proprietary technologies that drive customer loyalty.

4.2.5.3.3 Artistic-related intangible assets

A copyright is an example of a contractual or legal right that would meet the criteria for recognition of an artistic-related asset apart from goodwill. In the US, copyrights are granted by the federal government for the life of the creator plus 50 years and can be transferred either in their entirety through assignment or in part through licensing agreements. The existence of any assignments or licensing agreements is considered in determining the fair value of a copyright intangible asset. The guidance in ASC 805 does not preclude an acquiring company from recognizing an intangible copyright asset and any related assignments or licensing agreements as a single intangible asset if their useful lives are similar. In general, intangible artistic-related assets might arise from any rights of the acquired entity pertaining to books, musical works, plays, pictures, video materials, movies, television programs, etc.

4.2.5.3.4 Contract-based intangible assets

A contract-based intangible asset represents the value of rights that arise from an executory contract arrangement. The value of the rights may relate to either "off-market" terms or the inherent value in an "at market" (or "at-the-money") contract, as discussed in sections 4.4.4.1 and 4.4.4.2, respectively. The fact that a contract is cancelable does not affect the recognition of an intangible asset; however, the ability of the counterparty to cancel the contract would affect the measurement of the asset.

4.2.5.3.4.1 Servicing rights

An intangible asset representing an acquired servicing asset[23] is recognized apart from goodwill if the servicing right qualifies to be recognized separately from the underlying acquired financial asset pursuant to the guidance in ASC 860-50. If a servicing right does not qualify for separate recognition, the value of that servicing right is considered in measuring the fair value of the underlying acquired financial assets.

---

[21] Pamela R. Schlosser, Professional Accounting Fellow, Office of the Chief Accountant, *Remarks before the 2005 AICPA National Conference on Current SEC and PCAOB Developments*, December 5, 2005.

[22] Joseph B. Ucuzoglu, Professional Accounting Fellow, Office of the Chief Accountant, *Remarks before the 2006 AICPA National Conference on Current SEC and PCAOB Developments*, December 11, 2006.

[23] The Master Glossary in ASC 860 defines a servicing asset as "a contract to service financial assets under which the benefits of servicing are expected to more than adequately compensate the servicer for performing the servicing. A servicing contract is either:

- Undertaken in conjunction with selling or securitizing the financial assets being serviced
- Purchased or assumed separately."

If mortgage loans, credit card receivables or other financial assets are acquired in a business combination with embedded servicing rights, the inherent servicing rights associated with those assets are not a separate intangible asset because the fair value of those servicing rights is included in the measurement of the fair value of the acquired financial asset.

4.2.5.3.4.2 Leases

An acquired "in-the-money" lease arrangement meets the intangible asset recognition criteria under ASC 805. In-the-money leases might include arrangements where either (1) the target company is an owner-lessor of a leased asset or (2) the target company is a lessee. When the target company is an owner-lessor, the value of an in-place lease must be recognized apart from the acquired leased property. As the useful life of an in-place lease is normally shorter than the remaining life of the leased asset, separate recognition and amortization will affect the net earnings of the acquiring entity. See sections 4.4.4.3 and 4.4.4.4 for a further discussion of acquired leases.

Similar concepts apply to assumed lease obligations where terms of the lease arrangement are favorable or unfavorable relative to current market terms on the acquisition date. See sections 4.4.4.3 and 4.4.4.4 for a further discussion of the recognition of assumed leases.

4.2.5.3.5 Technology-based intangible assets

Many innovations and technological advances are protected by contractual or other legal rights, such as patents and copyrights, and therefore meet the criteria for recognition apart from goodwill.

4.2.5.3.5.1 Computer software and mask works

Computer software and program formats that are legally protected by patent or copyright meet the contractual-legal criterion. Even if not protected by patent or copyright, if the software and program formats can be separated or divided from the acquired business (individually or combined with a related asset, liability or contract) and sold, transferred, licensed, rented or exchanged, then the software and program formats meet the separability criterion.

Mask works are software permanently stored on a read-only memory chip as a series of stencils or integrated circuitry. In the US, mask works qualify for protection under the Semiconductor Chip Protection Act of 1984. Acquired mask works protected under the provision of the Act or other similar laws or regulations meet the contractual-legal criterion.

4.2.5.3.5.2 Databases, including title plants

A database that includes original works of authorship might be protected under copyright laws. If the database is protected by copyright, it meets the contractual-legal criterion. A database might also be comprised of information created as a consequence of normal operations, such as customer lists, a title plant, scientific data or credit information. Such databases might not be protected by copyright but might be exchanged in their entirety, or in part, and licensed or leased to others. Thus, even if the future economic benefit of a database does not arise from legal rights, it might meet the separability criterion for recognition as an intangible asset apart from goodwill.

Title plant assets are bought and sold in exchange transactions (either in whole or in part) or are leased. Title plant assets therefore meet the separability criterion. ASC 950-350 states that "a title plant consists of all of the following: (a) indexed and catalogued information for a period concerning the ownership of, and encumbrances on, parcels of land in a particular geographic area; (b) information relating to persons having an interest in real estate; (c) maps and plats; (d) copies of prior title insurance contracts and reports; and (e) other documents and records. A title plant constitutes a historical record of all matters affecting title to parcels of land in a particular geographic area."

4.2.5.3.5.3 *Trade secrets such as secret formulas, processes and recipes*

A trade secret is "information, including a formula, pattern, compilation, program, device, method, technique or process, that (1) drives independent economic value, actual or potential, from not being generally known … and (2) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy."[24] If the future economic benefit of an acquired trade secret is protected legally, such as by the Uniform Trade Secrets Act or other laws or regulations, that asset meets the contractual-legal criterion. Anti-piracy laws or regulations frequently exist to protect trade secrets and other intellectual property. Even if laws or regulations do not protect a trade secret, a trade secret generally would be recognized as an intangible asset apart from goodwill if the separability criterion is met, which the FASB believes likely would be the case. However, the value of such a trade secret might be adversely affected by the lack of legal or regulatory protection.

4.2.5.3.6 *Assembled workforce*

Excerpt from Accounting Standards Codification

Business Combinations — Identifiable Assets and Liabilities, and Any Noncontrolling Interest

Implementation Guidance and Illustrations

805-20-55-6

The acquirer subsumes into goodwill the value of an acquired intangible asset that is not identifiable as of the **acquisition date**. For example, an acquirer may attribute value to the existence of an assembled workforce, which is an existing collection of employees that permits the acquirer to continue to operate an acquired business from the acquisition date. An assembled workforce does not represent the intellectual capital of the skilled workforce—the (often specialized) knowledge and experience that employees of an acquiree bring to their jobs. Because the assembled workforce is not an identifiable asset to be recognized separately from goodwill, any value attributed to it is subsumed into goodwill.

An assembled workforce is a collection of employees that allows the acquirer to continue to operate. That is, the acquirer does not need to go through the process of finding, hiring and training the employees because they are already in place and performing. ASC 805 precludes recognition of an assembled workforce as a separate acquired asset in a business combination. The FASB believes that because an assembled workforce is (1) not an individual employee but rather a collection of employees and (2) generally not able to be sold or transferred, it does not meet either the contractual or separable criteria required for intangible asset recognition in a business combination. However, employment contracts, including collective bargaining agreements and those between individual employees and employers, generally meet the contractual-legal criterion and are recognized and valued apart from goodwill as an intangible asset (or potentially as a liability). See section 4.4.4.6 for further discussion on employment contracts in a business combination.

4.2.5.3.6.1 *Assembled workforce in an asset acquisition*

In ASC 350-30-25-4, the FASB observed that while the contractual-legal and separable criteria constitute a useful basis for the recognition of intangible assets, these criteria are not applicable in transactions that are not business combinations (i.e., asset acquisitions). Therefore, intangible assets that do not qualify for separate recognition in a business combination (i.e., are subsumed into goodwill), such as an assembled workforce, are separately valued and recognized in an asset acquisition, for which no goodwill is recognized. See Appendix A for further discussion of the accounting for asset acquisitions.

---

[24] M. Simensky and B. Lanning, The New Role of Intellectual Property in Commercial Transactions (New York: John Wiley & Sons, 1998), page 293.

4.2.5.3.7 Reacquired rights

Excerpt from Accounting Standards Codification

Business Combinations — Identifiable Assets and Liabilities, and Any Noncontrolling Interest

Recognition

805-20-25-14

As part of a business combination, an acquirer may reacquire a right that it had previously granted to the acquiree to use one or more of the acquirer's recognized or unrecognized assets. Examples of such rights include a right to use the acquirer's trade name under a franchise agreement or a right to use the acquirer's technology under a technology licensing agreement. A reacquired right is an identifiable intangible asset that the acquirer recognizes separately from goodwill. Paragraph 805-20-30-20 provides guidance on measuring a reacquired right, and paragraph 805-20-35-2 provides guidance on the subsequent accounting for a reacquired right.

805-20-25-15

If the terms of the contract giving rise to a reacquired right are favorable or unfavorable relative to the terms of current market transactions for the same or similar items, the acquirer shall recognize a settlement gain or loss. Paragraph 805-10-55-21 provides guidance for measuring that settlement gain or loss.

Initial Measurement

805-20-30-20

The acquirer shall measure the value of a reacquired right recognized as an intangible asset in accordance with paragraph 805-20-25-14 on the basis of the remaining contractual term of the related contract regardless of whether market participants would consider potential contractual renewals in determining its fair value.

As part of a business combination, an acquirer may reacquire a right that it previously had granted to the acquiree to use one or more of the acquirer's recognized or unrecognized assets. Examples of such rights include a right to use the acquirer's trade name under a franchise agreement or a right to use the acquirer's technology under a technology licensing agreement. The guidance in ASC 805 requires (1) a reacquired right to be recognized as an identifiable intangible asset separate from goodwill, and (2) a settlement gain or loss to be recognized to the extent the terms of the contract are favorable or unfavorable, respectively, compared to current market terms. See section 4.5.4 for a further discussion on measuring a settlement gain or loss in connection with the acquisition of a reacquired right.

From a measurement perspective, the guidance in ASC 805 precludes including the value of any renewal rights (both explicit and implicit renewal rights) in determining the fair value of the intangible reacquired right asset. While market participants generally would reflect expected renewals of the term of a contractual right in their estimate of the fair value of a right traded in the market, the FASB observed that an acquirer who controls a reacquired right could assume indefinite renewals of its contractual term, effectively making the reacquired right an indefinite-lived intangible asset. The FASB therefore concluded that a right reacquired from an acquiree is no longer a contract with a third party and in substance has a finite life (i.e., a renewal of the contractual term after the business combination is not part of what was acquired in the business combination). Accordingly, the FASB decided to measure reacquired rights based solely on the remaining contractual term, which constitutes one of the exceptions to the fair value recognition requirement of ASC 805.

4.2.5.3.7.1 *Subsequent accounting for reacquired rights*

Excerpt from Accounting Standards Codification

Business Combinations — Identifiable Assets and Liabilities, and Any Noncontrolling Interest

Subsequent Measurement

805-20-35-2

A reacquired right recognized as an **intangible asset** in accordance with paragraph 805-20-25-14 shall be amortized over the remaining contractual period of the contract in which the right was granted. An acquirer that subsequently sells a reacquired right to a third party shall include the carrying amount of the intangible asset in determining the gain or loss on the sale.

For the same reasons discussed in section 4.2.5.3.7 regarding the determination of the fair value of a reacquired right, the guidance in ASC 350 limits the period over which the intangible asset is amortized (i.e., its useful life) to the remaining contractual term (i.e., excluding renewal periods) of the contract from which the reacquired right arises. If a reacquired right is subsequently sold to a third party, the acquirer recognizes a gain or loss on the sale based on the difference between the sales price and any remaining carrying value of the reacquired right.

4.2.5.3.8 *Other examples of intangible assets*

The implementation guidance in ASC 805 is a useful tool in identifying intangible assets that may arise from business combinations, but it is not intended to be all-inclusive. The determination of whether a specific acquired intangible asset meets the criteria in ASC 805 for recognition apart from goodwill is based on the facts and circumstances of each acquisition, including relevant industry considerations. Because the implementation guidance in ASC 805 is not intended to be all-inclusive, many industry-specific intangible assets may not be included in that list. Examples of intangible assets that might arise in certain industries and qualify for recognition in a business combination include:

Industry	Intangible assets
Banking	▸ Core deposit intangibles ▸ Distribution channels ▸ Mortgage servicing rights ▸ Trust department relationships
Insurance	▸ Distribution channels (agents/agencies) ▸ Insurance in-force, renewal rights, value of business acquired (VOBA) ▸ Licenses, product approvals, registrations ▸ Reinsurance contracts
Broker-dealers	▸ Account relationships ▸ Proprietary products
Credit card issuers	▸ Agent bank agreements ▸ Cardholder relationships ▸ Merchant relationships ▸ Recourse rights ▸ Servicing rights
Asset management	▸ Account relationships ▸ Broker relationships ▸ Investment management contracts
Energy	▸ Easements ▸ Leases ▸ Licenses and permits ▸ Seismic data

Industry	Intangible assets
Product distribution	▸ Distribution agreements ▸ Exclusivity arrangements ▸ Sales representative agreements ▸ Sales representative employment contracts ▸ Supply contracts
Telecommunications	▸ Easements ▸ Federal Communications Commission (FCC) licenses
Real estate	▸ Agency agreements ▸ Leases ▸ Licenses ▸ Listing agreements
Media	▸ Advertising contracts ▸ Broadcast (FCC) licenses ▸ Franchise rights ▸ Network affiliation agreements
Health care/health sciences	▸ Certificates of need ▸ Contracts with insurers ▸ Operating licenses ▸ Physician/provider contracts

4.2.5.4 Measurement of identifiable intangible assets

The guidance in ASC 805 requires intangible assets acquired in a business combination to be measured at their acquisition-date fair value pursuant to the guidance in ASC 820 unless the intangible asset qualifies for a measurement exception (e.g., reacquired rights).

4.2.5.5 Acquired intangible assets to be sold

If an acquired intangible asset meets the criteria in ASC 360 to be classified as held for sale, the asset initially is recognized at fair value less cost to sell. See section 4.2.4.2 above and the FRD, ***Impairment or disposal of long-lived assets***, for further discussion.

If an acquired intangible asset does not meet the held-for-sale criteria, the asset initially is recognized at its acquisition-date fair value in accordance with the guidance in ASC 805.

4.2.5.6 SEC observations on the recognition and measurement of intangible assets in a business combination

The SEC staff has challenged whether additional intangible assets should have been recognized in a business combination. The SEC staff's comments have focused on the values assigned to specific identifiable intangible assets, as well as the significant estimates and assumptions used in calculating fair value measurements and the subsequent accounting for such recognized intangibles. Specifically, the SEC staff has requested that registrants discuss in MD&A the valuation method and principal assumptions they used to determine the fair value of each major class of intangible assets acquired.

The SEC staff also challenges whether registrants have recognized all identifiable intangible assets when other public disclosures or information about an acquisition (e.g., press releases) indicate that there potentially could be value included in goodwill that should be accounted for separately. When the goodwill resulting from a business combination represents a significant portion of the consideration transferred, the SEC staff often challenges whether all identifiable intangible assets acquired were appropriately identified and measured.

4.2.6 Research and development (R&D) assets

Under ASC 805, acquired IPR&D assets are not permitted to be written-off upon acquisition. The FASB believed that IPR&D acquired in a business combination generally satisfied the CON 6, as it existed during Statement 141(R) deliberations, definition of an asset because the observable exchange at the acquisition date provides evidence that the parties to the exchange expect future economic benefits to result from that research and development. Further, the FASB concluded that if an intangible asset is identifiable, its fair value can be measured reliably.

The guidance in ASC 805 requires the recognition of tangible and intangible assets that result from or are to be used in research and development activities as assets, irrespective of whether the acquired assets have an alternative future use. Acquired IPR&D assets are required to be measured at their acquisition-date fair value. Uncertainty about the outcome of an individual project does not affect the recognition of an IPR&D asset but is reflected in its fair value.

Examples of IPR&D assets include patents, blueprints, formulae and designs associated with a specific IPR&D project in process and the associated values derived from productive results of target company R&D activities conducted before the acquisition.

4.2.6.1 R&D definitions and scope

Even though the principles of accounting for R&D are described and applied collectively, ASC 730 defines the terms "research" and "development" separately. Activities that are not covered by the definitions of research or development in ASC 730 are not included in the scope of ASC 730, and accordingly, would not qualify as IPR&D assets. The distinctions and definitions are consistent with how businesses that conduct R&D typically delineate the activities.

Sections 4.2.6.1.1 through 4.2.6.2.9 below include a discussion of activities that qualify as R&D activities.

4.2.6.1.1 Research

The Master Glossary in ASC 730 defines research as the "planned search or critical investigation aimed at discovery of new knowledge with the hope that such knowledge will be useful in developing a new product or service (referred to as product) or a new process or technique (referred to as process) or in bringing about a significant improvement to an existing product or process."

4.2.6.1.2 Development

The Master Glossary in ASC 730 defines development as "the translation of research findings or other knowledge into a plan or design for a new product or process or for a significant improvement to an existing product or process whether intended for sale or use. It includes the conceptual formulation, design, and testing of product alternatives, construction of prototypes, and operation of pilot plants." Development does not include routine or periodic alterations to existing products, production lines, manufacturing processes, and other ongoing operations even though those alterations may represent improvements and it does not include market research or market testing activities.

4.2.6.1.3 Examples of research and development costs

Excerpt from Accounting Standards Codification

Research and Development — Overall

Implementation Guidance and Illustrations

Examples of Activities Typically Included in Research and Development

730-10-55-1

The following activities typically would be considered **research and development** within the scope of this Topic (unless conducted for others under a contractual arrangement—see paragraph 730-10-15-4[a]):

a. Laboratory research aimed at discovery of new knowledge

b. Searching for applications of new research findings or other knowledge

c. Conceptual formulation and design of possible product or process alternatives

d. Testing in search for or evaluation of product or process alternatives

e. Modification of the formulation or design of a product or process

f. Design, construction, and testing of preproduction prototypes and models

g. Design of tools, jigs, molds, and dies involving new technology

h. Design, construction, and operation of a pilot plant that is not of a scale economically feasible to the entity for commercial production

i. Engineering activity required to advance the design of a product to the point that it meets specific functional and economic requirements and is ready for manufacture

j. Design and development of tools used to facilitate research and development or components of a product or process that are undergoing research and development activities.

Examples of Activities Typically Excluded from Research and Development

730-10-55-2

The following activities typically would not be considered research and development within the scope of this Topic:

a. Engineering follow-through in an early phase of commercial production

b. Quality control during commercial production including routine testing of products

c. Trouble-shooting in connection with break-downs during commercial production

d. Routine, ongoing efforts to refine, enrich, or otherwise improve upon the qualities of an existing product

e. Adaptation of an existing capability to a particular requirement or customer's need as part of a continuing commercial activity

f. Seasonal or other periodic design changes to existing products

g. Routine design of tools, jigs, molds, and dies

h. Activity, including design and construction engineering, related to the construction, relocation, rearrangement, or start-up of facilities or equipment other than the following:

   1. Pilot plants (see [h] in the preceding paragraph)

   2. Facilities or equipment whose sole use is for a particular research and development project (see paragraph 730-10-25-2[a]).

i. Legal work in connection with patent applications or litigation, and the sale or licensing of patents.

Accounting for costs associated with conducting R&D activities on behalf of another entity under a contractual arrangement is not within the scope of ASC 805's guidance on IPR&D. These arrangements are considered executory contracts and are covered by the relevant guidance in ASC 730. In a business combination, these arrangements would be accounted for as executory contracts (intangible assets or liabilities) at fair value. See section 4.4.4 for a discussion of executory contracts.

ASC 350-40 provides that costs related to the development of internal use software are not R&D costs (unless it is a pilot project or the software will be used in a R&D project). Therefore, the acquisition of an internal use software project in a business combination is initially recognized and measured at fair value (provided the asset meets the criteria of being identifiable) and subsequently measured in accordance with the provisions of ASC 350-40. As a result, such assets are amortized over their estimated useful lives.

In addition, we believe an acquired out-licensing arrangement will be considered an IPR&D asset only if the acquirer intends to play an active role in the development of the out-licensed asset. Otherwise, the acquired out-licensing arrangement would be considered a contract-based intangible asset. For purposes of determining whether the acquirer will play an active role in the development of the out-licensed asset, we believe companies should look to the guidance in ASC 808-10-15-8 through 15-9.

4.2.6.2 Application of AICPA Accounting & Valuation Guide, Assets Acquired to Be Used in Research and Development Activities (the Guide)

The Guide provides best practices regarding the initial and subsequent measurement for, valuation of and disclosures related to the acquisition of IPR&D assets in a business combination or an asset acquisition. While the Guide focuses primarily on the software, electronic devices, and life sciences industries, it is a useful reference for recognizing and measuring acquired IPR&D assets in all industries. Although the Guide is not authoritative GAAP, there is little other guidance regarding the recognition and measurement of IPR&D. In general, practice has looked to the methodologies included in the Guide for recognizing and measuring IPR&D.

The Guide concludes that for IPR&D assets to be recognized in a business combination:

- The acquired asset (whether tangible or intangible) must satisfy the recognition criteria in ASC 805-20-25-1 through 25-3 (i.e., meet the definition of an asset as of the acquisition date and be part of what the acquirer and acquiree exchanged in the business combination, as discussed in section 3.4.1).
- There is persuasive evidence that the specific IPR&D project has substance and is incomplete (see section 4.2.6.2.1).

If the acquired IPR&D asset does not possess each of the above characteristics, the IPR&D asset is not recognized in the business combination. However, the fact that the acquired assets do not qualify as IPR&D does not mean they are not recognized in the business combination. For example, if the project has substance but is complete or the acquired assets will be used in a future R&D project that has not been commenced, the acquired assets generally would be considered identifiable intangible assets that result from R&D activities and are recognized in the business combinations at their acquisition-date fair value.

4.2.6.2.1 Attributes of an acquired IPR&D project

In addition to satisfying the general recognition criteria ASC 805-20-25-1 through 25-3, in order to qualify as IPR&D, there must be persuasive evidence that the project has substance and is incomplete.

4.2.6.2.1.1 Substance

For a specific IPR&D project to have substance, an acquired company must have performed R&D activities before the date of acquisition that constituted more than an insignificant effort and that (a) meets the definition of R&D in ASC 730-10 and (b) result in the creation of value. If an acquired IPR&D project does not have substance, it is not recognized as an asset apart from goodwill.

The Guide describes the life cycle of an R&D project as having four phases (more than one of which might occur simultaneously): conceptualization, applied research, development and pre-production. A future product, service, or process is defined, and its potential economic benefits are identified at some point within the life cycle after the project's conceptualization. After the time that a future product, service, or process has been defined and its potential economic benefits have been identified, a specific IPR&D project begins to demonstrate substance. This generally occurs when more than insignificant R&D efforts have been expended after the characteristics of the future product, service, or process have been defined. In contrast, if the acquired company has only articulated a concept, this does not constitute substantive activities.

Factors that may demonstrate that a specific IPR&D project has substance include whether management has:

- Acquired the business to obtain the project, or the project constituted a significant part of the business acquired
- Considered the impact of potential competition and other factors (that is, existing patents that would block plans for further development and commercialization) on the potential economic benefits of the project
- Approved continued project funding
- Been able to make reasonably reliable estimates of the project's completion date
- Been able to make reasonably reliable estimates of costs to complete

In addition, contemporaneous documentation of project attributes increases the likelihood that a project has substance as of the acquisition date.

4.2.6.2.1.2 Incompleteness

Incompleteness means there are remaining significant costs, engineering/technical risks or certain remaining regulatory approvals at the date of acquisition. Both of the following factors should be considered in evaluating whether a specific IPR&D project is incomplete:

- Whether the combined enterprise expects to incur more than de minimis future costs related to the acquired project that would qualify as R&D costs under ASC 730-10
- Whether additional steps or milestones in a specific R&D project remain for the combined enterprise, such as successfully overcoming the remaining engineering/technical risks or obtaining regulatory approvals related to the results of the R&D

The following are examples of circumstances in which a specific R&D project is incomplete as of the acquisition date:

- *Tangible products that are not subject to governmental regulations*. The acquired company's project has not reached a level of completion such that "first customer acceptance" (or a similar demonstration of completion for those products not subject to first customer acceptance) of the product has occurred.
- *Software to be sold, licensed, or otherwise marketed*. The software product is not available for general release to customers, even if it has reached technological feasibility. However, if a software product has reached technological feasibility and requires only minor, routine modifications prior to general release to customers (which is considered to be imminent), that software product generally would be viewed as a completed R&D project. If the acquirer is assessing whether a software product is complete based technological feasibility, an issue may arise if the acquirer and the target have different accounting policies defining when technological feasibility is achieved. For example, the acquirer may define the achievement of technological feasibility upon the completion of a detailed program design, while the target may view the achievement of technological feasibility as the completion of a working model. In such cases, the acquirer determines technological feasibility based on the consistent application of its own accounting policy.
- *Pharmaceutical products and processes related to right to market or use that are subject to governmental regulations*. The acquired company's product or process has not been approved for marketing or production by the appropriate regulatory body. For example, in the United States, only Food and Drug Administration (FDA) approval of a product is sufficient for a project to be complete (FDA approval of a product for marketing also includes approval of the manufacturing process).

There may be circumstances in which a specific IPR&D project comprises a number of subprojects that, individually, could be used by the reporting entity in a manner that would create an anticipated economic benefit. If any of those subprojects are complete and it is anticipated that the reporting entity will derive incremental economic benefit from the discrete exploitation of those subprojects, then the fair values of the completed subprojects would not represent an IPR&D asset. Instead, it would represent an asset resulting from R&D activities.

4.2.6.2.2 Distinguishing between assets used in R&D activities and assets resulting from R&D activities

The Guide distinguishes between acquired assets used in R&D activities and acquired assets resulting from R&D activities. This distinction is important because the subsequent accounting for assets used in R&D activities (classified as indefinite-lived intangible assets) differs significantly from the accounting for assets resulting from R&D activities (classified as finite-lived intangible assets).

The following table distinguishes between assets used in R&D activities and assets resulting from R&D activities.

Category of asset	Used in R&D activities	Resulting from R&D activities
R&D efforts	Assets that will continue to be pursued by the acquirer in its ongoing R&D activities.	Assets generated from R&D activities that are complete.
Defensive	The acquired defensive IPR&D asset will defend other ongoing R&D projects of the acquirer (see section 4.2.6.2.6)	The acquired defensive IPR&D asset will defend a developed product of the acquirer (see section 4.2.6.2.6)
Out-licensed	The acquirer intends to play an active role in the development of the out-licensed asset (see section 4.2.6.1.3).	The acquirer does not intend to play an active role in the development of the out-licensed asset (see section 4.2.6.1.3).
Idled	Assets temporarily idled.	Assets indefinitely idled.

4.2.6.2.3 Measurement

The fair value measurement concepts of in ASC 820 are applied to all acquired IPR&D assets. Although not to be considered an all-inclusive list, some of the factors that are considered in the measurement of acquired IPR&D include the:

- Size and duration of the market for the product
- Time and costs to commercialize and market
- Potential customers
- Share of the market
- Selling price
- Production and related costs for the product

The Guide contains a chapter discussing fair value measurement in further detail and a comprehensive example. The following sections are included in that valuation chapter:

- Considerations related to ASC 820
- The use of prospective financial information (PFI)
- Application of the multi-period excess earnings method
- Application of the relief from royalty method
- Application of decision tree analysis
- Other methods
- Valuation report considerations
- Comprehensive example

See our FRD, ***Fair value measurement***, for further discussion of fair value measurement.

4.2.6.2.4 Unit of account

When IPR&D assets are acquired in a business combination, questions arise as to whether it is appropriate to combine such assets into a single unit of account. The Guide indicates that companies may combine IPR&D assets that are classified as indefinite-lived into a single unit of account if they are "substantially the same." The unit of account determination will require the exercise of professional judgment based on the particular facts and circumstances of each acquisition. To help companies determine whether assets are "substantially the same," the Guide provides the following factors to consider (none of the factors taken individually is determinative nor is this list all-inclusive):

- The phase of development of the related IPR&D project
- The nature of the activities and costs necessary to further develop the related IPR&D project
- The risks associated with the further development of the related IPR&D project
- The amount and timing of benefits expected to be derived in the future from the developed asset(s)
- The expected economic life of the developed asset(s)

- Whether there is an intent to manage costs for the developed asset(s) separately or on a combined basis in areas such as strategy, manufacturing, advertising and selling
- Whether the asset, whether an incomplete IPR&D project or when ultimately completed, would be transferred by itself or with other separately identifiable assets

The table below discusses how a company might consider each of the factors above in its determination of the unit of account for an acquired IPR&D project in which the acquirer is planning to seek regulatory approval in more than one jurisdiction.

Factor	Indicative of a single unit of account	Indicative of multiple units of account
Phase of development	The IPR&D project is in an early phase of development.	The IPR&D project is in a later phase of development and development risks associated with each jurisdiction are known.
Nature of activities/costs	The costs and activities to further develop the compound are substantially the same regardless of jurisdiction (for example, the development of the project will occur centrally, and the company intends to incur only a small amount of development costs to obtain approval within each regulatory jurisdiction towards the later stages of testing).	Different activities and costs will be required to complete the compound in each jurisdiction (for example, the development of the project will occur centrally for a portion of the process, but the extent of separate regulatory approval costs is expected to be a significant portion of the overall development cost).
Associated risks	The risks of further development (i.e., risk of patent not being approved) are substantially the same in each jurisdiction. For example, the acquirer believes it will likely result in approval in each jurisdiction or no jurisdiction, although the timing of approval may differ.	The risks of further development vary widely based on jurisdiction. For example, the acquirer believes the risks of obtaining approval in each jurisdiction is different and they do not believe approval in one jurisdiction has relevance to the other jurisdictions.
Expected economic life	The amount and timing of benefits expected to be derived in the future from the developed assets and the expected economic life of the developed assets are substantially the same (for example, if approved, the patent is expected to have approximately the same life in each jurisdiction).	The amount and timing of benefits expected to be derived in the future from the developed assets and the expected economic life of the developed assets are not substantially the same. For example, if approved, the patent life is expected to be different for each jurisdiction.
Strategy, manufacturing, advertising and selling costs	The acquirer intends to manage strategy, manufacturing, advertising and selling costs from the perspective of the global brand, not the individual jurisdictions where the product is sold.	The acquirer intends to manage strategy, manufacturing, advertising and selling costs separately in each jurisdiction the compound is sold.
Transferred separately or with other assets	The compound (if ever transferred) would be transferred in one worldwide arrangement.	The compounds (if ever transferred) would not be transferred as a single asset.

See section 4.2.6.2.7 for a further discussion of subsequent accounting for IPR&D assets.

4.2.6.2.5 Recognition of an IPR&D asset acquired in a business combination with associated milestone and royalty obligations

In some business combinations, the acquiree may have previously licensed the rights to a product candidate from a third party in exchange for an up-front payment, additional payments if certain substantive milestones are achieved and royalties for any resulting product sales. Questions arise in practice regarding whether the future milestone and royalty obligations should be considered elements of the acquired IPR&D asset (net presentation) or a separate unit of account (gross presentation). Provided that separation is not required by other accounting literature, we believe that the future milestone and royalty obligations should be considered elements of the acquired IPR&D asset (net presentation). We believe this view is consistent with the fact that the license generally could not be sold or sub-licensed to another party without the related milestone and royalty obligations.

This is illustrated in the following example.

Illustration 4-4:	**Recognition of an IPR&D asset acquired in a business combination with associated milestone and royalty obligations**

Company A acquired Company B in a business combination. Prior to the date of acquisition, Company B had entered into a licensing arrangement with Company C. Pursuant to the terms of the license, Company B acquired the worldwide exclusive right to develop, make, distribute, and sell a drug candidate that had been patented by Company C. At the time of Company B's license, the drug candidate had not yet been approved for marketing. In exchange for these rights, Company B made a payment at the inception of the agreement and is obligated to make additional payments if certain substantive milestones are achieved (e.g., initiation of Phase 3 clinical trials), as well as royalties based on a percentage of sales of the drug if it is approved for marketing. Company A will continue pursuing this project.

Analysis

Provided that separation is not required by other accounting literature, we believe that the milestone and royalty obligations should be considered elements of the acquired IPR&D asset. In determining the fair value of this IPR&D asset, Company A will most likely use an income approach, such as a discounted cash flow method, that will consider all of the anticipated cash flows associated with this contract that a market participant would consider. Accordingly, in addition to the anticipated development costs, revenues, cost of product, commercialization costs, and other cash flows, Company A would also consider the anticipated milestones and royalties and, if necessary, would adjust the cash flows to reflect market participant assumptions. Therefore, the milestone and royalty obligations would reduce the fair value of the licensed IPR&D asset.

In some cases, an acquiree may have consummated a prior business combination that included contingent consideration payable (e.g., future cash payments contingent on the achievement of certain development milestones associated with an acquired drug candidate). When an acquirer assumes an obligation associated with a prior business combination by the acquiree, it should account for that arrangement as a liability assumed in the business combination. That is, it should consider the contingent consideration arrangement separate from any acquired IPR&D and measure it at fair value. See section 6.4.8 for additional information.

This is illustrated in the following example.

Illustration 4-5:	**Recognition of an IPR&D asset acquired in a business combination with associated milestone obligations**

Company Z acquired Company Y in a business combination. At the acquisition date, Company Y was developing a patented drug candidate, which Company Z recorded as an IPR&D asset. The terms of the acquisition agreement required Company Z to make a cash payment at the acquisition date, as well as additional cash payments to the former shareholders of Company Y if certain substantive milestones were achieved in the future relating to the acquired drug candidate (e.g., initiation of Phase 3 clinical trials). Company Z accounted for the contingent milestone payments as contingent consideration and, therefore, recorded a contingent consideration liability at fair value at the acquisition date. Company X subsequently acquired Company Z in a business combination. At the time of the acquisition, none of the milestones related to the drug candidate had been achieved. Company X recorded the IPR&D asset relating to the patented drug candidate that was previously recorded by Company Z at fair value at the acquisition date.

Analysis

Because ASC 805 generally requires assumed liabilities to be recognized at fair value, contingent consideration arrangements of an acquiree that have been assumed by the acquirer in a business combination would be separately recognized. Company X should treat the preexisting contingent consideration arrangement as a separate unit of account. Thus, when determining the fair value of the IPR&D asset, Company X should not include the future milestone payments in the discounted cash flow analysis to avoid double-counting.

4.2.6.2.6 Defensive IPR&D assets

Defensive IPR&D assets represent intangible assets, such as technology, that an acquirer does not intend to actively use (i.e., develop). Instead, the acquirer intends to lock up the intangible assets and prevent competitors from gaining access to them. See section 4.2.1 for further discussion on defensive assets.

The Guide indicates that the accounting for a defensive IPR&D asset will depend on the underlying asset that the acquired asset is intended to defend. If the acquired defensive IPR&D asset will defend other ongoing research and development projects of the acquirer, the acquired asset would be considered "used in R&D activities." Therefore, the acquired defensive IPR&D asset would be assigned an indefinite life until the defended IPR&D project is completed or abandoned. While the IPR&D asset is considered an indefinite-lived asset, it would be tested for impairment annually or more frequently if events or changes in circumstances indicate that the asset might be impaired. Upon completion or abandonment of the acquirer's existing research and development project, the IPR&D asset's useful life would be determined based on the guidance in ASC 350.

On the other hand, if the acquired defensive IPR&D asset will defend a developed product of the acquirer, the acquired asset would not be considered "used in R&D activities" because it will not be associated with R&D. Therefore, the defensive IPR&D asset would be amortized over its useful life, as determined based on the guidance in ASC 350. In that situation, the useful life generally would be based on the time period over which the defensive IPR&D asset would provide defensive value as it relates to the existing product.

The following example illustrates the concept of acquired defensive IPR&D assets:

Illustration 4-6: Acquisition of IPR&D assets in a business combination for defensive purposes

Company A acquires an IPR&D asset in a business combination. The reporting entity does not intend to complete the acquired R&D project because if the project was completed, the technology developed would compete with one of Company A's existing products. Instead, Company A intends to hold the project to prevent its competitors from obtaining access to the technology. Company A believes that holding the project will delay the development of a competing product, allowing Company A to keep its current market share for a longer period than it would if the competing project was completed.

Analysis

Because the acquired defensive IPR&D asset will defend one of Company A's developed products, the acquired asset would not be considered "used in R&D activities." Therefore, Company A would amortize the defensive IPR&D asset over its estimated useful life.

The fair value measurement of defensive IPR&D assets is based on a market participant perspective, which requires the exercise of professional judgment. For example, if an acquirer would use IPR&D assets in a defensive manner, but market participants would actively use the assets, then the acquirer generally should estimate the fair value of the assets based on market participant assumptions of actively using and developing the assets. On the other hand, if market participants also would use the IPR&D assets in defense, then the acquirer generally should estimate the fair value of the assets based on market participant assumptions of using the assets defensively.

4.2.6.2.7 Subsequent accounting for IPR&D acquired in a business combination

After capitalizing acquired IPR&D in a business combination, the provisions of ASC 350 are applied to those recognized IPR&D assets. The guidance in ASC 350 specifies that intangible assets acquired in a business combination for use in a particular R&D project are considered indefinite-lived intangible assets until the completion or abandonment of the associated R&D efforts. Accordingly, during the development period after the acquisition, these assets are not amortized but, instead, are subject to the impairment review and testing provisions of ASC 350-30-35-18 for indefinite-lived intangibles.

These requirements make it necessary for companies to track capitalized R&D project costs for impairment testing purposes. As projects evolve or multiple projects are combined, such tracking is necessary for companies to properly test assets for impairment and determine the point of project completion or abandonment. Impairment of acquired IPR&D assets immediately after acquisition would not be expected.

Upon completion of the development process for the acquired R&D project, an acquirer will need to determine the useful life of the asset resulting from R&D activities pursuant to the guidance in ASC 350. However, prior to changing its life from indefinite to finite, the asset is tested for impairment under ASC 350-30 as if it were still indefinite-lived. Note that the guidance in ASC 350 provides that R&D projects that have been temporarily idled are not written-off as abandoned. See our FRD, ***Intangibles — goodwill and other***, for further discussion.

Question 4.2 **How should the acquirer account for R&D costs incurred on acquired IPR&D subsequent to the business combination?**

Research and development costs incurred after the acquisition date related to IPR&D assets acquired in a business combination should be accounted for in accordance with the guidance in ASC 730. Accordingly, those costs are charged to expense when incurred unless they have an alternative future use.

4.2.6.2.8 IPR&D acquired in an asset acquisition

The FASB considered whether to extend the changes related to IPR&D assets acquired in a business combination to acquisitions of IPR&D assets that are acquired outside of a business combination; that is, to IPR&D assets acquired individually or in a group that do not constitute a business. Assets acquired outside a business combination that are to be used in a particular research and development project and have no alternative future use should continue to be charged to expense at the acquisition date in accordance with ASC 730, considering the guidelines included in the Guide. See Appendix A for a further discussion on the accounting for asset acquisitions.

4.2.6.2.9 Acquired IPR&D assets to be sold

If acquired IPR&D assets are expected to be sold and the criteria included in ASC 360 are met at the acquisition date or within a reasonable period of time subsequent to the acquisition date, they are initially recognized at fair value less cost to sell. See section 4.2.4.2 and our FRD, ***Impairment or disposal of long-lived assets***.

4.2.7 Indemnification assets

Excerpt from Accounting Standards Codification

Business Combinations — Identifiable Assets and Liabilities, and Any Noncontrolling Interest

Recognition

805-20-25-27

The seller in a business combination may contractually indemnify the acquirer for the outcome of a contingency or uncertainty related to all or part of a specific asset or liability. For example, the seller may indemnify the acquirer against losses above a specified amount on a liability arising from a particular contingency; in other words, the seller will guarantee that the acquirer's liability will not exceed a specified amount. As a result, the acquirer obtains an indemnification asset. The acquirer shall recognize an indemnification asset at the same time that it recognizes the indemnified item, measured on the same basis as the indemnified item, subject to the need for a valuation allowance for uncollectible amounts. Therefore, if the indemnification relates to an asset or a liability that is recognized at the acquisition date and measured at its acquisition-date fair value, the acquirer shall recognize the indemnification asset at the acquisition date measured at its acquisition-date fair value.

805-20-25-28

In some circumstances, the indemnification may relate to an asset or a liability that is an exception to the recognition or measurement principles. For example, an indemnification may relate to a contingency that is not recognized at the acquisition date because it does not satisfy the criteria for recognition in paragraphs 805-20-25-18A through 25-19 at that date. In those circumstances, the indemnification asset shall be recognized and measured using assumptions consistent with those used to measure the indemnified item, subject to management's assessment of the collectibility of the indemnification asset and any contractual limitations on the indemnified amount.

Initial Measurement

805-20-30-18

Paragraph 805-20-25-27 requires that the acquirer recognize an indemnification asset at the same time that it recognizes the indemnified item, measured on the same basis as the indemnified item, subject to the need for a valuation allowance for uncollectible amounts. That paragraph also requires that, if the indemnification relates to an asset or a liability that is recognized at the acquisition date and measured at its acquisition-date fair value, the acquirer recognize the indemnification asset at the acquisition date measured at its acquisition-date fair value. For an indemnification asset measured at fair value, the effects of uncertainty about future cash flows because of collectibility considerations are included in the fair value measure and a separate valuation allowance is not necessary, as noted in paragraph 805-20-30-4.

805-20-30-19

Paragraph 805-20-25-28 states that in some circumstances, the indemnification may relate to an asset or a liability that is an exception to the recognition or measurement principles, and provides an example of an indemnification that may relate to a contingency that is not recognized at the acquisition date because it does not satisfy the criteria for recognition in paragraphs 805-20-25-18A through 25-19 at that date. Alternatively, an indemnification may relate to an asset or a liability, for example, one that results from an uncertain tax position that is measured on a basis other than acquisition-date fair value. (Paragraph 805-20-30-13 identifies the business-combination-related measurement requirements for income taxes.) Paragraph 805-20-25-28 establishes that in those circumstances, the indemnification asset shall be recognized and measured using assumptions consistent with those used to measure the indemnified item, subject to management's assessment of the collectibility of the indemnification asset and any contractual limitations on the indemnified amount.

An acquiree's selling shareholders might provide an indemnification to an acquirer for uncertainties about the settlement amounts of acquired assets or liabilities assumed by the acquirer (e.g., uncertain tax positions, environmental liabilities or other legal matters). Indemnifications often require the acquiree's selling shareholders to reimburse the acquirer for some or all of the costs incurred by the acquirer in connection with an assumed preacquisition contingency. From the acquirer's perspective, this indemnification arrangement is an acquired asset that is recognized. The guidance in ASC 805 provides that an indemnification asset is recognized on the same basis as is the indemnified item. For example, if the indemnification relates to a preacquisition contingent liability initially measured at fair value, the indemnification asset is recognized and measured at its acquisition-date fair value, which considers any contractual limitations and would reflect credit risk of the indemnifying party. As such, no separate valuation allowance would be recognized at the acquisition-date related to collectibility concerns for indemnification assets measured at fair value. The illustration below reflects this concept:

Illustration 4-7: Initial accounting for indemnification asset when corresponding contingency is measured at fair value

Acquirer acquires Target in a business combination. Target is subject to a product defect claim at the acquisition date and Seller agrees to indemnify Acquirer for any losses that result from the claim after the acquisition date. Acquirer determines that the fair value of the potential liability could be determined and records that amount as part of the business combination. Because the product defect claim meets the definition of a liability and is recognized, a corresponding indemnification asset would be recognized in the business combination at its acquisition-date fair value. Absent any contractual limitations or collectibility issues, the fair value of the indemnification asset would be equal to the fair value of the contingent liability.

For indemnifications related to liabilities that are not required to be measured at fair value in business combination accounting under ASC 805 (e.g., uncertain tax positions or preacquisition contingencies where fair value cannot be determined), the asset is recognized and measured using assumptions consistent with those used to measure the liabilities to which they relate, subject to any contractual limitations as to the indemnification amount and management's assessment of collectibility. Accordingly, an indemnification for an uncertain tax position would be recognized at the amount of the liability, reduced for the effect of any contractual limitations (i.e., indemnification is limited to a specific amount) or assessment of collectibility. As discussed in section 4.4.1, if a preacquisition contingency is not recognized because its fair value cannot be determined, the guidance in ASC 450 applies to the recognition and measurement of the assumed contingent liability. As such, if at the acquisition date, the recognition criteria in ASC 450 are not met for the preacquisition contingency, no liability is recognized, and no amount would be recorded for any related indemnification asset. The illustration below reflects this concept:

Illustration 4-8: Initial accounting for indemnification asset when fair value of corresponding contingency cannot be determined

Acquirer acquires Target in a business combination. Target is subject to a product defect claim at the acquisition date and Seller agrees to indemnify Acquirer for any losses that result from the claim after the acquisition date. Acquirer determines that the fair value of the potential liability **cannot** be determined. After analyzing the potential liability based on the recognition criteria in ASC 450, Acquirer concludes that such criteria have not been met. At the acquisition date, no contingent liability or indemnification asset would be recognized in the business combination.

While indemnification arrangements are often included in the acquisition agreement, they can also exist as a result of a separate agreement. In such instances, indemnification accounting would apply provided that the separate indemnification arrangement is an agreement between the acquirer and seller that was entered into on the acquisition date and relates to a specific contingency or uncertainty of the acquiree. Whether

such an arrangement should be accounted for as part of the business combination or as a separate transaction will require evaluation of all facts and circumstances of the particular arrangement. See section 3.4.1.2 for further details on determining what is considered part of the business combination.

4.2.7.1 Subsequent accounting for indemnification assets (updated June 2023)

Excerpt from Accounting Standards Codification

Business Combinations — Identifiable Assets and Liabilities, and Any Noncontrolling Interest

Subsequent Measurement

805-20-35-4

At each subsequent reporting date, the acquirer shall measure an indemnification asset that was recognized in accordance with paragraphs 805-20-25-27 through 25-28 at the **acquisition date** on the same basis as the indemnified liability or asset, subject to any contractual limitations on its amount, except as noted in paragraph 805-20-35-4B, and, for an indemnification asset that is not subsequently measured at its fair value, management's assessment of the collectibility of the indemnification asset.

Derecognition

805-20-40-3

The acquirer shall derecognize an indemnification asset recognized in accordance with paragraphs 805-20-25-27 through 25-28 only when it collects the asset, sells it, or otherwise loses the right to it.

After acquisition, indemnification assets (whether or not measured at fair value in business combination accounting under ASC 805) are measured using assumptions consistent with those used to measure the indemnified contingency after the acquisition date, subject to any contractual limitations as to the indemnification amount and management's updated assessment of collectibility. The change in the value of the indemnification asset would generally be recorded as a charge or credit to operating results. However, in limited circumstances, the indemnification may relate to costs incurred by the acquirer in the post-combination period for a capital asset (e.g., capitalized improvements to property and equipment). In those situations, we believe it would be acceptable to recognize changes in the measurement of the indemnification asset as a change in the cost of the capital asset.

Illustration 4-9: Subsequent accounting for indemnification assets

Assume the same facts as in Illustration 4-7 above. Subsequent to the acquisition date, Acquirer determines there is new information related to the product defect claim indicating that the amount is higher than initially recognized. The new information results in an increase to both the liability and the indemnification asset and both increases are recognized in current earnings. The increase to the indemnification asset should equal the increase to the liability, assuming no contractual limitations or collectibility issues.

Alternatively, assume the same facts as in Illustration 4-8 above. Subsequent to the acquisition date, Acquirer determines that it is probable a loss will result from the product defect claim and records a liability pursuant to ASC 450, through current earnings. We believe that the indemnification asset, to the extent it would not exceed the recognized loss, would also be recognized under ASC 450 if collection of the amount is deemed probable. To the extent that the indemnification asset exceeds the recognized loss (which normally would not be the case), the excess would represent a gain contingency and would be recognized only when realized.[25]

[25] See related guidance in ASC 610-30 and ASC 410-30.

Illustration 4-10: Subsequent accounting for indemnification assets

Acquirer acquires Target from Seller in a business combination on 1 January 20X0. Target owns pipeline assets that are subject to oversight by a local government that has mandated certain safety improvements. Seller agrees to indemnify Acquirer for the cost of improvements Acquirer is required to make as a result of the local mandate during the first two years after the business combination (up to $3 million).

At the acquisition date, no contingent liability was recognized associated with the cost of improvements. Accordingly, no indemnification asset was recognized in the business combination.

On 1 February 20X1, Acquirer incurred $4 million for safety improvements related to the acquired pipeline assets and requested reimbursement of $3 million from Seller in accordance with the terms of the indemnification. Acquirer capitalizes the $4 million cost of improvements to its acquired pipeline assets. Acquirer also recognizes an indemnification asset of $3 million and reduces the pipeline asset by $3 million, resulting in a net increase of $1 million to the pipeline asset.

As discussed in section 4.2.7, an acquirer recognizes an indemnification asset at the same time that it recognizes an obligation. However, if for example, a preacquisition contingency is not recognized because its fair value cannot be determined and it does not meet the recognition criteria in ASC 450, the acquirer would not recognize an indemnification asset. If, subsequent to the acquisition date (whether within or outside the measurement period), the recognition criteria in ASC 450 are met and the acquirer recognizes the preacquisition contingency, the acquirer would be required to also recognize the indemnification asset. However, the indemnification asset would be subjected to any contractual limitations as well as an evaluation of collectibility.

If an indemnified item is recognized outside of the measurement period and there is a difference between the amounts recognized for the indemnified item and the indemnification asset, that difference is recognized in the statement of operations. That is, if a contractual arrangement or the indemnifying party's credit risk results in the indemnification asset being less than the indemnified item, that difference is recognized in the statement of operations and not as part of the accounting for the business combination. The example below illustrates this concept:

Illustration 4-11: Indemnification asset that does not meet the recognition criteria as of the acquisition date

Company A acquires all of the outstanding common stock of Company B on 1 April 20X0. Company B is subject to an outstanding lawsuit at the acquisition date and the previous owners of Company B agree to indemnify Company A for any losses up to $10 million from the lawsuit. Company A does not recognize a liability as of the acquisition date because the fair value of the preacquisition contingency cannot be determined during the measurement period and the recognition criteria in ASC 450 are not met as of the acquisition date. Subsequent to the acquisition date and after the end of the measurement period, Company A determines that it is probable a loss will result from the lawsuit and recognizes a liability of $15 million pursuant to ASC 450, through current earnings. We believe that the indemnification asset of $10 million (maximum amount Company B agreed to indemnify Company A) would also be recognized under ASC 450 if collection of the amount is deemed probable resulting in an offset to the $15 million in expense. As such, there would be a net pretax impact on current earnings of $5 million.

4.2.7.1.1 Subsequent accounting for an indemnification asset recognized at the acquisition date as a result of a government-assisted acquisition of a financial institution

Excerpt from Accounting Standards Codification

Business Combinations — Identifiable Assets and Liabilities, and Any Noncontrolling Interest

Subsequent Measurement

805-20-35-4B

An indemnification asset recognized at the acquisition date in accordance with paragraphs 805-20-25-27 through 25-28 as a result of a government-assisted acquisition of a financial institution involving an indemnification agreement shall be subsequently measured on the same basis as the indemnified item. In certain circumstances, the effect of the change in expected cash flows of the indemnification agreement shall be amortized. Any amortization of changes in value shall be limited to the lesser of the contractual term of the indemnification agreement and the remaining life of the indemnified assets. For example, for indemnified assets accounted for under paragraph 310-30-35-10, if the expected cash flows on the indemnified assets increase (and there is no previously recorded valuation allowance), an entity shall account for the associated decrease in the indemnification asset by amortizing the change over the lesser of the contractual term of the indemnification agreement and the remaining life of the indemnified assets. Alternatively, if the expected cash flows on the indemnified assets increase such that a previously recorded valuation allowance is reversed, an entity shall account for the associated decrease in the indemnification asset immediately in earnings. Any remaining decrease in the indemnification asset shall be amortized over the lesser of the contractual term of the indemnification agreement and the remaining life of the indemnified assets.

Pending Content:

Transition Date: *(P) December 16, 2019; (N) December 16, 2022* | **Transition Guidance:** 326-10-65-1

805-20-35-4B

An indemnification asset recognized at the acquisition date in accordance with paragraphs 805-20-25-27 through 25-28 as a result of a government-assisted acquisition of a financial institution involving an indemnification agreement shall be subsequently measured on the same basis as the indemnified item. For example, if the expected cash flows on indemnified assets increase such that a previously recorded valuation allowance is reversed, an entity shall account for the associated decrease in the indemnification assets immediately in earnings.

In October 2012, the FASB issued ASU 2012-06 to address how to subsequently measure an indemnification asset recognized at the acquisition date as a result of a government-assisted acquisition of a financial institution that includes a loss-sharing agreement. Prior to the issuance of ASU 2012-06, there was diversity in practice on how to subsequently measure the indemnification asset when there was an increase in the expected cash flows on the indemnified item (i.e., the underlying loans). In particular there were differing views on what was meant by the terms on the same basis and contractual limitations in ASC 805-20-35-4.

ASU 2012-06 added paragraph ASC 805-20-35-4B to ASC 805, which requires any changes in the expected cash flows of an indemnification asset to be measured on the same basis as the underlying loans. Any amortization period for the changes in value is limited to the lesser of the contractual term of the indemnification agreement and the remaining life of the underlying loans. For example, for indemnified assets accounted for under ASC 310-30-35-10, if the expected cash flows increase (and there is no previously recorded valuation allowance), an entity accounts for the associated decrease in the indemnification asset by amortizing the change over the lesser of the contractual term of the indemnification agreement and the remaining life of the underlying loans. In addition, when the unit of account is a pool of loans that is accounted for pursuant to ASC 310-30, any amortization of changes in value of the indemnification asset may be limited to the lesser of the contractual term of the indemnification agreement and the remaining life of the indemnified loan pool (instead of the individual loan).

In June 2016, the FASB issued ASU 2016-13. ASU 2016-13 amends the guidance on recognizing credit losses on financial assets held at amortized cost and available-for-sale debt securities. It also changes how an entity subsequently accounts for any changes in the expected cash flows for an indemnification asset initially recognized as a result of a government-assisted acquisition of a financial institution. If there is an increase in the expected cash flows on the indemnified item (i.e., underlying loan), entities will no longer be able to amortize the associated decrease in the indemnification asset over time when a previous valuation allowance had not been established. Instead, the change in the indemnification asset's value will be immediately recognized as expense in the financial statements.

We believe the guidance in ASC 805-20-35-4B is limited to indemnification assets recognized at the acquisition date as a result of a government-assisted acquisition of a financial institution and should not necessarily be analogized to in other situations.

4.2.8 Equity method investments

The amount assigned to an acquired company's investment accounted for by the equity method is the investment's fair value on the date of acquisition pursuant to the guidance in ASC 820. After acquisition, any embedded basis differences between the ASC 805 acquisition-date value of the acquired investment and the carrying amounts of the underlying net assets as of the acquisition date would be subsequently reflected in the determination of the acquirer's equity in the earnings of the investee. That is, an acquirer is required to complete a one-line business combination accounting pursuant to the guidance in ASC 323, on the acquisition date, effectively recognizing a pro-rata share of the fair value of the investee's net assets. See our FRD, ***Equity method investments and joint ventures***, for further discussion of the accounting for equity method investments.

4.2.9 Financial assets

Entities should recognize and measure financial assets acquired in a business combination at fair value. The Master Glossary in ASC 805 defines a financial asset as "cash, evidence of an ownership interest in an entity, or a contract that conveys to one entity a right to do either of the following:

- Receive cash or another financial instrument from a second entity
- Exchange other financial instruments on potentially favorable terms with the second entity."

Examples of financial assets may include receivables, investments in equity securities and investments in debt securities. An entity should carefully consider the nature of an acquired asset to determine whether it is a financial asset. For example, an entity would recognize a financial asset for a contractual right to receive future payments that may be contingent on the occurrence of specified events provided it has no ongoing obligation associated with its right to receive those payments.

4.3 Liabilities assumed

4.3.1 Pension, postretirement obligations and bonuses (updated June 2022)

Excerpt from Accounting Standards Codification

Business Combinations — Identifiable Assets and Liabilities, and Any Noncontrolling Interest

Recognition

Employee Benefits

805-20-25-22

The acquirer shall recognize a liability (or asset, if any) related to the acquiree's employee benefit arrangements in accordance with other GAAP. For example, employee benefits in the scope of the guidance identified in paragraphs 805-20-25-23 through 25-26 would be recognized in accordance with that guidance and as specified in those paragraphs.

805-20-25-23

Guidance on defined benefit pension plans is presented in Subtopic 715-30. If an acquiree sponsors a single-employer defined benefit pension plan, the acquirer shall recognize as part of the business combination an asset or a liability representing the funded status of the plan (see paragraph 715-30-25-1). Paragraph 805-20-30-15 provides guidance on determining that funded status. If an acquiree participates in a multiemployer plan, and it is probable as of the acquisition date that the acquirer will withdraw from that plan, the acquirer shall recognize as part of the business combination a withdrawal liability in accordance with Subtopic 450-20.

805-20-25-24

The Settlements, Curtailments, and Certain Termination Benefits Subsections of Sections 715-30-25 and 715-30-35 establish the recognition guidance related to accounting for settlements and curtailments of defined benefit pension plans and certain termination benefits.

805-20-25-25

Guidance on defined benefit other postretirement plans is presented in Subtopic 715-60. If an acquiree sponsors a single-employer defined benefit postretirement plan, the acquirer shall recognize as part of the business combination an asset or a liability representing the funded status of the plan (see paragraph 715-60-25-1). Paragraph 805-20-30-15 provides guidance on determining that funded status. If an acquiree participates in a multiemployer plan and it is probable as of the acquisition date that the acquirer will withdraw from that plan, the acquirer shall recognize as part of the business combination a withdrawal liability in accordance with Subtopic 450-20.

Other Employee Benefit Arrangements

805-20-25-26

See also the recognition-related guidance for the following other employee benefit arrangements:

a. One-time termination benefits in connection with exit or disposal activities. See Section 420-10-25.

b. Compensated absences. See Section 710-10-25.

c. Deferred compensation contracts. See Section 710-10-25.

d. Nonretirement postemployment benefits. See Section 712-10-25.

Initial Measurement

Employee Benefits

805-20-30-14

The acquirer shall measure a liability (or asset, if any) related to the acquiree's employee benefit arrangements in accordance with other GAAP. For example, employee benefits in the scope of the guidance identified in paragraphs 805-20-30-15 through 30-17 would be measured in accordance with that guidance and as specified in those paragraphs.

Pension and Postretirement Benefits Other than Pensions

805-20-30-15

Guidance on defined benefit pension plans is presented in Subtopic 715-30. Guidance on defined benefit other postretirement plans is presented in Subtopic 715-60. Paragraphs 805-20-25-23 and 805-20-25-25 require an acquirer to recognize as part of a business combination an asset or a liability representing the funded status of a single-employer defined benefit pension or postretirement plan. In determining that funded status, the acquirer shall exclude the effects of expected plan amendments, terminations, or curtailments that at the acquisition date it has no obligation to make. The projected benefit obligation assumed shall reflect any other necessary changes in assumptions based on the acquirer's assessment of relevant future events.

805-20-30-16

The Settlements, Curtailments, and Certain Termination Benefits Subsection of Section 715-30-35 establishes the measurement guidance related to accounting for settlements and curtailments of defined benefit pension plans and certain termination benefits.

Other Employee Benefit Arrangements

805-20-30-17

See also measurement-related guidance for the following other employee benefit arrangements:

a. One-time termination benefits in connection with exit or disposal activities. See Section 420-10-30.

b. Compensated absences. See Section 710-10-25.

c. Deferred compensation contracts. See Section 710-10-30.

d. Nonretirement postemployment benefits. See Section 712-10-25.

Employee benefit arrangements that are within the scope of ASC 710, 712 and 715 are exceptions to the recognition and measurement criteria of ASC 805 and, in a business combination, are accounted for in accordance with the applicable standards. The FASB concluded that it was not feasible to require all employee benefit obligations assumed in a business combination to be measured at their acquisition-date fair values as to do so would effectively require the FASB to comprehensively reconsider the relevant standards for those employee benefits as a part of the business combinations project. Given the complexities in accounting for employee benefit obligations in accordance with existing requirements, the FASB decided that the only practicable alternative is to require those obligations, and any related assets, to be measured in accordance with their applicable standards.

A liability for the projected benefit obligation (PBO) in excess of the fair value of the plan assets (or an asset for the fair value of plan assets in excess of the PBO) of a single-employer defined benefit pension plan obligation, including supplemental executive retirement plans, assumed in an acquisition is measured and recognized in accordance with ASC 805-20-25-23 and 30-15. Likewise, a liability for the accumulated postretirement benefit obligation (APBO) in excess of the fair value of plan assets (or an asset for the fair value of plan assets in excess of the APBO) of a postretirement benefit plan other than a pension plan (OPEB) assumed in an acquisition is measured and recognized in accordance with ASC 805-20-25-25. Thus, in connection with the business combination, any previously unrecognized prior service cost, gains or losses and transition amounts of the acquired company related to the assumed plan, including amounts previously recognized in other comprehensive income, are eliminated for financial reporting purposes. The following example represents a reconciliation of an acquired pension plan's funded status immediately before and after a business combination:

	Acquired plan before acquisition	**Acquired plan after acquisition**
PBO	$ (10,000)	$ (10,000)
Plan assets — at fair value	12,000	12,000
Net gain included in other comprehensive income	(1,100)	N/A
Prior service cost included in other comprehensive income	1,500	N/A
Prepaid pension cost per balance sheet	$ 2,000	$ 2,000

After the acquisition, the eliminated items in other comprehensive income will have no effect on the acquiring company's net periodic benefit cost. However, those types of items might have to be considered for subsequent funding purposes.

Pension and OPEB plans are measured for purposes of a business combination based on benefits attributed to acquiree employee service prior to the date of the business combination and on the *acquirer's* assumptions and assessments of relevant future expectations. However, significant differences between a target company's pension and OPEB plan assumptions and future expectations and the assumptions and future expectations used by an acquiring company in measuring the obligation (or asset) in a business combination should be explainable and the assumptions of both entities should fall within a range of acceptability. Generally, we would expect such differences, if any, to be immaterial to the acquirer.

4.3.1.1 Modifications to pension and OPEB obligations in connection with a business combination

As noted in section 3.4.1.1, an underlying principle in ASC 805 is that to qualify as assets acquired and liabilities assumed in a business combination, the CON 8.4 definition of an asset or liability must be met at the acquisition date. That is, an asset must be acquired and a liability must be assumed from the target and not created or modified by actions undertaken by the acquirer.

Consistent with this underlying principle, modifications (e.g., terminations, curtailments, and plan amendments) by an acquirer to an assumed acquiree pension or OPEB plan are not accounted for as part of the business combination unless the acquirer is obligated to make the modification as of the acquisition date and as a result of the acquisition. Generally, we believe that in order for the modification to be accounted for as part of the business combination, the obligation to modify a plan would need to be substantive and the result of legal, regulatory or contractual requirements (e.g., the modification is required by the pension or OPEB plan document of the acquiree). In negotiating the terms of the acquisition agreement, an acquirer may agree to modify an existing pension or OPEB plan that would not otherwise have required modification. While an acquirer would be obligated, based on the terms of the acquisition agreement, to modify the assumed pension or OPEB plan, in such a situation we believe the modifications should be carefully assessed to determine whether it is truly part of the business combination (e.g., the modification benefits the selling shareholders) or whether it is simply part of the acquirer's compensation strategy and should be accounted for outside of the business combination. The effect of modifications that the acquirer is not obligated to make (i.e., not a part of the business combination) is recognized in current operations or other comprehensive income in the post-combination financial statements of the combined entity based on the requirements of ASC 715. See section 3.4.1.2 for further discussion of the accounting for transactions apart from the business combination.

4.3.1.2 Effect of employee terminations on obligations for pension benefits, other postretirement benefits and postemployment benefits

An entity that has agreed to a business combination may develop a plan to terminate certain employees. The plan will be implemented only if the combination is consummated, but the entity assesses the likelihood of the combination to be probable. In this circumstance, when terminated, the employees might be entitled to termination benefits under a preexisting plan or contractual relationship. The termination of the employees also may affect the entity's assumptions in estimating its obligations for pension benefits, other postretirement benefits, and postemployment benefits; that is, the termination of the employees may trigger curtailment losses or the recording of a contractual termination benefit.

In accordance with the guidance in ASC 805-20-55-50 and 55-51, the liability for the contractual termination benefits and the curtailment losses under employee benefit plans that will be triggered by the consummation of the business combination is not recognized when it is probable that the business combination will be consummated; rather it is recognized when the business combination is consummated. In other words, the liabilities are recognized as part of the business combination.

4.3.1.3 Multiemployer pension plans

Liabilities recognized in a business combination for multiemployer pension plans are measured in accordance with the provisions of ASC 715. Multiemployer pension plans are accounted for differently than single employer plans, as discussed in ASC 715-80. Liabilities for multiemployer plans generally are recognized only for due and unpaid contributions as of the acquisition date. Liabilities for unfunded benefit obligations are not required to be recognized unless withdrawal from the multiemployer plan is probable and the liability can be reasonably estimated in accordance with the provisions of ASC 450.

4.3.1.4 Accrued bonus

An acquired company may have recorded a liability as of the acquisition date relating to a bonus plan for its employees. The acquirer recognizes an assumed liability in the business combination if the acquired company had a present or an unavoidable obligation to pay the employees for their past services. Bonuses to be settled in cash are measured in accordance with the provisions of ASC 710 whereas bonuses to be settled in shares would be subject to the provisions of ASC 718. See our FRD, ***Share-based payment***, for further discussion of bonuses settled partly or entirely in shares.

In some situations, employment agreements or other arrangements with executives may provide the executive with a bonus or other payment upon a change in control. Further, some arrangements (such as stay bonus arrangements) may be negotiated contemporaneously with the business combination to make sure that certain executives or employees remain employed at the acquired company for a period of time.

When an arrangement is negotiated contemporaneously with the business combination (e.g., a stay bonus arrangement, an employee transaction bonus), an acquirer begins the analysis of determining whether the transaction is part of the business combination by evaluating the factors in ASC 805-10-55-18. Careful consideration should be given to the facts and circumstances to determine whether such arrangements should be accounted for as part of the business combination or as a separate transaction. See section 6.4.5.9 for further information.

4.3.2 Cost of restructuring an acquired company

Excerpt from Accounting Standards Codification

Business Combinations — Identifiable Assets and Liabilities, and Any Noncontrolling Interest

Recognition

805-20-25-2

To qualify for recognition as part of applying the acquisition method, the identifiable assets acquired and liabilities assumed must meet the definitions of assets and liabilities in FASB Concepts Statement No. 6, Elements of Financial Statements, at the acquisition date. For example, costs the acquirer expects but is not obligated to incur in the future to effect its plan to exit an activity of an acquiree or to terminate the employment of or relocate an acquiree's employees are not liabilities at the acquisition date. Therefore, the acquirer does not recognize those costs as part of applying the acquisition method. Instead, the acquirer recognizes those costs in its postcombination financial statements in accordance with other applicable generally accepted accounting principles (GAAP).

The guidance in ASC 805 specifies that an acquirer would recognize a liability for restructuring or exit activities associated with the target company in a business combination only if the recognition criteria in ASC 420 are met by the target as of the acquisition date:

Excerpt from Accounting Standards Codification

Exit or Disposal Cost Obligations — Overall

Recognition

420-10-25-2

A liability for a cost associated with an exit or disposal activity is incurred when the definition of a liability included in FASB Concepts Statement No. 6, Elements of Financial Statements, is met. Only present obligations to others are liabilities under the definition. An obligation becomes a present obligation when a transaction or event occurs that leaves an entity little or no discretion to avoid the future transfer or use of assets to settle the liability. 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 noted in section 3.4.1.1, an underlying principle of ASC 805 is that to qualify as acquired assets and assumed liabilities in a business combination, the CON 8.4 definition of an asset or liability must be met at the acquisition date.[26] As such, the guidance in ASC 805 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.

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 ASC 420 by the acquiree before the business combination. However, the acquirer must, in any event, continue to meet the ASC 420 criteria as of the acquisition date. The following example illustrates this concept:

Illustration 4-12: Cost of restructuring an acquired company

On 1 June 20X9, Acquirer enters into a business combination agreement to acquire Target. Acquirer will take control of target on the closing date of the transaction, 1 January 20X0. During the time between 1 June 20X9 and 1 January 20X0, Acquirer completes a restructuring plan to close certain of Target's facilities and terminate the employees of those facilities at a total cost of $5 million. On the acquisition date, 1 January, all of the ASC 420 criteria are met, for the recognition of the restructuring liability. Additionally, on the closing date, Target has an existing restructuring liability related to an operating lease that it terminated before the end of its term of $1 million that was recognized pursuant to the guidance in ASC 420 on 1 April 20X8, prior to the contemplation of the business combination. Acquirer has elected to continue the restructuring initiated by Target in 20X8.

In this example, Acquirer would recognize a liability of $1 million in the business combination, representing the assumed restructuring liability. Acquirer would also recognize a restructuring liability of $5 million on the acquisition date; however, since Acquirer initiated the restructuring, it is not considered a liability assumed in the business combination and it is recognized by Acquirer in its post-acquisition earnings.

4.3.2.1 Cost of restructuring initiated by the acquiree

As noted in the above section, restructuring liabilities that are assumed from the acquiree might be recognized by the acquirer in a business combination. However, the recognition in business combination accounting of any liability for a restructuring plan initiated by the acquiree in conjunction with or near the time of a business combination (or an agreement to enter into a business combination) should be subject to

[26] The FASB issued CON 8.4 to replace CON 6 in December 2021, but we do not believe the FASB intended to change how a liability for costs associated with an exit or disposal activity should be recognized and initially measured.

significant scrutiny. As discussed in section 3.4.1.2, the guidance in ASC 805 includes a requirement to assess what transactions are part of the business combination. We believe that any assumed restructuring liability should be substantive, leave an acquiree little or no discretion to avoid the future transfer or use of assets to settle the liability, and generally, meet the ASC 420 criteria prior to the contemplation of a business combination. If the restructuring plan was implemented at the request of the acquirer, or would not make strategic sense absent the business combination, we believe that the restructuring activities likely would be accounted for outside of the business combination in the acquirer's post-acquisition operating results.

4.3.3 Guarantees

The requirement in ASC 805 to recognize and measure liabilities assumed in a business combination includes guarantees made by the acquired entity that are assumed by the acquiring entity. Assumed guarantees are recognized in accordance with the guidance in ASC 460 and measured at fair value (as defined in ASC 820) on the acquisition date.

4.3.4 Instruments indexed to or settled in shares and classified as liabilities

An acquired entity may have issued securities that are equity in legal form, but classified and accounted for as a liability, as discussed in ASC 480 and ASC 715. Regardless of the legal form or accounting classification, if the instruments remain outstanding after the business combination, they are required to be recognized on the acquisition date as part of the business combination and measured at their fair value. As discussed in section 4.6.1 and ASC 810, equity instruments classified as liabilities are not considered noncontrolling interests. The subsequent accounting for such liabilities is addressed in the literature described above.

4.3.5 Measuring the fair value of debt assumed

When an acquirer assumes the outstanding debt of an acquiree in a business combination, the acquirer measures the assumed debt at fair value as of the acquisition date. When an income approach is used to estimate the fair value of the debt obligation, the risk associated with the uncertainty in the cash flows can be captured either solely through the discount rate (i.e., discount rate adjustment technique) or in the expected cash flows (i.e., expected present value technique).[27]

If the discount rate adjustment technique is used, typically the contractual cash flows of the debt obligation would be discounted using a market rate of return for such cash flows. In determining what would constitute an appropriate market discount rate, we believe the valuation should consider whether the acquirer guarantees or becomes obligated (directly or indirectly) for the assumed debt.

When the acquirer guarantees or becomes directly obligated for the assumed debt, we believe a market participant would base the discount rate on the credit standing of the combined entity because the debt has become an obligation of the acquirer. However, when the debt remains the obligation of the acquiree only, it is important to assess the extent to which a market participant would assume that the acquirer would allow (or not allow) the acquiree to default on the debt. In such circumstances, judgment is required to understand whether the discount rate should be primarily based on the credit standing of the combined entity (thereby inferring that market participants assume that the acquirer has indirectly guaranteed the debt) or based on the acquiree's stand-alone creditworthiness at the date of acquisition (thereby inferring that market participants assume that the acquirer would allow the acquiree to default on the debt). We would expect the acquirer to have evidence to support its assertion that market participants would expect it to effectively guarantee the acquired debt even though it has not legally agreed to do so.

---

[27] It should be noted that the discount rate adjustment technique is utilized more commonly in measuring the fair value of debt given the nature of a debt obligation and the subjectivity and uncertainty of adjusting the cash flows in the expected present value technique. See section 21 of our FRD, ***Fair value measurement***, for additional discussion on the discount rate adjustment technique and the expected present value technique.

4.3.5.1 Debt issuance costs (updated June 2022)

Companies frequently incur debt issuance costs that are reported in the balance sheet as a direct deduction from the face amount of the debt (i.e., a discount) and amortized over the term of the debt. Similar to virtually all assets acquired and liabilities assumed in a business combination, outstanding debt assumed in the business combination is recognized at fair value. Further, debt issuance costs do not meet the definition of an asset in CON 8.4. As such, unamortized debt issuance costs of an acquired entity are not recognized in a business combination and do not affect the estimate of fair value of the recognized debt.

However, there are additional considerations that are relevant in the pre-acquisition financial statements of the acquiree or when an acquiree continues to issue separate financial statements and has not elected to apply pushdown accounting. Pursuant to ASC 470-50, debt issuance costs may be written-off only when debt is extinguished. Therefore, unamortized debt issuance costs may be written-off in the financial statements of the acquiree only when debt has been extinguished as of the acquisition date. See sections 2.5.1 in our FRDs, ***Issuer's accounting for debt and equity financings (before the adoption of ASU 2020-06, Accounting for Convertible Instruments and Contracts in an Entity's Own Equity)*** and ***Issuer's accounting for debt and equity financings (after the adoption of ASU 2020-06, Accounting for Convertible Instruments and Contracts in an Entity's Own Equity)***, for further discussion on evaluating whether debt has been extinguished before and after the adoption of ASU 2020-06,[28] respectively.

4.4 Amounts that might be assets or liabilities

4.4.1 Preacquisition contingencies

Excerpt from Accounting Standards Codification

Business Combinations — Identifiable Assets and Liabilities, and Any Noncontrolling Interest

Recognition

805-20-25-18A

The following recognition guidance in paragraphs 805-20-25-19 through 25-20B applies to assets and liabilities meeting both of the following conditions:

a. Assets acquired and liabilities assumed that would be within the scope of Topic 450 if not acquired or assumed in a business combination

b. Assets or liabilities arising from contingencies that are not otherwise subject to specific guidance in this Subtopic.

805-20-25-19

If the acquisition-date fair value of the asset or liability arising from a contingency can be determined during the measurement period, that asset or liability shall be recognized at the acquisition date. For example, the acquisition-date fair value of a warranty obligation often can be determined.

[28] For PBEs other than smaller reporting companies as defined by the SEC, ASU 2020-06 is effective for annual periods beginning after 15 December 2021, and interim periods therein. For all other entities, it is effective for annual periods beginning after 15 December 2023, and interim periods therein. Early adoption is permitted for fiscal years beginning after 15 December 2020, but an entity must adopt the new guidance as of the beginning of a fiscal year.

805-20-25-20

If the acquisition-date fair value of the asset or liability arising from a contingency cannot be determined during the measurement period, an asset or a liability shall be recognized at the acquisition date if both of the following criteria are met:

a. Information available before the end of the measurement period indicates that it is probable that an asset existed or that a liability had been incurred at the acquisition date. It is implicit in this condition that it must be probable at the acquisition date that one or more future events confirming the existence of the asset or liability will occur.

b. The amount of the asset or liability can be reasonably estimated.

805-20-25-20A

The criteria in paragraph 805-20-25-20 shall be applied using the guidance in Topic 450 for application of similar criteria in paragraph 450-20-25-2.

805-20-25-20B

If the recognition criteria in paragraphs 805-20-25-19 through 25-20A are not met at the acquisition date using information that is available during the measurement period about facts and circumstances that existed as of the acquisition date, the acquirer shall not recognize an asset or liability as of the acquisition date. In periods after the acquisition date, the acquirer shall account for an asset or a liability arising from a contingency that does not meet the recognition criteria at the acquisition date in accordance with other applicable GAAP, including Topic 450, as appropriate.

Initial Measurement

805-20-30-9

Paragraphs 805-20-25-18A through 25-20B establish the requirements related to recognition of certain assets and liabilities arising from **contingencies**. Initial measurement of assets and liabilities meeting the recognition criteria in paragraph 805-20-25-19 shall be at acquisition-date fair value. Guidance on the initial measurement of other assets and liabilities from contingencies not meeting the recognition criteria of that paragraph, but meeting the criteria in paragraph 805-20-25-20 is at paragraph 805-20-30-23.

805-20-30-23

Initial measurement of assets and liabilities meeting the recognition criteria in paragraph 805-20-25-20 shall be at the amount that can be reasonably estimated by applying the guidance in Topic 450 for application of similar criteria in paragraph 450-20-25-2.

ASC 805 requires that assets acquired and liabilities assumed in a business combination that arise from contingencies be recognized at fair value, in accordance with the guidance in ASC 820, if the fair value can be determined during the measurement period. If the fair value of a preacquisition contingency cannot be determined during the measurement period, ASC 805 requires that the contingency be recognized at the acquisition date in accordance with the guidance in ASC 450, if it meets the criteria for recognition in that guidance.

4.4.1.1 What is considered a preacquisition contingency?

The Master Glossary in ASC 805 defines a contingency as "an existing condition, situation, or set of circumstances involving uncertainty as to possible gain (hereinafter a 'gain contingency') or loss (hereinafter a 'loss contingency') to an entity that will ultimately be resolved when one or more future events occur or fail to occur." A preacquisition contingency of an acquired entity is a gain or loss contingency

that is in existence before the consummation of the combination. A preacquisition contingency can be a contingent asset or a contingent liability. Potential environmental liabilities, litigation losses, insurance claims or warranty obligations that exist and are associated with an acquired entity before and as of the date of acquisition are examples of preacquisition contingencies.

Although a preacquisition contingency must have existed at or resulted from events that occurred prior to the acquisition date, the FASB did not intend to limit the recognition of preacquisition contingencies only to items known as of the acquisition date. Thus, it is required only that the preacquisition contingency existed as of the acquisition date and be identified within the measurement period (see section 7.3 for a discussion of the measurement period in which new information about facts that existed as of the acquisition date would be considered in adjusting the acquisition date measurement of a preacquisition contingency).

Illustration 4-13: Business combination with preacquisition contingencies

In January 20X9, Acquirer obtains control of Target. Target owns an industrial site and is responsible for any environmental contamination that is caused by operations undertaken at the site. During the due diligence process, Acquirer did not identify any environmental issues at the site that would require remediation and did not recognize a liability for an environmental obligation related to the site in the preliminary business combination accounting.

In June 20X9, Acquirer was notified by the EPA of remediation requirements at a nearby river that the agency has attributed to contaminated run-off from the industrial site that occurred during periods prior to the acquisition. At the end of June 20X9, Acquirer is still assessing the magnitude of contamination and the cost of the cleanup effort. Accordingly, pursuant to ASC 805-20-50-4A, the acquirer discloses that the initial accounting for the contingent liability is incomplete in its June 20X9 interim financial statements.

Analysis

Because Acquirer becomes aware of new information during the measurement period about the contamination that existed as of the acquisition date for which it may be responsible, Acquirer determines in July 20X9 that a preacquisition contingency exists as of the acquisition date.

Due to uncertainties associated with the environmental obligation, Acquirer determines that it cannot estimate the fair value of the assumed contingency as of the acquisition date. Accordingly, Acquirer applies ASC 450 and determines that it must recognize a liability because the preacquisition contingency is probable and reasonably estimable.

Acquirer's best estimate of the liability is $20 million based on information available during the measurement period about facts and circumstances that existed as of the acquisition date. This amount is recognized as an adjustment to the initial amounts recognized in the business combination. Although not identified at the acquisition date, the remediation requirement existed as of the acquisition date, and the amount of the associated obligation is probable and can be reasonably estimated.

4.4.1.2 Initial recognition and measurement guidance

4.4.1.2.1 Fair value can be determined

The guidance in ASC 805 requires that preacquisition contingencies be recognized at fair value, if fair value can be determined. In practice, relatively few preacquisition liabilities are measured at fair value, with most contingent liabilities being recognized based on the guidance in ASC 450. In particular, we believe this is because it is uncommon that the fair value of contingencies for litigation can be determined given the inherent uncertainties in the litigation process.

While the fair value of most preacquisition contingencies will not be able to be determined, the FASB believes that the acquisition-date fair value of a warranty obligation often can be determined. We believe that acquirers will often be able to determine the fair value of warranty obligations associated with products or services that have been offered for an extended period and for which there is significant warranty claim history. If the acquirer concludes that fair value can be determined, it will be required to initially recognize warranty obligations at fair value. If the fair value of the warranty obligation cannot be determined, it would be accounted for as described in section 4.4.1.2.2.

4.4.1.2.1.1 Measuring the fair value of preacquisition contingencies

Because most acquirers conclude that the fair value of preacquisition contingencies cannot be determined and default to the ASC 450 recognition and measurement criteria, estimating the fair value of preacquisition contingent assets and liabilities in a business combination is an area for which there is little guidance or practical experience. The process of estimating the fair value of preacquisition contingencies is highly subjective and judgmental and should consider all the relevant facts and circumstances that a market participant would consider. Generally, we believe a discounted cash flow technique, in which the objective is to develop probability-weighted cash flow estimates of the various outcomes, would be used to measure preacquisition contingencies in a business combination.

4.4.1.2.2 Fair value cannot be determined

If the fair value of a preacquisition contingency cannot be reasonably determined during the measurement period, the guidance in ASC 805 requires the entity to recognize that asset or liability as of the acquisition date if the following two criteria are met:

- Information available before the end of the measurement period indicates that it is probable that an asset existed or that a liability had been incurred at the acquisition date.
- The amount of the asset or liability (determined pursuant to the guidance in ASC 450) can be reasonably estimated.

It is implicit in the first criterion above that it must be probable at the acquisition date that one or more future events confirming the existence of the asset or liability will occur. ASC 805 specifies that these criteria are to be applied using the guidance provided in ASC 450.

Contingent assets are recognized using the guidance in ASC 450 applicable to contingent liabilities (i.e., a contingent asset would be recognized if the probable and reasonably estimable criteria are met). As noted in ASC 450-10-15-2A, the guidance for contingent assets in ASC 450 would not be applied upon initial recognition.

The guidance in ASC 410 permits discounting of contingent liabilities if the aggregate amount of the obligation and the amount and timing of the cash payments are fixed or reliably determinable. However, if payments are fixed or reliably determinable, we believe that fair value is generally able to be determined and the asset or liability initially would be recognized at fair value.

4.4.1.3 Subsequent accounting for preacquisition contingencies

Excerpt from Accounting Standards Codification

Business Combinations — Identifiable Assets and Liabilities, and Any Noncontrolling Interest

Subsequent Measurement

805-20-35-3

An acquirer shall develop a systematic and rational basis for subsequently measuring and accounting for assets and liabilities arising from **contingencies** depending on their nature.

ASC 805 does not provide subsequent accounting guidance, other than to state that subsequent accounting should be applied on a systematic and rational basis. We believe that subsequent accounting for preacquisition contingencies should be influenced by the initial recognition and measurement of the contingent liability or asset.

4.4.1.3.1 Preacquisition contingencies recognized at fair value

Preacquisition contingencies that initially are recognized at fair value are subsequently measured using a systematic and rational method. For example, the FASB believes that a subsequent accounting model similar to that for guarantees initially recognized at fair value in accordance with ASC 460 may be appropriate for warranty obligations initially measured at fair value.

For other contingent obligations initially recognized at fair value, we believe that the systematic and rational approach considers accretion of the liability as well as changes in estimates of the cash flows. For example, we believe that a subsequent accounting model similar to that prescribed by ASC 410 for asset retirement obligations likely would be an acceptable method to account for preacquisition contingencies initially measured at fair value. Other approaches that result in remeasurement of the asset or liability using the original discount rate for both increases and decreases in expected cash flows also may be acceptable. However, we believe that the approaches to subsequently measuring contingent assets and liabilities previously provided in Statement 141(R) (e.g., higher of fair value or ASC 450 amount for liabilities) would not be appropriate because of the implementation issues and inconsistencies associated with those measurements.[29]

We would expect any systematic and rational model to be consistently applied among similar assets or similar liabilities.

4.4.1.3.2 Preacquisition contingencies recognized pursuant to the guidance in ASC 450

We believe that contingent liabilities initially recognized and measured in accordance with the guidance in ASC 450 should subsequently be accounted for in accordance with that guidance.

4.4.1.4 Adjustment to preacquisition contingencies during the measurement period

An adjustment to a preliminary amount recognized for a preacquisition contingency is recognized as an adjustment to the assets acquired and liabilities assumed in the business combination if the adjustment results from a change in estimate based on facts that existed as of the acquisition date and is made within the measurement period (as discussed in section 7.3). That is, the subsequent accounting discussed in section 4.4.1.5 does not apply to qualifying measurement period adjustments. Adjustments resulting from facts that were not in existence as of the acquisition date or that are obtained after the measurement period is closed are recognized in operations subject to the guidance in section 4.4.1.5.

Illustration 4-14: Adjustment to preacquisition contingencies during the measurement period — Information that existed as of the acquisition date
Acquirer purchases Target in a business combination in June 20X9. Target's historical financial statements include a contingent liability of $5 million. As part of the initial accounting for the business combination, Acquirer preliminarily estimates the fair value of the assumed contingency to be $3 million and records that amount as of the acquisition date. Acquirer is waiting for further information in order to finalize its preliminary estimate.

[29] The referenced approaches previously provided in Statement 141(R) were amended by the issuance of FSP FAS 141(R)-1 in April 2009.

Acquirer discloses in the notes to its financial statements as of and for the interim periods ended 30 June 20X9 and 30 September 20X9, that it is awaiting additional information on the assumed contingent obligation. In December 20X9, Acquirer receives information from third parties hired to assist in the valuation indicating that the fair value of the obligation at the acquisition date was $4 million. As such, the Acquirer increases the assumed liability to $4 million by an adjustment to its initial business combination accounting and does not repeat the disclosure that additional information is forthcoming that will be used to adjust the initial business combination accounting. The adjustment is recorded in the period ended December 20X9.

Illustration 4-15: Adjustment to preacquisition contingencies during the measurement period — information obtained subsequent to the acquisition date

Acquirer purchases Target in a business combination in March 20X9 and recognizes a $10 million liability as a provisional amount in its March 20X9 interim financial statements (based on information that is available related to a legal contingency of Target that existed on the acquisition date). Acquirer discloses that the initial accounting for the contingent liability is incomplete.

In August 20X9, Acquirer becomes aware of similar and unrelated litigation that was resolved in favor of the plaintiff. Based on this information, Acquirer determines that its best estimate of the preacquisition contingency is $12 million. Further evaluation of the reasons for the Acquirer's change in estimate is required, including whether the change is the result of new information about facts and circumstances that existed as of the acquisition date, to determine whether the $2 million over the provisional amount recognized should be recorded in the Acquirer's income statement or recognized as a measurement period adjustment (i.e., as an adjustment to goodwill).

4.4.1.5 Preacquisition contingencies that are not recognized in a business combination

If an assumed preacquisition contingency does not meet the recognition requirements described in section 4.4.1, no amounts are recognized in the business combination. Accounting for contingencies after the acquisition date is based on the guidance in ASC 450. That is, for preacquisition loss contingencies that, when assessed on the acquisition date, did not meet the probable and reasonably estimable recognition criteria in ASC 450, subsequent recognition is based on the guidance in ASC 450. Subsequent recognition of preacquisition gain contingencies that are not recognized in the business combination occurs only when the contingency is resolved; that is, when the acquired gain contingency is no longer contingent. All subsequent accounting is recognized by charges or credits to results of operations pursuant to the guidance in ASC 450.

4.4.1.5.1 Contingencies that are not considered preacquisition contingencies

Contingencies that arise from the acquisition (e.g., litigation over the acquisition transaction itself) are not considered to be preacquisition contingencies of the acquired entity. Therefore, such contingencies are accounted for by the acquirer in accordance with the guidance in ASC 450 and recognized in the acquirer's income statement. Also, contingencies that did not exist as of the acquisition date whether or not they arose before the end of the measurement period (see section 7.3 for a discussion of the measurement period), are not preacquisition contingencies. Income tax uncertainties or temporary differences, including loss carryforwards, are not considered preacquisition contingencies and are accounted for in a business combination pursuant to the guidance in ASC 740. Section 4.4.1.5.1.1 below describes the accounting for the settlement of litigation arising from the business combination.

4.4.1.5.1.1 Settlement of litigation arising from the business combination

After a business combination, disputes may arise between the acquirer and the former shareholders of the acquired entity such as disputes over the value of consideration transferred or representations of fact underlying the acquisition. If the parties transfer amounts to settle the dispute, questions may arise about whether the acquirer should reflect any amounts paid or received as an adjustment to the consideration transferred or whether the amounts paid or received should be recognized in the post-combination income statement. At the 2003 AICPA Conference on Current SEC Developments, the SEC staff[30] indicated that the acquirer's cost to settle litigation with the acquiree's former shareholders generally are not preacquisition contingencies and, therefore, should be recorded as an expense when incurred unless there is a clear and direct link to the consideration transferred. If the acquirer is able to establish a clear and direct link to the consideration transferred, we believe that any adjustment to the consideration transferred would be appropriate only in those circumstances in which the measurement period is open. If the measurement period is closed, we believe that any settlement amount should be recorded as an expense. While the SEC staff speech was issued prior to the issuance of Statement 141(R), we believe the views of the SEC staff continue to apply under ASC 805.

Litigation seeking enforcement of an escrow or escrow-like arrangement, such as specifying a minimum amount of working capital in the acquired business, may establish a clear and direct link to the consideration transferred. On the other hand, claims asserted that one party misled the other or that a provision of the purchase agreement is unclear are not unique to business combination agreements and do not generally establish a clear and direct link to the consideration transferred. Therefore, the settlement of such claims is recognized as a charge to earnings.

With respect to establishing a clear link, the SEC staff provided an example of a dispute between the acquirer and the former shareholders of the acquired entity whereby the purchase agreement is explicit that each "acquired customer" is worth $1,000 and that not less than 1,000 customers will be transferred as of the consummation date. Subsequent litigation determined that the actual number of acquired customers was only 900. In this case, the effects of a litigation settlement should properly be reflected as part of the consideration transferred (in this case, a reduction of the consideration transferred). In contrast, if the purchase agreement obligates the seller to put forth its best efforts to retain customers through the consummation date and litigation subsequently determines that the seller failed to do so, the effects are not clearly and directly linked to the consideration transferred and, accordingly, should be recognized as a charge to earnings.

Frequently, claims seeking enforcement of an escrow or escrow-like arrangement also include claims of misrepresentation or otherwise constitute a mixed claim (i.e., a claim with attributes of both consideration transferred and ongoing expense). Similarly, the SEC staff believes that to reflect all or some of the settlement cost of such a claim as an adjustment to the consideration transferred of an acquired business, the acquirer should be able to persuasively demonstrate that all or a specifically identified portion of the mixed claim is clearly and directly linked to the consideration transferred.

Costs incurred to settle litigation brought by the acquirer's shareholders should always be reflected in the acquirer's income statement.

4.4.1.6 Escrow payments

Many acquisition agreements require that proceeds from the sale be placed in escrow to secure the seller's performance for certain indemnifications. For example, assume that $1 million is placed in escrow by the acquirer pending the outcome of certain litigation against the target that has been assumed by the acquirer. If the litigation is lost, the escrowed funds are used to pay damages to the plaintiff and the seller has no

[30] Comments by Randolph P. Green, Professional Accounting Fellow at the SEC, at the 2003 Thirty-First AICPA National Conference on Current SEC Developments.

further obligation to indemnify the acquirer. If the defendant prevails, the escrowed funds are released to the seller. Because any release of the escrowed funds is based on facts and circumstances that existed as of the acquisition date, the escrow amount is treated as consideration transferred (i.e., there is no future event or condition that must occur). See section 6.4.1 for additional guidance about determining whether consideration held in escrow represents contingent consideration. Escrowing part of the purchase price is a way of protecting the buyer against risk for the seller's indemnification. The fact that proceeds were escrowed does not change the accounting for the buyer's contingent liability or its indemnification asset, although it does affect the measurement of the indemnification asset. Accordingly, the acquirer accounts for the preacquisition contingency associated with the litigation in accordance with the guidance described in section 4.4.1. If a liability is recognized at fair value pursuant to that guidance, an indemnification asset would be recognized on the same fair value basis in accordance with the guidance described in section 4.2.7. The measurement of the fair value of the indemnification would reflect the fact that the indemnification is limited to $1 million and that the seller's performance is secured by the escrowed proceeds.

4.4.1.7 Working capital adjustments

A working capital adjustment provision is often included in a purchase and sale agreement when one company acquires a portion of another company and some uncertainty exists about the working capital that existed on the acquisition date. For example, a purchase and sale agreement might provide that the consideration will be adjusted based on the difference between (1) the actual balance of working capital at the closing date and (2) the balance of working capital at the date the agreement is signed or a stated amount in the agreement.

Question 4.4 **How should the acquirer account for consideration that will be transferred or received subsequent to the acquisition date based on changes in working capital?**

Because working capital is determined at the acquisition date and, subsequent adjustments are not determined by events occurring in the future or conditions being met after the acquisition date, changes in working capital requiring subsequent payments or receipts should adjust the consideration transferred by the acquirer if the adjustment is made after the acquisition date but before the end of the measurement period (see section 7.3 for more discussion about the measurement period). Working capital adjustments paid or received after the end of the measurement period should be recognized as a charge or credit to income.

4.4.2 Income taxes

See section 5.

4.4.3 Contracts with customers (before the adoption of ASU 2021-08) (updated June 2022)

Before adoption of ASU 2021-08, an acquired contract with a customer that is in progress as of the acquisition date is recognized at fair value under ASC 820 based on an exit price that would be paid or received to transfer all of the rights and obligations of the contract to a market participant. Under the guidance in ASU 2021-08, entities are required to apply ASC 606 to recognize and measure contract assets and contract liabilities from contracts with customers acquired in a business combination. This ASU created another exception to the general recognition and measurement principle of ASC 805.[31] Refer to section 4.4.3A for guidance on the accounting for an acquired contract with a customer after adoption of ASU 2021-08.

[31] ASU 2021-08 is effective for fiscal years beginning after 15 December 2022, and interim periods therein for PBEs. For all other entities, it is effective for fiscal years beginning after 15 December 2023, and interim periods therein.

The following sections provide guidance on the accounting for an acquired contract with a customer before adoption of ASU 2021-08:

- Section 4.4.3.1 discusses considerations for determining the appropriate unit of account for an acquired contract with a customer.
- Section 4.4.3.2 discusses valuation considerations for an acquired contract with a customer.
- Section 4.4.3.3 discusses considerations for assets acquired from an acquired contract with a customer.
- Section 4.4.3.4 discusses considerations for liabilities assumed from an acquired contract with a customer.
- Section 4.4.3.5 discusses additional considerations on accounting for an acquired contract with a customer with performance obligations that are satisfied over time.

4.4.3.1 Determining the unit of account for an acquired contract with a customer

Excerpt from Accounting Standards Codification

Business Combinations — Identifiable Assets and Liabilities, and Any Noncontrolling Interest

Implementation Guidance and Illustrations

805-20-55-23

If an entity establishes relationships with its customers through contracts, those customer relationships arise from contractual rights. Therefore, customer contracts and the related customer relationships acquired in a business combination meet the contractual-legal criterion, even if confidentiality or other contractual terms prohibit the sale or transfer of a contract separately from the acquiree.

805-20-55-24

A customer contract and the related customer relationship may represent two distinct intangible assets. Both the useful lives and the pattern in which the economic benefits of the two assets are consumed may differ.

805-20-55-25

A customer relationship exists between an entity and its customer if the entity has information about the customer and has regular contact with the customer, and the customer has the ability to make direct contact with the entity. Customer relationships meet the contractual-legal criterion if an entity has a practice of establishing contracts with its customers, regardless of whether a contract exists at the acquisition date. Customer relationships also may arise through means other than contracts, such as through regular contact by sales or service representatives. As noted in paragraph 805-20-55-22, an order or a production backlog arises from contracts such as purchase or sales orders and therefore is considered a contractual right. Consequently, if an entity has relationships with its customers through these types of contracts, the customer relationships also arise from contractual rights and therefore meet the contractual-legal criterion.

An acquired contract with a customer may consist of the following components (which also represent the elements of value):

- A customer relationship intangible asset (see section 4.2.5.3.2)
- An intangible asset for the inherent or in-place value of the contract (i.e., the price a market participant is willing to pay for an at-market contract, often referred to in practice as "contract backlog") (see section 4.4.4.2)
- An intangible asset or liability to the extent that the terms of the contract are not "at market" at the acquisition date (generally referred to as the "off-market component") (see section 4.4.4.1)

- An asset (i.e., a receivable or contract asset under ASC 606) for the target's right to consideration for transferring a promised good or service to a customer before the business combination (see section 4.4.3.3)
- A liability (i.e., a contract liability under ASC 606, which may include deferred revenue) for a target's obligation to transfer goods or services to a customer for which the target has received consideration (or an amount of consideration is due) from the customer prior to the business combination (see section 4.4.3.4)

The first three components are acquired intangible assets and liabilities and generally would meet the contractual-legal or separability criterion to be recognized separately from goodwill at the acquisition date. The fourth and fifth components generally would represent assets acquired or liabilities assumed.

The interrelationship of the first three components may pose challenges in determining the appropriate unit of account. ASC 805-20-55-24 indicates that it may be necessary to separately recognize intangible assets that relate to a single customer relationship (i.e., the customer relationship and contract backlog) if the useful lives and the pattern in which the economic benefits of the assets are consumed differ. In addition to the guidance in ASC 805-20-55-24, we believe the determination of whether a customer relationship intangible asset and contract backlog intangible asset should be combined into a single unit account will depend on other factors such as the nature of the customer and the interdependency of the related cash flows.

An acquirer should carefully consider the nature of an acquired asset to determine whether to recognize a financial asset (e.g., a receivable), a contract asset or a separately identifiable intangible asset.

4.4.3.2 Valuation considerations for an acquired contract with a customer

Under ASC 805, intangible assets acquired in a business combination in connection with the acquisition of contracts with customers are required to be measured at fair value. The fair value of the acquired intangible assets is not affected by the method of accounting (e.g., the method used to measure progress under ASC 606) to be used by the acquirer after the acquisition nor is it affected by the method of accounting used by the target before the acquisition.

Economically, the recognition and fair value measurement of an intangible asset represents the benefit that the acquirer is expected to realize by acquiring an already existing intangible asset as compared to creating the intangible asset organically. This "make" versus "buy" decision affects the price that buyers and sellers would pay to acquire a business that includes this intangible asset.

Under ASC 820, the following three valuation techniques may be considered to value an acquired intangible asset: (1) the income approach, (2) the market approach and (3) the cost approach. Intangible assets, including contracts with customers, are rarely valued utilizing a market approach given the lack of transactions for similar assets individually. The fair value of intangible assets that are unique and not easily replaced typically is determined using an income approach. That is, the fair value would be estimated as the risk-adjusted, present value of expected future cash flows that could be generated by the subject asset. Conversely, if an asset is easily replaceable or fungible, fair value typically is based on a cost approach. That is, the fair value would be estimated based on the replacement cost of a like-kind asset. However, the use of a cost approach generally is appropriate only when the principle of substitution is valid for the intangible asset. Under this principle, a ready substitute for the asset can be reconstructed, rebuilt or replaced because the asset is not proprietary, novel or one-of-a-kind. In some industries, an acquired contract with a customer often is unique and not easily replaced. In such situations, we believe an income approach generally would provide a more appropriate representation of fair value than a cost approach.

The components of value of an acquired contract with a customer (as described in section 4.4.3.1) generally are measured as follows:

- Customer relationship intangible asset — This component is commonly measured as the expected present value of future cash flows available from future contracts with that customer.
- Contract backlog intangible asset — This component is commonly measured as the value derived under the income approach based on the present value of expected future cash flows available from the existing contract.
- Off-market component intangible asset (or liability) — This component is commonly measured as the present value of the amount by which the current contract terms deviate from what a market participant could achieve on the acquisition date.
- Contract-related asset — This component is commonly measured as the present value of expected future cash flows. Such an asset may be characterized as a receivable or contract asset. See sections 4.2.2 and 4.4.3.3 for additional guidance on measuring receivables and contract assets, respectively.
- Contract-related liability — This component is measured at fair value, which may be less than the amount recognized by the acquired entity in its preacquisition financial statements. This type of liability may be characterized as a contract liability or deferred revenue. See section 4.4.3.4 for additional guidance on measuring assumed liabilities for performance obligations.

Regardless of the unit of account conclusions reached, an important aspect of valuing an acquired contract with a customer is to verify that all components of value have been considered (that is, none of the components of value have been omitted or double counted) and appropriately reflected in the fair value measurement. No matter the unit of account conclusion, we believe companies should verify that all cash flow components identified above are being considered in the valuation of each contract.

4.4.3.3 Assets acquired from contracts with customers (updated June 2022)

Excerpt from Accounting Standards Codification

Business Combinations — Identifiable Assets and Liabilities, and Any Noncontrolling Interest

Glossary

805-20-20

Contract Asset

An entity's right to consideration in exchange for goods or services that the entity has transferred to a **customer** when that right is conditioned on something other than the passage of time (for example, the entity's future performance).

When an entity transfers a promised good or service to a customer, the entity has earned a right to consideration from the customer and, therefore, has an asset. Such assets may represent conditional or unconditional rights to consideration. If an entity must transfer other goods or services in the contract before it is entitled to payment from the customer, the right is conditional and presented as a contract asset. Conversely, a right to consideration is unconditional if nothing other than the passage of time is required before payment of that consideration is due. An entity that has an unconditional right to receive consideration from the customer accounts for that right as a receivable and presents it separately from its contract assets. Refer to section 10.1 of our FRD, ***Revenue from contracts with customers (ASC 606)***, for additional guidance on distinguishing between a contract asset and a receivable. See section 4.2.2 for additional guidance on measuring receivables and contract assets acquired in a business combination.

The components of value of acquired contracts with customers may include contract assets and receivables. When measuring the fair value of acquired contracts with customers, an acquirer should verify that all of the components of value have been considered (that is, an acquirer should verify that none of the components of value have been omitted or double counted). An acquirer also should verify that all of the components are appropriately reflected in the fair value measurement. See section 4.4.3.2 for additional guidance on valuing acquired contracts with customers.

4.4.3.3.1 Deferred costs under ASC 340-40 incurred by a target (updated June 2022)

An acquired company may have recognized an asset in its preacquisition financial statements for the costs it incurred (and expects to recover) to obtain or fulfill a contract with a customer in accordance with ASC 340-40. Because the acquirer has not obtained an economic benefit, we do not believe these costs qualify for separate asset recognition by the acquirer in a business combination. The cash flows that the acquirer expects to receive in the future to recover these costs may affect the valuation of other assets recognized as part of the related acquired customer contract (e.g., a customer-related intangible asset, contract backlog asset, inventory, or property, plant and equipment).

4.4.3.4 Assumed liabilities for performance obligations of an acquired company

An acquired company may have recognized a liability in its preacquisition financial statements for a future obligation to transfer goods or services to a customer for which it has received consideration from the customer. For example, a liability could represent up-front payments for services or products that have yet to be delivered. See section 4.4.3.4.1 for additional guidance on accounting for these assumed liabilities.

4.4.3.4.1 Contract liabilities of an acquired company (updated June 2022)

Excerpt from Accounting Standards Codification

Business Combinations — Identifiable Assets and Liabilities, and Any Noncontrolling Interest

Glossary

606-10-20

Contract Liability

An entity's obligation to transfer goods or services to a **customer** for which the entity has received consideration (or the amount is due) from the customer.

Performance Obligation

A promise in a **contract** with a **customer** to transfer to the customer either:

a. A good or service (or a bundle of goods or services) that is distinct

b. A series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.

In a business combination, the acquiring entity recognizes a contract liability (e.g., deferred revenue) related to the performance obligations that it assumes if the acquired entity has received consideration (or the amount is due) from the customer.

We believe that an acquiring entity should consistently apply the definition of a performance obligation. That is, we believe an acquirer should apply the definition of a performance obligation in ASC 606 to determine whether it has assumed a performance obligation. Our view is consistent with the FASB's conclusions in ASU 2021-08.

When applying the definition of a performance obligation under ASC 606 as of the acquisition date, the acquiring entity identifies the remaining promised goods and services in a contract with a customer and evaluates whether the goods and services it must provide to a customer in the future are an assumed performance obligation for which the acquired entity has received consideration (or the amount is due). A promised good or service is a performance obligation if it is both capable of being distinct and is distinct in the context of the contract. Under ASC 606, a performance obligation may be created based on a customer's reasonable expectations and may include promises that are implied by an entity's customary business practices or industry norms. See section 4 of our FRD, ***Revenue from contracts with customers (ASC 606)***, for additional guidance on identifying performance obligations in a contract with a customer.

If a contract liability for an assumed performance obligation is recognized, the acquirer derecognizes the contract liability and recognizes revenue in the statement of operations as it provides those goods or services after the acquisition date.

An assumed performance obligation is measured at fair value at the date of acquisition, pursuant to the guidance in ASC 820. There generally are two acceptable methods for measuring the fair value of the assumed performance obligation. The first method is a cost buildup approach. The cost buildup approach is based on a market participant's estimate of the costs that will be incurred to fulfill the obligation plus a "normal" profit margin for the level of effort or assumption of risk by the acquirer after the acquisition date. The normal profit margin also should be from the perspective of a market participant and should not include any profit related to selling or other efforts completed prior to the acquisition date. The second and less frequently used method for measuring the fair value of an assumed performance obligation is by obtaining evidence from market information about the amount of revenues an entity would earn in a transaction to provide the remaining obligation under the contract, less the cost of the selling effort (which has already been performed by the acquiree prior to the acquisition date) and the profit margin on that selling effort. As noted previously, the normal profit margin should be from the perspective of a market participant.

4.4.3.5 Accounting for contracts with customers in a business combination that have performance obligations that are satisfied over time

The revenue recognition guidance provides accounting methods that entities may apply to account for long-term contracts with customers, including the methods that may be used to measure progress toward completion over time. As described in section 4.4.3.2, the fair value of acquired intangible assets associated with a long-term contract is not affected by the method of accounting to be used by the acquirer after the acquisition nor is it affected by the method of accounting used by the target before the acquisition (e.g., the method used to measure progress under ASC 606).

Before adoption of ASU 2021-08, for a performance obligation satisfied over time, an entity should measure progress toward completion solely based on the remaining effort of the acquirer after the acquisition date (i.e., the measure of progress as of the acquisition date should not include effort expended by the acquired entity before the acquisition). For example, a vendor (acquirer) would use as the denominator the estimate of costs it will incur to complete the remaining work required under the contract rather than the estimated cost of the entire project. Also, any contract-related intangible asset or liability recognized at the acquisition date relating to the off-market or contract backlog components would be amortized over the remaining term of the contract. Any customer relationship intangible asset would be amortized separately over its remaining useful life.

The revenue recognition conclusions and account descriptions in the illustrations below were determined by applying ASC 606.

Illustration 4-16: Contract with a customer with a single performance obligation that is satisfied over time — contract is 'at market'

Acquirer acquires the outstanding shares of Target in a business combination on 1 January 20X9. Target has a long-term contract to construct a building that Target appropriately accounted for as a single performance obligation satisfied over time. Both Target and Acquirer use the cost-to-cost method (i.e., costs incurred to date divided by the total amount of costs expected to be incurred for the performance obligation) to measure progress towards satisfying the performance obligation and, therefore, recognize revenues and costs of goods sold based on that measure of progress. At 1 January 20X9, the status of the contract is as follows:

Stated amount of contract	$ 1,000
Target's expected costs to complete the contract	800
Target's costs incurred through 1 January 20X9	200
Target's amount billed through 1 January 20X9	250
Progress toward completion as of 1 January 20X9	25% (200 / 800)

After reviewing the contract as part of its accounting for the business combination, Acquirer determines that the expected profit margin of 20% to complete the remaining work under the terms of the contract is consistent with the profit margin a market participant would achieve at the acquisition date (i.e., the contract is "at market"). Acquirer identifies the following relevant aspects of the contract:

Amount remaining to be billed under the contract	750
Acquirer estimated costs to complete the contract	600
Contract backlog intangible asset	24
Customer relationship intangible asset	100

Acquirer completes the contract in 20X9 and there are no changes to Acquirer's cost estimates. Acquirer determines that the useful life of the acquired customer relationship intangible asset is four years. Based on its facts and circumstances, Acquirer determines that the contract backlog and customer relationship intangible assets should be recorded as separate units of account.

Analysis

At the acquisition date, Acquirer would recognize an intangible asset relating to the contract backlog of $24 and a customer relationship intangible asset of $100 representing the expected cash flows from new contracts. Subsequent to the acquisition date, Acquirer would record the following entries in 20X9.

Contract costs	$ 600	
Cash		$ 600
To capitalize contract costs incurred.		
Cost of goods sold	$ 600	
Contract costs		$ 600
*To recognize cost of goods sold relating to the progress towards completion [$600 = ($600 * 100%)].*		
Contract asset	$ 750	
Revenue		$ 750
*To recognize revenue relating to the progress towards completion [$750 = ($750 * 100%)].*		
Accounts receivable	$ 750	
Contract asset		$ 750
To recognize a receivable for work billed pursuant to the terms of the contract.		
Cash	$ 750	
Accounts receivable		$ 750
To recognize cash received pursuant to the terms of the contract.		

Amortization expense — contract-related[1]	$	24		
Contract backlog intangible asset			$	24
To amortize the intangible asset relating to the contract backlog of the acquired contract.				
Amortization expense	$	25		
Customer relationship intangible asset			$	25
To amortize the customer relationship intangible asset over its estimated useful life of 4 years [$25 = ($100 / 4 years)].[2]				

Notwithstanding the fact that the contract was "at market" at the acquisition date, Acquirer's ultimate operating profit likely will be lower than that of an organically-generated contract due to the additional amortization expense associated with the acquired intangible assets.

[1] Generally, the amortization of the contract-related intangible asset is recognized as either a reduction in revenue or as additional cost of goods sold. However, other alternatives may exist in practice.

[2] The straight-line amortization method was used for illustrative purposes. In practice, the pattern of consumption of a customer-related intangible asset may indicate that a different amortization method is appropriate. See section 2.2.1 of our FRD, ***Intangibles — goodwill and other***, for a discussion of determining the appropriate amortization method for a customer-related intangible asset.

Illustration 4-17: Contract with a customer with a single performance obligation that is satisfied over time — contract is 'off market'

Acquirer acquires the outstanding shares of Target in a business combination on 1 January 20X9. Target has a long-term contract to construct a building that Target appropriately accounted for as a single performance obligation satisfied over time. Both Target and Acquirer use the cost-to-cost method (i.e., costs incurred to date divided by the total amount of costs expected to be incurred for the performance obligation) to measure progress towards satisfying the performance obligation and, therefore, recognize revenues and costs of goods sold based on that measure of progress. At 1 January 20X9, the status of the contract is as follows:

Stated amount of contract	$ 1,000
Target's expected costs to complete the contract	800
Target's costs incurred through 1 January 20X9	200
Target's amount billed through 1 January 20X9	0
Target's costs in excess of billings (i.e., contract asset) as of 1 January 20X9	250
Progress towards completion as of 1 January 20X9	25% (200/800)

After reviewing the contract as part of its accounting for the business combination, Acquirer determines that the expected profit margin of 20% to complete the remaining work under the terms of the contract is favorable relative to market (i.e., a market participant would achieve a profit margin of only 15%). Acquirer identifies the following relevant aspects of the contract:

Amount remaining to be billed under the contract	1,000
Acquirer's estimated costs to complete	600
Off-market component intangible asset	6
Contract backlog intangible asset	18
Customer relationship intangible asset	100

Acquirer completes the contract in 20X9, and there are no changes to Acquirer's cost estimates. Acquirer determines that the useful life of the acquired customer relationship intangible asset is four years. Based on its facts and circumstances, Acquirer determines that the off-market component, contract backlog and customer relationship intangible assets should be recorded as separate units of account.

Analysis

At the acquisition date, Acquirer would recognize a contract asset relating to its conditional right to receive consideration from the customer of $250,[1] an intangible asset relating to the favorable off-market component of $6, an intangible asset relating to the contract backlog of $18 and a customer relationship intangible asset of $100 representing the expected cash flows from new contracts.[2] Subsequent to the acquisition date, Acquirer would record the following entries in 20X9.

Contract costs	$ 600	
Cash		$ 600
To capitalize contract costs incurred.		
Cost of goods sold	$ 600	
Contract costs		$ 600
*To recognize cost of goods sold relating to the progress towards completion [$600 = ($600 * 100%)].*		
Contract asset	$ 750	
Revenue		$ 750
*To recognize revenue relating to the progress towards completion [$750 = ($750 * 100%)].*		
Accounts receivable	$ 1,000	
Contract asset		$ 1,000
To recognize a receivable for work billed pursuant to the terms of the contract. Because Target did not previously invoice the customer, Acquirer is entitled to bill the contractual amount of the contract of $1,000. This entry also reclassifies the contract asset of $250 that was recorded at the acquisition date.		
Cash	$ 1,000	
Accounts receivable		$ 1,000
To recognize cash received pursuant to the terms of the contract.		
Amortization expense — contract-related[3]	$ 6	
Off-market intangible asset		$ 6
To amortize the intangible asset relating to the off-market component of the acquired contract.		
Amortization expense — contract-related[3]	$ 18	
Contract backlog intangible asset		$ 18
To amortize the intangible asset relating to the contract backlog of the acquired contract.		
Amortization expense	$ 25	
Customer relationship intangible asset		$ 25
To amortize the customer relationship intangible asset over its estimated useful life of 4 years [$25 = ($100 / 4 years)].		

Although the amortization of the favorable off-market component intangible asset reduces Acquirer's profit margin to make it more in line with an "at market" contract, Acquirer's ultimate operating profit likely will be lower than that of an organically generated contract due to the additional amortization expense associated with the acquired intangible assets.

---

[1] Depending on the type of arrangement, Acquirer may not have a contractual right to receive cash for the contract asset of Target. If that were the case, Acquirer would not recognize an asset for the contract asset. Rather, it would include those expected cash flows in the valuation of the off-market component of the acquired contract.

[2] Note that in Illustration 4-16 the contract was at market and the value of the backlog was $24. In this Illustration, the value of the contract remains at $24, but the contract value consists of the contract backlog of $18 and an off-market component of $6. These illustrations describe the accounting for the various components associated with a long-term construction contract and do not describe the valuation assumptions required to determine the value of these components. Refer to our FRD, ***Fair value measurement***, for further guidance on determining fair value under ASC 820.

[3] Generally, the amortization of the contract-related intangible asset is recognized as either a reduction in revenue or as additional cost of goods sold. However, other alternatives may exist in practice.

4.4.3A Contracts with customers (after the adoption of ASU 2021-08) (added June 2022)

Excerpt from Accounting Standards Codification

Pending Content:

Transition Date: *(P) December 16, 2022; (N) December 16, 2023* | **Transition Guidance:** 805-20-65-3

Business combinations — Identifiable Assets and Liabilities, and Any Noncontrolling Interest

Recognition

805-20-25-28C

The acquirer shall recognize a contract asset or contract liability in accordance with Topic 606 on revenue from **contracts** with **customers**. This includes a contract asset or contract liability from the following:

a. Contracts with customers

b. Other contracts to which the provisions of Topic 606 apply.

Initial Measurement

805-20-30-27

An acquirer shall measure a contract asset or contract liability in accordance with Topic 606 on revenue from **contracts** with **customers**. This includes a contract asset or contract liability from the following:

a. Contracts with customers

b. Other contracts to which the provisions of Topic 606 apply.

805-20-30-28

An acquirer shall measure the contract assets and contract liabilities of the acquired contract as if the acquirer had originated the acquired contract. Topic 606 specifies when certain assessments and estimates should be made, for example, as of contract inception or on a recurring basis. At the acquisition date, the acquirer shall make those assessments as of the dates required by Topic 606.

ASU 2021-08 changes how an entity accounts for revenue contracts it acquires in a business combination. The changes require entities to apply ASC 606 to recognize and measure contract assets and contract liabilities from contracts with customers in a business combination, creating another exception to the general recognition and measurement principle of ASC 805.

The FASB issued the guidance in response to questions raised by stakeholders about whether an acquirer in a business combination should apply the concept of a performance obligation introduced by ASC 606 when determining whether to recognize a contract liability for the target's revenue contracts.

Stakeholders had also raised questions about how an acquirer should measure a target's contract assets and liabilities from revenue contracts. They noted that applying the subsequent measurement provisions of ASC 606 could be challenging if a revenue contract that contains variable consideration or contingent payment terms (e.g., sales-based royalties) is measured at fair value on the acquisition date. Measuring contract liabilities in a business combination at fair value often results in total revenue that is lower than would have been recognized under that contract had it not been acquired in a business combination.

The Board also observed that the measurement of acquired revenue contracts at fair value can result in acquirers recognizing different amounts of post-combination revenue for two contracts with the same performance obligations, depending on the contractual timing of payments.

ASU 2021-08 improves the comparability for the recognition and measurement of revenue contracts acquired in a business combination by addressing when an acquirer should recognize a contract asset or contract liability and how the contract asset and contract liability should be measured. ASU 2021-08 also improves the comparability between revenue contracts acquired in a business combination and those originated by an acquirer.

4.4.3A.1 Scope of ASU 2021-08 (added June 2022)

ASU 2021-08 applies to all contract assets and contract liabilities (as defined by ASC 606) in a business combination that result from (1) contracts with customers accounted for under ASC 606 and (2) other contracts to which the provisions of ASC 606 apply. For further discussions on contract assets and contract liabilities, see sections 4.4.3A.3 and 4.4.3A.4, respectively.

The FASB said in the Background Information and Basis for Conclusions that the guidance does not apply to contract-based intangible assets and liabilities, deferred costs under ASC 340-40, or other assets and liabilities that may be recognized under ASC 606. That is because the Board believed that the scope of the ASU as issued addresses the objective of providing consistency in revenue for acquired revenue contracts between the pre- and post-acquisition periods.[32]

The out-of-scope components continue to be accounted for at fair value at the acquisition date unless another recognition and measurement exception applies. Entities will need to consider any possible effects of the measurement exception for contract assets and liabilities on their fair value measurement of other intangible assets (e.g., cash flows for which a contract asset is not recognized in accordance with ASC 606 at the acquisition date will likely be captured in the fair value measurement of another intangible asset).

Scope includes:	Scope excludes:
▸ Contract assets as defined by ASC 606 ▸ Contract liabilities as defined by ASC 606 ▸ Contract assets and liabilities that arise from other contracts to which the provisions of ASC 606 apply (e.g., contract liabilities that arise from the sale of nonfinancial assets that are in scope of ASC 610-20[33] and contract liabilities that may arise from certain collaborative arrangements that are in the scope of ASC 808[34])	▸ Receivables under ASC 310 and ASC 326-20 ▸ Contract-based intangible assets and liabilities, such as customer relationships and contracts with off-market terms[35] ▸ Deferred costs under ASC 340-40 ▸ Other assets and liabilities that may be recognized under ASC 606, such as refund liabilities and up-front payments to customers

[32] Basis for Conclusions (BC) 52 from ASU 2021-08.

[33] BC51 from ASU 2021-08.

[34] We believe this also applies to instances where entities are in the scope of ASC 808 and apply ASC 606 by analogy.

[35] BC38 from ASU 2021-08.

4.4.3A.2 Components of acquired revenue contracts (added June 2022)

Excerpt from Accounting Standards Codification

Business Combinations — Identifiable Assets and Liabilities, and Any Noncontrolling Interest

Implementation Guidance and Illustrations

805-20-55-23

If an entity establishes relationships with its customers through contracts, those customer relationships arise from contractual rights. Therefore, customer contracts and the related customer relationships acquired in a business combination meet the contractual-legal criterion, even if confidentiality or other contractual terms prohibit the sale or transfer of a contract separately from the acquiree.

805-20-55-24

A customer contract and the related customer relationship may represent two distinct intangible assets. Both the useful lives and the pattern in which the economic benefits of the two assets are consumed may differ.

805-20-55-25

A customer relationship exists between an entity and its customer if the entity has information about the customer and has regular contact with the customer, and the customer has the ability to make direct contact with the entity. Customer relationships meet the contractual-legal criterion if an entity has a practice of establishing contracts with its customers, regardless of whether a contract exists at the acquisition date. Customer relationships also may arise through means other than contracts, such as through regular contact by sales or service representatives. As noted in paragraph 805-20-55-22, an order or a production backlog arises from contracts such as purchase or sales orders and therefore is considered a contractual right. Consequently, if an entity has relationships with its customers through these types of contracts, the customer relationships also arise from contractual rights and therefore meet the contractual-legal criterion.

An acquired contract with a customer may consist of the following components (which also represent the elements of value):

- An asset (e.g., a receivable or contract asset under ASC 606) for the target's right to consideration for transferring a promised good or service to a customer before the business combination (see section 4.4.3A.3)
- A liability (e.g., a contract liability under ASC 606) for a target's obligation to transfer goods or services to a customer for which the target has received consideration (or an amount of consideration is due) from the customer before the business combination (see section 4.4.3A.4)
- A customer relationship intangible asset (see section 4.2.5.3.2)
- An intangible asset for the inherent or in-place value of the contract (i.e., the price a market participant is willing to pay for an at-market contract, often referred to in practice as contract backlog) (see section 4.4.4.2)
- An intangible asset or liability to the extent that the terms of the contract are not "at market" at the acquisition date (generally referred to as the off-market component) (see section 4.4.4.1)

The first and second components generally would represent assets acquired or liabilities assumed. The last three components are acquired intangible assets and liabilities and generally would meet the contractual-legal or separability criterion to be recognized separately from goodwill at the acquisition date.

The interrelationship of the last three components may pose challenges in determining the appropriate unit of account. ASC 805-20-55-24 indicates that it may be necessary to separately recognize intangible assets that relate to a single customer relationship (i.e., the customer relationship and contract backlog) if the useful lives and the pattern in which the economic benefits of the assets are consumed differ. In addition to the guidance in ASC 805-20-55-24, we believe the determination of whether a customer relationship intangible asset and contract backlog intangible asset should be combined into a single unit account will depend on other factors, such as the nature of the customer and the interdependency of the related cash flows. Regardless of the unit of account conclusion, we believe companies should verify that all cash flow components identified are being considered in the valuation of each contract.

An acquirer should carefully consider the nature of an acquired asset to determine whether to recognize a financial asset (e.g., a receivable), a contract asset or a separately identifiable intangible asset. Refer to section 4.4.3A.6.3 for additional information about contract-based intangible assets and liabilities.

4.4.3A.3 Contract assets (added June 2022)

Excerpt from Accounting Standards Codification

Business Combinations — Identifiable Assets and Liabilities, and Any Noncontrolling Interest

Glossary

805-20-20

Contract Asset

An entity's right to consideration in exchange for goods or services that the entity has transferred to a **customer** when that right is conditioned on something other than the passage of time (for example, the entity's future performance).

When an entity transfers a promised good or service to a customer, it has earned a right to consideration from the customer and, therefore, has an asset. This asset may represent a conditional or unconditional right to consideration.

If an entity must transfer other goods or services in the contract before it is entitled to payment from the customer, the right is conditional and presented as a contract asset. In contrast, if nothing other than the passage of time is required before payment of consideration is due, the right to consideration is unconditional. An entity that has an unconditional right to receive consideration from the customer accounts for it as a receivable and presents it separately from its contract assets. Refer to section 10.1 of our FRD publication, ***Revenue from contracts with customers (ASC 606)***, for more guidance on distinguishing between a contract asset and a receivable.

Upon adoption of ASU 2021-08, an acquired contract asset is measured in accordance with ASC 606 at the acquisition date. When the contract consideration is fixed, the amount an acquirer recognizes as a contract asset at the acquisition date is more likely to approximate the amount it would recognize at fair value under ASC 805 before adoption of ASU 2021-08.

However, when the contract consideration is variable and has been constrained or the sales- and usage-based exception for licenses of intellectual property (IP) is applied, the amount an acquirer recognizes as a contract asset at the acquisition date is generally lower than the amount it would recognize at fair value under ASC 805 before adoption of ASU 2021-08. This results in an acquirer recognizing more revenue post-acquisition than it would before it adopted ASU 2021-08. Consider the following example:

Illustration 4-18: Sales-based royalty exception

Target enters into a 15-year arrangement with a customer for a perpetual, exclusive license to commercialize a compound on 1 January 20X2. This compound is approved by the Food and Drug Administration (FDA). The license requires the customer to pay a sales-based royalty of 5% of its gross sales associated with the compound. The contract does not contain any additional performance obligations. Target transfers the compound to the customer on 1 January 20X2.

The customer's estimated gross sales associated with the compound are $200 million a year. Target applies the sales-based royalty exception and recognizes revenue when sales occur.

Acquirer purchases Target, which is a business, on 2 January 20X2.

Analysis

Acquirer does not recognize a contract asset on the acquisition date because it continues to apply the sales-based royalty exception. Acquirer recognizes revenue when the customer's sales occur. The cash flows from the estimated sales associated with the compound are included in the measurement of the acquired intangible asset. Acquirer estimates the fair value of the cash flows associated with the remaining royalties to be $150 million and recognizes an intangible asset in that amount. Acquirer subsequently amortizes the intangible asset on a straight-line basis over the useful life of the asset, unless the pattern in which the asset is consumed can be reliably determined.[36]

The requirement to measure acquired contract assets in accordance with ASC 606 may not affect the amount of goodwill recognized in a business combination. That is because the acquirer continues to verify that all cash flows related to the contract have been appropriately considered (i.e., not omitted or double counted) when determining the fair value of intangible assets recognized in the business combination.

4.4.3A.4 Contract liabilities (added June 2022)

Excerpt from Accounting Standards Codification

Business Combinations — Identifiable Assets and Liabilities, and Any Noncontrolling Interest

Glossary

805-20-20

Contract Liability

An entity's obligation to transfer goods or services to a **customer** for which the entity has received consideration (or the amount is due) from the customer.

Performance Obligation

A promise in a **contract** with a **customer** to transfer to the customer either:

a. A good or service (or a bundle of goods or services) that is distinct

b. A series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.

[36] ASC 350-30-35-6.

A target may have recognized a liability in its preacquisition financial statements for a future obligation to transfer goods or services to a customer for which it has received consideration (or the amount is due) from the customer. For example, a liability could represent up-front payments for goods and services that have yet to be delivered.

The acquirer recognizes a contract liability (e.g., deferred revenue) related to the performance obligations, as defined under ASC 606, that it assumes if the target has received consideration (or the amount is due) from the customer.

When applying the definition of a performance obligation under ASC 606 as of the acquisition date, the acquirer identifies the remaining promised goods and services in a contract with a customer and evaluates whether the goods and services it must provide to a customer in the future are an assumed performance obligation for which the target has received consideration (or for which the customer is required to remit consideration). A promised good or service is a performance obligation if it is both capable of being distinct and is distinct in the context of the contract. A performance obligation may be created based on a customer's reasonable expectations and may include promises that are implied by an entity's customary business practices or industry norms. See section 4 of our FRD, ***Revenue from contracts with customers (ASC 606)***, for additional guidance on identifying performance obligations in a contract with a customer.

Remaining performance obligations as of the acquisition date are measured by applying ASC 606. Measuring a contract liability under ASC 606 will likely result in the recognition of an amount higher than what would have been recognized before the adoption of ASU 2021-08. A primary reason for this difference is that the fair value measurement of a contract liability is often based on the remaining costs to be incurred by the combined company to satisfy the remaining performance obligations in the arrangement plus a reasonable profit margin. The fair value measurement excludes any profit that would otherwise be included in the transaction price related to the target's selling effort.

Any contract liability recognized at the acquisition date is derecognized as the combined company performs and satisfies the remaining performance obligation(s). Higher contract liability amounts recognized at the acquisition date result in increased revenue in the post-combination period(s).

The following example illustrates how an acquirer recognizes and measures a contract liability in a software arrangement after adoption.

Illustration 4-19: Contract liability acquired – PCS

Target enters into a two-year arrangement on 1 January 20X2 to provide a term-based software license and two years of post-contract customer support (PCS) to a customer in exchange for an up-front fee of $300,000. Target has determined that the contract contains two performance obligations: (1) the software license and (2) the PCS. Based on the standalone selling prices (SSP), Target allocates $240,000 (80%) of the total transaction price to the license and $60,000 (20%) to the PCS.

Target recognizes $240,000 in revenue on 1 January 20X2 related to the software license. Target determines that time elapsed is an appropriate measure of progress and recognizes $60,000 in revenue from PCS ratably over the two-year contract period.

Acquirer purchases Target, which meets the definition of a business, on 1 January 20X3. Acquirer and Target use the same method for estimating SSP.

Analysis

After the Acquirer performs an assessment of the Target's ASC 606 accounting (discussed below), Acquirer recognizes a contract liability of $30,000 ($60,000/two-year contract period) related to the partially satisfied performance obligation for the PCS on the acquisition date. Revenue related to the PCS is recognized ratably over the remaining contractual term of one year. A contract liability related to the term-based software license is not recognized because that performance obligation was satisfied before the acquisition. Any customer-related intangible asset would be recognized at fair value in accordance with ASC 805 and amortized over the useful life of the asset.

The following example illustrates how an acquirer recognizes and measures a contract liability related to symbolic IP after adoption of ASU 2021-08.

Illustration 4-20: Contract liability acquired – symbolic IP

Target enters into a 20-year arrangement with a customer to market and sell consumer packaged goods using the Target's brand on 1 January 20X2. The license arrangement requires the customer to pay an up-front fee of $10 million on 1 January 20X2.

The license to use the Target's brand represents symbolic IP because it does not have significant standalone functionality since its utility is derived from the Target's ongoing or past support (e.g., activities that support the value of a brand name). Target determines that time elapsed is an appropriate measure of progress, and therefore, the initial up-front payment is recognized ratably under ASC 606 as the Target satisfies the performance obligation over the 20-year term.

Acquirer purchases Target, which is a business, on 1 January 20X5.

Analysis

While the Target may have no legal obligation other than to allow for the continued use of its brand over the license term, the Acquirer records a contract liability of $8.5 million based on the remaining performance obligation at acquisition date as if it had originated the license arrangement. Acquirer recognizes revenue related to the symbolic IP ratably over the remaining contractual term of 17 years. There are no future cash flows associated with the license arrangement, and the contract liability recorded will result in more goodwill being recognized in the business combination than would have been recognized before adoption of the new guidance. This is because a substantially smaller contract liability would have been recognized using a fair value measurement given the lack of future cash outflows associated with the contract.

ASU 2021-08 eliminates the complexity of determining the fair value of contract liabilities and may result in higher balances for contract liabilities acquired in a business combination. The FASB acknowledged that an increase in contract liabilities under the guidance will result in a higher amount of goodwill recognized in a business combination.[37]

Adoption of ASU 2021-08 may also result in more post-combination revenue being recognized by the acquirer. However, the amount of revenue should generally be consistent with the amount the target would have recognized if it hadn't been acquired. During the FASB's outreach, investors stated that making the post-acquisition reporting of cash flows and revenue comparable to the pre-acquisition reporting would provide information that is more decision-useful about the combined company after the acquisition.

[37] BC41 from ASU 2021-08.

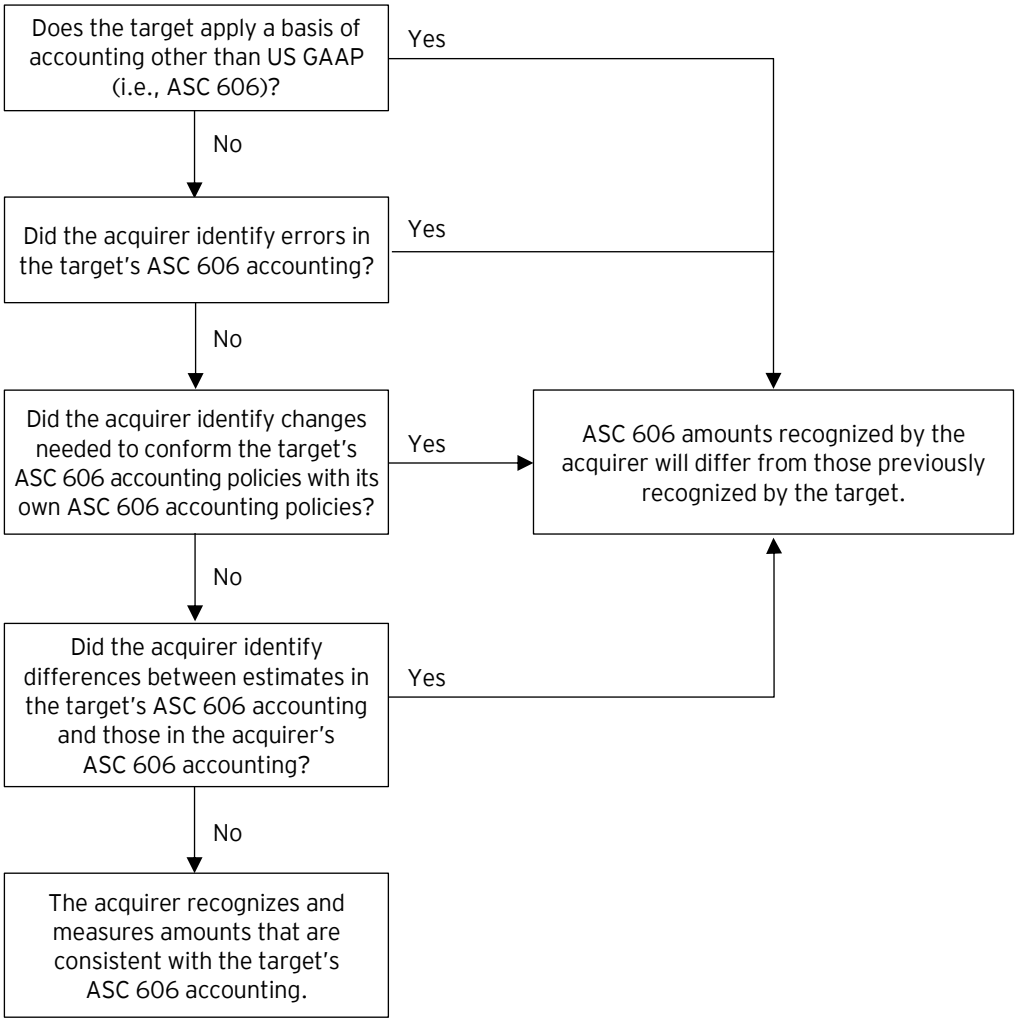
4.4.3A.5 Acquirer's assessment of the target's ASC 606 accounting (added June 2022)

While ASU 2021-08 requires that an acquirer account for the acquired contract under ASC 606 as if it had originated the acquired contract, the FASB said in the Basis for Conclusions in ASU 2021-08 that the "acquirer would assess the acquiree's accounting" under ASC 606. If, based on this assessment, an acquirer determines that the target's ASC 606 accounting is well documented and supported, it may recognize the acquired contract assets and contract liabilities in the business combination at amounts that are consistent with those reported by the target immediately before the acquisition date (i.e., it carries over the target's accounting related to those revenue contracts). For purposes of section 4.4.3A, "carry over" means the acquirer recognizes and measures amounts that are consistent with the target's ASC 606 accounting.

While the acquirer may carry over the target's ASC 606 accounting, the acquirer is ultimately responsible for the contract asset and liability amounts reported under ASC 606 in connection with the business combination.

The Board also acknowledged that there may be circumstances in which the acquirer cannot carry over the target's ASC 606 accounting. The flowchart below provides a roadmap for entities to follow as they determine whether they are able to recognize and measure the acquired contract assets and liabilities that are consistent with the target's ASC 606 accounting.

Assessment



Making this assessment will require judgment and will likely require changes to an acquirer's business combination processes. These changes include additional or revised internal controls to execute the assessment of the target's ASC 606 accounting and may also include additional or revised internal controls to address the risks of material misstatement related to the recognition and measurement of contract assets and contract liabilities as of the acquisition date. The nature, extent and precision of the additional or expanded controls will depend on the acquirer's evaluation of risks related to both the performance of the assessment and the ASC 606 accounting for the acquired contract assets and liabilities.

Considerations for the acquirer in performing the assessment of the target's ASC 606 accounting may include:

- Financial reporting framework of the target (e.g., US GAAP, IFRS, local statutory framework)
- How the target applied ASC 606 to the acquired contracts (e.g., the target's accounting policies and how those policies were applied to the in-process acquired revenue contracts)
- The nature of the target's revenue contracts (e.g., long-term contracts, including variable consideration and the application of the constraint)

Understanding the target's internal control over financial reporting (ICFR) may help an acquirer determine the nature and extent of both the processes it needs to have in place for the assessment and the procedures it needs to perform in the assessment. An acquirer that determines, based on its assessment, that it cannot carry over the target's ASC 606 accounting for some or all of the target's contracts with customers must reevaluate the target's ASC 606 accounting at the acquisition date. This will require the acquirer to have the appropriate processes and procedures to implement ASC 606 accounting as of the acquisition date as if the acquirer was applying ASC 606 to the acquired contracts as of contract inception.

The acquirer will also have to retain reasonable support for its internal control assessment, when applicable, and documentation of the design of the controls is an integral part of reasonable support. Generally, we would expect management's support and documentation to be more robust as the assessed risk of material misstatement increases.

Acquirers will need to carefully assess the target's ASC 606 accounting to determine whether it can carry over the target's ASC 606 accounting. This will impact the acquirer's processes and procedures related to business combinations. See Appendix E for additional information.

4.4.3A.5.1 Reevaluating target estimates (added June 2022)

ASC 606 provides guidance about judgments and estimates that an entity must make when accounting for revenue contracts with customers. ASC 606 requires an entity to make certain of those judgments and estimates at the contract inception date, such as identifying performance obligations and estimating SSP. Other estimates must be made on a recurring basis, such as estimates of variable consideration and an entity's measure of progress toward satisfying its performance obligations.

When the acquirer determines that it cannot carry over a target's ASC 606 accounting because of differences in estimates, the acquirer will reevaluate one or more of a target's estimates, including those determined at contract inception and those updated on a recurring basis. The acquirer could elect one or both of the available practical expedients discussed in section 4.4.3A.9.

The following example illustrates a difference between the target and the acquirer's estimation of SSP for a contract.

Illustration 4-21: Difference in measuring SSP estimates

Target enters into a two-year arrangement on 1 January 20X2 to provide a perpetual software license and two years of PCS to a customer in exchange for an up-front fee of $300,000. Target has determined that the contract contains two performance obligations: (1) the software license and (2) the PCS. Based on the SSP, Target allocates $240,000 (80%) of the total transaction price to the license and $60,000 (20%) to the PCS.

Target recognizes $240,000 in revenue on 1 January 20X2 related to the software license. Target determines that time elapsed is an appropriate measure of progress and recognizes $60,000 in revenue from PCS ratably over the two-year contract period.

Acquirer purchases Target, which meets the definition of a business, on 1 January 20X3. Acquirer and Target use different acceptable methods to estimate SSP. Acquirer assesses the Target's ASC 606 accounting and determines that the Acquirer's estimation of SSP is more reasonable because it believes certain observable inputs should be weighted differently. Instead of allocating 80% ($240,000) of the total transaction price to the license and 20% ($60,000) to the PCS, Acquirer allocates 70% ($210,000) of the transaction price to the license and the remaining 30% ($90,000) to PCS.

Analysis

Acquirer recognizes a contract liability of $45,000 ($90,000/two-year contract period) on the acquisition date. The $30,000 decrease to the transaction price allocated to the software license would not be recognized at the acquisition date because that performance obligation was satisfied before the acquisition. Revenue related to the PCS is recognized ratably over the remaining contractual term of one year. Any customer-related intangible asset is recognized at fair value in accordance with ASC 805 and amortized over the useful life of the asset.

The following example illustrates when the estimated revenue from the acquired revenue contract is updated on a recurring basis by both the target before acquisition and the acquirer after acquisition.

Illustration 4-22: Target acquired with trailing commissions

Target, an insurance broker, executes a contract with Company A, a health insurance provider, on 1 January 20X0. Target receives an initial fee of $100 when a consumer buys an insurance policy from Company A. In addition, Target receives "trailing commissions" from Company A of $50 whenever one of those consumers renews a policy.

Target has a large pool of historical data about consumer renewal patterns, given its significant experience with similar contracts. Target noted that the amount of consideration is highly susceptible to factors outside its influence, and the uncertainty could stretch out over multiple years. However, it also has significant experience with similar types of contracts, and its experience has predictive value.

Even though most of the consideration Target will be entitled to is uncertain and depends on the actions of third parties (i.e., whether consumers renew), Target determined it can estimate a minimum amount of variable consideration for which it is probable that a significant reversal of cumulative revenue will not occur. Assuming that the Target's performance was complete for brokering the health insurance policy upon a consumer's initial signing of the policy on 1 January 20X0, Target recognized the initial $100 fee that was received from Company A plus $150 (the minimum amount related to future renewals that is not constrained).

Acquirer acquires Target, which is a business, on 2 January 20X0.

Analysis

Target recognized an estimated amount of revenue ($250) upon the execution of the consumer's health insurance policy with Company A that includes the amount it expects to be entitled to receive for renewals of that policy. Before the acquisition date, Target received the initial fee of $100 but none of the "trailing commissions" of $150 from Company A. Accordingly, Target had a $150 contract asset recorded immediately before the acquisition date.

At the acquisition date, Acquirer assesses the Target's ASC 606 accounting for the contract with Company A as if it originated the contract. Acquirer considers (1) the expected revenue of $250 recognized by Target from contract inception through the acquisition date and (2) its best estimate of expected revenue based on its experience with similar types of contracts. Acquirer determines that the total expected revenue of $250 is consistent with what it would have recorded if it had originated the contract. Acquirer determines it can carry over Target's accounting and recognizes a contract asset in the amount of $150, consistent with Target.

At each future reporting period, Acquirer will reassess its estimate of expected revenue from future policy renewals in accordance with ASC 606, including the variable consideration constraint. It will recognize increases or decreases to revenue from any changes to the estimate of policy renewals. In addition, Acquirer will recognize amortization expense related to the customer-related intangible asset that was recorded at the acquisition date.

An acquirer may determine that it cannot carry over the target's ASC 606 accounting based on differences between estimates of the target and acquirer. Determining under which circumstances an acquirer cannot carry over the target's accounting based on differences in estimates will require significant judgment. The acquirer's assessment of the target's accounting will need to consider the reasonableness of prior estimates made by the target. Differences in estimation between the acquirer and target may occur more often in circumstances where the acquirer has significant experience in the target's industry and the acquired contracts require more estimation (e.g., long-term, significant variable consideration).

4.4.3A.5.2 Accounting for contracts with customers in a business combination that have performance obligations that are satisfied over time (added June 2022)

Revenue for some contracts may be recognized over time as the entity transfers control of the promised goods or services to the customer. ASC 606 requires the use of measures of progress that focus solely on the entity's performance in transferring control of the goods or services. When a performance obligation is satisfied over time, two types of methods can be used to measure progress under the contract: an input method and an output method. An entity should select a single measure of progress for each performance obligation that depicts the entity's performance in transferring control of goods or services promised to a customer.

Before the adoption of ASU 2021-08, acquired contracts with performance obligations satisfied over time are recognized at fair value based on the amount of effort remaining for the combined company to satisfy the remaining performance obligations. This results in a reset of the measure of progress as of the acquisition date, and the arrangement is effectively considered to be a new contract for the remaining performance obligations as of the acquisition date.

After the adoption of ASU 2021-08, an acquirer should measure progress toward completion as if it originated the contract. The measure of progress as of the acquisition date should include effort expended by the target before the acquisition. For example, an acquirer would use the actual costs the target incurred before the acquisition date plus the estimate of costs it will incur to complete the remaining work required under the contract to measure progress toward completion as of the acquisition date. Any difference in the measure of progress will be reflected as an adjustment to the contract asset or liability balance under purchase accounting.

In the post-combination period, the acquirer would continue to update the measure of progress for the acquired contract under ASC 606. We believe the acquirer would use the measure of progress established in the business combination updated for any post-combination effort expended on that contract and adjusted for any changes in the estimate of costs to complete under ASC 606.

The following example illustrates an entity's considerations when acquiring a long-term construction contract in a business combination after adoption of ASU 2021-08.

Illustration 4-23: Acquisition of long-term construction contract

Target enters into a contract with a municipality to construct a tunnel on 1 January 20X1 for total consideration of $1,000,000. The construction is expected to take five years to complete and is considered a single performance obligation satisfied over time. Target determines that the contract does not include a significant financing component, and the municipality pays for the contract as certain milestones are achieved. Target uses an input method to determine the measure of progress based on costs incurred compared with total estimated costs to complete construction of the tunnel.

Acquirer acquires Target, which is a business, on 1 January 20X3. Target estimates the contract to be 40% complete at the acquisition date based on the input-method measure of progress (total cost incurred as of 1 January 20X3 by Target of $320,000 over total estimated cost to complete of $800,000). Target recognizes $400,000 (40% x $1,000,000) in revenue and received $200,000 in payments from the municipality as of the acquisition date.

Target recognizes a contract asset of $200,000 ($400,000 - $200,000) at the acquisition date (and not a receivable) since all future payments to Target are conditioned upon achieving a future milestone in the project. Target determined it was appropriate to include the $200,000 estimate of variable consideration associated with the milestone payment in the transaction price (i.e., the variable consideration was not constrained).

Analysis

Acquirer determines that its estimate of the costs to complete the construction of the tunnel is $700,000 ($320,000 of costs incurred through 1 January 20X3 and Acquirer's estimate of $380,000 to complete the tunnel), which is lower than Target's total estimated cost to complete. Acquirer has a more favorable cost structure than Target due to Acquirer's purchasing power. Acquirer estimates that the construction of the tunnel is 46% complete as of 1 January 20X3.

Acquirer recognizes a contract asset of $260,000 (46% x $1,000,000, less $200,000 in payments received as of the acquisition date) at the acquisition date. This is $60,000 greater than the contract asset previously recognized by Target and will result in $60,000 less revenue in the post-combination period.

Also, any contract-related intangible asset or liability recognized at the acquisition date relating to the off-market or contract backlog components is amortized over the remaining term of the contract. Any customer relationship intangible asset is amortized separately over its remaining useful life. As previously stated, these components are not in the scope of ASU 2021-08 and continue to be recognized at fair value.

4.4.3A.6 Out-of-scope components (added June 2022)

The components of acquired revenue contracts discussed below are examples of components not in the scope of ASU 2021-08.

4.4.3A.6.1 Refund liabilities (added June 2022)

A target may have received consideration that it will need to refund to the customer in the future because the consideration is not an amount to which the target will ultimately be entitled to under the contract. A refund liability generally does not represent an obligation to transfer goods or services in the future. We believe that a refund liability does not typically meet the definition of a contract liability.

When an acquirer concludes that a refund liability is not a contract liability, it recognizes the acquired refund liability as of the acquisition date at fair value in accordance with the principles of ASC 820.

4.4.3A.6.2 Deferred costs under ASC 340-40 incurred by a target (added June 2022)

A target may have recognized an asset in its preacquisition financial statements for the costs it incurred (and expects to recover) to obtain or fulfill a contract with a customer in accordance with ASC 340-40. Because the acquirer has not obtained an economic benefit, we do not believe these costs qualify for separate asset recognition by the acquirer in a business combination. The cash flows that the acquirer expects to receive in the future to recover these costs may affect the valuation of other assets recognized as part of the related acquired customer contract (e.g., a customer-related intangible asset, contract backlog asset, inventory or property, plant and equipment).

4.4.3A.6.3 Contract-based intangible assets and liabilities (added June 2022)

Under ASC 805, intangible assets acquired in a business combination in connection with the acquisition of contracts with customers are required to be measured at fair value. The fair value of the acquired intangible assets is not affected by the method of accounting (e.g., the method used to measure progress under ASC 606) to be used by the acquirer after the acquisition nor by the method of accounting used by the target before the acquisition.

Economically, the recognition and fair value measurement of an intangible asset represent the benefit that the acquirer is expected to realize by acquiring an already existing intangible asset as compared to creating the intangible asset organically. This "make" versus "buy" decision affects the price that buyers and sellers would pay to acquire a business that includes this intangible asset.

Under ASC 820, the following three valuation techniques may be considered to value an acquired intangible asset: (1) the income approach, (2) the market approach and (3) the cost approach.

Intangible assets, including contracts with customers, are rarely valued utilizing a market approach given the lack of transactions for similar assets individually. The fair value of intangible assets that are unique and not easily replaced typically is determined using an income approach. That is, the fair value would be estimated as the risk-adjusted, present value of expected future cash flows that could be generated by the subject asset.

Conversely, if an asset is easily replaceable or fungible, fair value typically is based on a cost approach. That is, the fair value would be estimated based on the replacement cost of a like-kind asset. However, the use of a cost approach generally is appropriate only when the principle of substitution is valid for the intangible asset. Under this principle, a ready substitute for the asset can be reconstructed, rebuilt or replaced because the asset is not proprietary, novel or one-of-a-kind.

In some industries, an acquired contract with a customer often is unique and not easily replaced. In such situations, we believe an income approach generally would provide a more appropriate representation of fair value than a cost approach.

The intangible components of value of an acquired contract with a customer are commonly measured as follows:

- Customer relationship intangible asset — measured as the expected present value of future cash flows available from future contracts with that customer

- Contract backlog intangible asset — measured as the value derived under the income approach based on the present value of expected future cash flows available from the existing contract, net of cash flows associated with contract assets and receivables
- Off-market component intangible asset (or liability) — measured as the present value of the amount by which the current contract terms deviate from what a market participant could achieve on the acquisition date

An important aspect of valuing an acquired contract with a customer is to verify that all components of value have been considered (that is, none of the components of value have been omitted or double counted) and appropriately reflected in the measurement.

4.4.3A.6.4 Up-front payments to customers (added June 2022)

A target may have made an up-front payment to a customer in anticipation of future purchases. At the time of payment, the target accounts for the consideration paid or payable to a customer as a reduction of the transaction price and, therefore, of revenue unless the payment to the customer is in exchange for a distinct good or service that the customer transfers to the target.[38] When payments to customers are not in exchange for a distinct good or service and the target expects to generate future revenue associated with the payment, a target generally defers the up-front payment by recognizing an asset, separate from any contract asset or contract liability recorded, and reducing revenue as the related goods or services (or as expected related goods or services) are transferred to the customer.

In an acquisition, an acquirer would not continue to recognize a separate asset under ASC 606 for the up-front payment to the customer. However, the acquirer should carefully consider the facts and circumstances associated with the up-front payment when determining the fair value of the customer-related intangible asset, including whether the up-front payment results in an off-market component of the contract. After the acquisition date, the acquirer may recognize the amortization expense for the intangible asset as a reduction in revenue or as additional cost of goods sold, depending on the nature of the asset.

4.4.3A.7 Significant financing component considerations (added June 2022)

For some transactions, the timing of the receipt of consideration does not match that of the transfer of goods or services to the customer (e.g., the consideration is prepaid or is paid after the services are provided). When the customer pays in arrears, the entity is effectively providing financing to the customer. Conversely, when the customer pays in advance, the entity has effectively received financing from the customer.

The Board explained in the Basis for Conclusions of ASU 2014-09 that, conceptually, a contract that includes a financing component includes two transactions — one for the sale of goods and/or services and one for the financing. Accordingly, the Board decided to require entities to adjust the amount of promised consideration for the effects of financing only if the timing of payments specified in the contract provides the customer or the entity with a significant benefit of financing.[39]

When an entity acquires a contract that includes a significant financing component, the post-combination revenue and interest related to the significant financing component that are recognized by the combined company should be the same as those that would have been recognized by the target if the business combination had not occurred.[40]

---

[38] ASC 606-10-32-25.

[39] BC229 from ASU 2014-09.

[40] An acquirer may make other changes to contract assets and liabilities in instances where it does not carry over the target's accounting. Those changes could affect post-combination revenue and interest.

4.4.3A.8 Measurement period considerations (added June 2022)

Contract assets and contract liabilities acquired in a business combination will be subject to the measurement period provided in ASC 805. If the measurement period for an acquisition is open, the entity may report provisional amounts for contract assets and contract liabilities acquired in a business combination as of its financial reporting date. The acquirer discloses that the amounts recognized are provisional and discloses the information that the acquirer has arranged to obtain but has not yet received. In this case, the acquirer may be waiting for appropriate support to assess the target's ASC 606 accounting before it can say that the measurement period is complete for the contract assets and contract liabilities acquired.

If the acquirer records any adjustments to provisional amounts recognized, it must perform a careful evaluation of those amounts to determine whether the potential adjustment is the result of information that existed as of the acquisition date or whether the potential adjustment is the result of events occurring after the acquisition date.

Significant judgment will be required when evaluating whether the measurement period is open for acquired revenue contracts. Even though the measurement period is available for the recognition and measurement of acquired contract assets and liabilities in a business combination, an acquirer is required to apply ASC 606 to those acquired revenue contracts during the post-combination period.

It will be important for an acquirer to understand the items that it has not yet obtained for purposes of its acquisition date recognition and measurement and how those items relate to its ongoing revenue recognition. For example, the acquirer may be required to obtain certain information about acquired contracts to continue applying ASC 606 during the post-combination period (e.g., total costs incurred as of the end of the reporting period) that may also provide resolution to certain information necessary to identify and measure contract assets and liabilities as of the acquisition date.

Refer to section 7.3 for additional measurement period considerations.

4.4.3A.9 Practical expedients for ASU 2021-08 (added June 2022)

Excerpt from Accounting Standards Codification

Pending Content:

Transition Date: *(P) December 16, 2022; (N) December 16, 2023* | **Transition Guidance:** 805-20-65-3

Business combinations — Identifiable Assets and Liabilities, and Any Noncontrolling Interest

Initial Measurement

805-20-30-29

An acquirer may use one or more of the following practical expedients when applying paragraphs 805-20-30-27 through 30-28 at the acquisition date:

a. For contracts that were modified before the acquisition date, an acquirer may reflect the aggregate effect of all modifications that occur before the acquisition date when:

   1. Identifying the satisfied and unsatisfied **performance obligations**

   2. Determining the **transaction price**

   3. Allocating the transaction price to the satisfied and unsatisfied performance obligations.

b. For all contracts, for purposes of allocating the transaction price, an acquirer may determine the **standalone selling price** at the acquisition date (instead of the contract inception date) of each performance obligation in the contract.

805-20-30-30

For any of the practical expedients in paragraph 805-20-30-29 that an acquirer uses, the acquirer shall apply that expedient on an acquisition-by-acquisition basis. Each practical expedient that is elected shall be applied consistently to all contracts acquired in the same business combination. In addition, the acquirer shall provide the disclosures in paragraph 805-20-50-5.

ASU 2021-08 provides two practical expedients for acquirers, and all entities can apply them.

The first practical expedient relates to contracts that were modified[41] before the acquisition. It allows the acquirer to reflect the aggregate effect of all modifications that occurred before the acquisition date, as of the acquisition date, when:

- Identifying the satisfied and unsatisfied performance obligations
- Determining the transaction price
- Allocating the transaction price to the satisfied and unsatisfied performance obligations

This expedient is similar to a practical expedient that the FASB previously provided for entities to ease the transition to ASC 606.

The second practical expedient relates to the determination of SSP. ASC 606 allows for any reasonable estimation approach as long as it is consistent with the notion of an SSP, maximizes the use of observable inputs and is applied on a consistent basis for similar goods and services and customers. SSP is determined at contract inception under ASC 606, but the practical expedient allows the acquirer to determine SSP at the acquisition date instead of at contract inception.

An acquirer that elects to use this practical expedient as of the acquisition date should consider the guidance in ASC 606 for determining SSP as of the date of acquisition. This would include having the appropriate processes and procedures over the determination of the SSP estimates that are used in the acquirer's ASC 606 accounting for the acquired contracts. See section 6.1 of our FRD, ***Revenue from contracts with customers (ASC 606)***, for a discussion on determining SSP.

Consider the illustration below:

Illustration 4-24: Contract modification and SSP practical expedients

Target enters into a contract with a customer to sell equipment for $1 million and provide services for 10 years for $20,000 annually. The equipment is delivered on 1 January 20X0, and the service commences at that time. The equipment and the service are separate performance obligations.

The contract is modified several times between contract inception and 20X5. The modifications extended the contract by 10 years and provided an additional piece of equipment for $1 million. The additional equipment will be delivered in 20X7 and is a separate performance obligation.

[41] Contract modifications may occur when parties to an arrangement agree to modify the scope or price (or both) of their contract. Once an entity determines that a contract has been modified, it needs to determine the appropriate accounting for the modification. Certain modifications are treated as separate standalone contracts, while others are combined with the original contract and accounted for in that manner. In addition, some modifications are accounted for on a prospective basis, and others are accounted for on a cumulative catch-up basis. Accordingly, an acquirer will also need to consider the effect of contract modifications when reevaluating prior estimates.

Acquirer acquires Target on 1 January 20X6. Acquirer elects to apply the practical expedient on contracts that were modified before the acquisition and the practical expedient related to the determination of SSP.

Acquirer's total transaction price for the acquired modified contract at the acquisition date is $2,400,000 [$1 million (equipment) + $1 million (equipment) + (20 years x $20,000 (service))], which is the cumulative effect of all the contract modifications that occurred between contract inception and the acquisition date. The total transaction price is allocated to the two products and the service based on the SSP of each performance obligation at the acquisition date.

The transaction price allocated to the second piece of equipment and the remaining unperformed services would be recognized when or as they are transferred to the customer.

Any entity can elect to apply the practical expedients on an acquisition-by-acquisition basis. If elected, the expedients must be applied consistently to all acquired contracts with customers in each acquisition.

We believe the acquirer's implementation of ASC 606 for the acquired contracts will likely be similar to an initial adoption of ASC 606 in instances where the acquirer cannot carry over all of the target's accounting. The expedients provide relief in situations where the acquirer does not have appropriate data to evaluate the historical periods since contract inception. The Board has said that it does not expect the use of the practical expedients to be widespread.[42]

4.4.3A.10 Disclosure considerations (added June 2022)

Excerpt from Accounting Standards Codification

Pending Content:

Transition Date: *(P) December 16, 2022; (N) December 16, 2023* | **Transition Guidance:** 805-20-65-3

Business combinations — Identifiable Assets and Liabilities, and Any Noncontrolling Interest

Disclosure

805-20-50-5

For any of the practical expedients in paragraph 805-20-30-29 that an acquirer uses, the acquirer shall disclose all of the following information:

a. The expedients that have been used

b. To the extent reasonably possible, a qualitative assessment of the estimated effect of applying each of those expedients.

ASU 2021-08 does not require additional general or transition disclosures. The FASB determined that the disclosures required under ASC 805 and ASC 606 provide sufficient information for users of financial statements.[43] However, if the acquirer decides to elect a practical expedient in ASC 805-20-30-29, the acquirer should disclose:

- The expedients that have been used
- A qualitative assessment of the estimated effect of applying each of the expedients, to the extent reasonably possible

[42] BC36 from ASU 2021-08.

[43] BC54 and BC55 from ASU 2021-08.

4.4.3A.11 Effective date and transition for ASU 2021-08 (added June 2022)

Excerpt from Accounting Standards Codification

Business combinations — Identifiable Assets and Liabilities, and Any Noncontrolling Interest

Transition and Open Effective Date Information

805-20-65-3

The following represents the transition and effective date information related to Accounting Standards Update No. 2021-08, *Business Combinations (Topic 805): Accounting for Contract Assets and Contract Liabilities from Contracts with Customers*:

a. For **public business entities**, the pending content that links to this paragraph shall be effective for fiscal years, including interim periods within those fiscal years, beginning after December 15, 2022.

b. For all other entities, the pending content that links to this paragraph shall be effective for fiscal years, including interim periods within those fiscal years, beginning after December 15, 2023.

c. An entity shall apply the pending content that links to this paragraph prospectively to **business combinations** that occur after the effective date.

d. Early application of the pending content that links to this paragraph is permitted, including in any interim period, for:

   1. Public business entities for periods for which financial statements have not yet been issued

   2. All other entities for periods for which financial statements have not yet been made available for issuance.

e. An entity that elects early application of the pending content that links to this paragraph in an interim period shall apply the pending content:

   1. Retrospectively to all business combinations for which the acquisition date occurs on or after the beginning of the fiscal year that includes the interim period of early application

   2. Prospectively to all business combinations that occur on or after the date of initial application.

ASU 2021-08 is effective for fiscal years beginning after 15 December 2022, and interim periods therein for PBEs. For all other entities, it is effective for fiscal years beginning after 15 December 2023, and interim periods therein.

Early adoption is permitted for all entities, including adoption in an interim period. PBEs can early adopt the amendments for periods for which financial statements have not yet been issued, and all other entities can early adopt the amendments for periods for which the financial statements have not yet been made available for issuance. Further, early adoption is permitted in any interim period regardless of whether a business combination occurs in that period.

The guidance is applied prospectively. However, an entity that elects to early adopt must apply the amendments to all business combinations that occurred during the fiscal year that includes that interim period.

Further, an entity that early adopts the guidance cannot change the accounting for acquisitions that occurred in a prior annual period for which financial statements have already been issued.

An entity must apply the guidance to all acquisitions in its fiscal year of adoption, even those for which the measurement period closed before it adopted the guidance. For example, if an acquirer completed an acquisition earlier in its fiscal year of adoption and measured the contract assets and contract liabilities acquired at fair value, it must revise and remeasure the contract assets and contract liabilities retrospectively as of the acquisition date in accordance with ASC 606.

In addition, the acquirer needs to consider the effect on post-combination revenue. If it recognized revenue based on the fair value of the contract assets and contract liabilities before adopting ASU 2021-08, it has to adjust the revenue previously recognized to reflect the amount of revenue that should have been recognized if the contract assets and contract liabilities were recognized under ASC 606 as of the acquisition date.

Consider the illustration below:

Illustration 4-25: Early adoption of ASU 2021-08

Company A elects to early adopt ASU 2021-08 in the fourth quarter of fiscal year 20X1. Company A acquired Company B in the fourth quarter of fiscal year 20X0, Company C in the first quarter of fiscal year 20X1, and Company D in the fourth quarter of fiscal year 20X1.

After adoption of ASU 2021-08:

- Any contract assets and contract liabilities acquired in the acquisition of Company B continue to be recognized at fair value at the acquisition date. Because this acquisition occurred in the fourth quarter of fiscal year 20X0 in the fiscal year before adoption of ASU 2021-08, the provisions of ASU 2021-08 do not apply to this acquisition.
- Any contract assets and contract liabilities acquired in the acquisition of Company C are recognized in accordance with ASC 606 as of the acquisition date. Before adopting ASU 2021-08, Company A reflected the acquired revenue contracts at fair value at the acquisition date in its first-, second- and third-quarter financial statements. However, because Company A adopted ASU 2021-08 in fiscal year 20X1, it must remeasure the acquired revenue contracts in accordance with ASC 606 at the acquisition date, which may also impact goodwill and other assets and liabilities recognized in purchase accounting. Further, Company A adjusts the revenue previously recognized by determining the amount of revenue that should have been recognized if the contract assets and contract liabilities were recognized under ASC 606 as of the acquisition date. The remeasured amounts are reflected retrospectively when presenting comparative financial information in future periods.
- Any contract assets and contract liabilities acquired in the acquisition of Company D are recognized in accordance with ASC 606 as of the acquisition date. Company A acquired Company D in the same quarter that Company A adopted ASU 2021-08.

4.4.3A.11.1 Application of ASU 2021-08 to a target's prior business combinations (added June 2022)

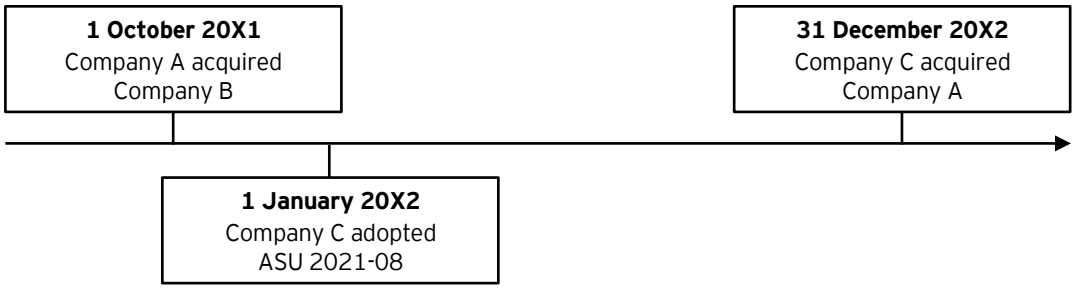
An acquirer may acquire a target that has previously acquired other businesses for which the target appropriately measured contract assets and liabilities at fair value before adoption of the ASU 2021-08. In this situation, we believe the acquirer would recognize all acquired revenue contracts of the target in accordance with ASU 2021-08. That is, any contracts previously acquired by the target in a business combination that are still in process as of the acquisition date will be remeasured by the acquirer in accordance with ASC 606. In this circumstance, the acquirer would be unable to carry over the target's contract assets and liabilities related to those previously acquired contracts.

Consider the following example:

Illustration 4-26: Revenue contracts acquired from target's previous acquisition

Company A acquired Company B on 1 October 20X1 before adopting ASU 2021-08. Company A acquired contract assets and contract liabilities in the acquisition of Company B. Company A recorded the acquired contract assets and contract liabilities at fair value as of the acquisition date.

Company C adopted ASU 2021-08 on 1 January 20X2 and subsequently acquired Company A on 31 December 20X2.



Analysis

Company C acquired contract assets and contract liabilities from Company A. Company A still had contract assets and contract liabilities acquired from Company B on its balance sheet as of 31 December 20X2. Company C measures all acquired contract assets and contract liabilities from Company A, inclusive of any remaining contract assets and liabilities from the Company B acquisition, in accordance with ASC 606, as if Company C had originated those acquired revenue contracts at the contract inception date.

4.4.4 Executory contracts

Although a consensus on EITF 03-17 was not reached, the EITF 03-17 abstract defined an executory contract as "a contract that remains wholly unperformed or for which there remains something to be done by either or both parties of the contract." This definition is rather broad, and we believe it provides a reasonable basis for considering whether a contract is an executory contract. Executory contracts include numerous forms of arrangements for both buyers and sellers of products and services. One example is a product purchase order in which one party's performance obligations are limited to accepting delivery and making agreed-upon payments. Other examples include, but are not necessarily limited to, employment contracts, lease arrangements, service contracts, certain derivative contracts, purchase and sales commitments, insurance contracts, franchise agreements and compensation arrangements.

Unless a specific executory contract is subject to one of the measurement exceptions in ASC 805 (see further discussion in section 3.4.3), the contract acquired or assumed in a business combination is recognized at its fair value. The fair value of the contract may consist of one or both of the following components: any off-market element of the contract and any inherent fair value (i.e., the price a market participant is willing to pay for an at-market contract).

4.4.4.1 Off-market element of fair value in executory contracts

To the extent that terms of acquired or assumed executory contracts contain terms that are not equivalent to market terms (based on a current transaction with a market participant) on the date of acquisition (i.e., the off-market element of fair value), an asset or liability is recognized in the business combination. Assets and liabilities recognized in a business combination that relate to the off-market element of fair value in an executory contract typically are amortized over the term of the contract. Conceptually, that amortization, plus or minus the actual effect on the acquirer resulting from performing under the contract after acquisition, results in a net (or aggregate) effect on results of operations in future periods during which the contract is completed as if the executory contract were consummated at market on the acquisition date.

At the 2006 AICPA National Conference on Current SEC and PCAOB Developments, the SEC staff specifically identified in-process revenue contracts as examples of executory contracts that should be recognized as unfavorable contract liabilities to the extent that the terms of the contracts are less favorable than the terms that could be realized in current market transactions. Conversely, and while not discussed by the SEC staff, an in-process revenue contract with terms that are favorable to the acquirer on the acquisition date should be recognized as an asset in a business combination.

The SEC staff stated that it generally would expect that in-process revenue contract terms originally negotiated between an acquired entity and its customer would represent a market rate of return at the date the contract was entered, because the contract would have been executed between a willing buyer and willing seller at market terms. Accordingly, an analysis of whether a contract is unfavorable at the acquisition date usually would focus on intervening events and changes in circumstances that occurred during the period between contract consummation and the acquisition date. Absent intervening events or changes in circumstances, the SEC staff can be expected to raise concerns about an assertion that an acquired contract was in an unfavorable position (i.e., unprofitable operations of an acquired entity does not necessarily mean that acquired contracts are unfavorable contracts). When determining the current market rate of return for a similar contract, assumptions used should reflect those that would relate to an actual transaction consummated in a competitive bidding environment among market participants, not the list price that a vendor would use as a starting point in contract negotiations.

Specific aspects of measuring and recognizing the off-market element of fair value as of the acquisition date for certain types of executory contracts are discussed in the following sections 4.4.4.3 through 4.4.4.6.

4.4.4.2 Inherent fair value in executory contracts

Excerpt from Accounting Standards Codification

Business Combinations — Identifiable Assets and Liabilities, and Any Noncontrolling Interest

Recognition

805-20-25-13

An identifiable intangible asset may be associated with an operating lease, which may be evidenced by market participants' willingness to pay a price for the lease even if it is at market terms. For example, a lease of gates at an airport or of retail space in a prime shopping area might provide entry into a market or other future economic benefits that qualify as identifiable intangible assets, such as a customer relationship. In that situation, the acquirer shall recognize the associated identifiable intangible asset(s) in accordance with paragraph 805-20-25-10.

Pending Content:

Transition Date: *(P) December 16, 2018; (N) December 16, 2021* | **Transition Guidance:** 842-10-65-1

805-20-25-10A

An identifiable intangible asset may be associated with a **lease**, which may be evidenced by market participants' willingness to pay a price for the lease even if it is at market terms. For example, a lease of gates at an airport or of retail space in a prime shopping area might provide entry into a market or other future economic benefits that qualify as identifiable intangible assets, such as a customer relationship. In that situation, the acquirer shall recognize the associated identifiable intangible asset(s) in accordance with paragraph 805-20-25-10.

805-20-25-13

Paragraph superseded by Accounting Standards Update No. 2016-02.

Fair value in an acquired or assumed executory contract might also include an inherent value element (i.e., the price a market participant is willing to pay for an at-market contract). The FASB observed that "at-market" contracts are bought and sold in exchange transactions (e.g., airport gates (operating leases) in the airline industry and customer contracts in the home security industry are bought and sold for valuable consideration even when the terms of the underlying and respective contracts are "at-market"). The FASB believes that those transactions provide evidence that a contract may have value for reasons other than its terms relative to the current market and, therefore, concluded that the amount by which the terms of a contract are favorable or unfavorable does not necessarily represent the full fair value of a contract.

At-market contracts generally are profitable and often costly to obtain. The at-market or inherent value of a contract from a market participant's perspective relates to the cost, time and effort required to obtain an at-market contract that is avoided by acquiring a target's preexisting contracts in a business combination. Further, as there is no uncertainty associated with whether a preexisting target company contract will be executed (because by definition it already has been executed), at-market value might also reflect avoided uncertainty.

The following sections, 4.4.4.3 through 4.4.4.6, discuss unique aspects of certain common types of executory contracts.

4.4.4.3 Leases (before the adoption of ASC 842)

A lease is an agreement conveying the right to use property, plant or equipment. Under a lease, the party obtaining the right to use the leased property is referred to as a lessee and the party conveying the right to use the property is referred to as a lessor. Accounting guidance for lease arrangements for both lessees and lessors under US GAAP is primarily contained in ASC 840 (before the adoption of ASC 842) and is applicable to all entities (see ASC 840-10-15 and our FRD, ***Lease accounting: Accounting Standards Codification 840, Leases***, for additional guidance on evaluating whether an arrangement is or contains a lease).

Excerpt from Accounting Standards Codification

Leases — Overall

Recognition

840-10-25-27

In a business combination or an **acquisition by a not-for-profit entity**, the acquiring entity shall retain the previous classification in accordance with this Subtopic for the leases of an acquired entity unless the provisions of the lease are modified as indicated in paragraph 840-10-35-5. That paragraph addresses the accounting for a lease modification that was planned at the time of a business combination but made after the acquisition date.

Subsequent Measurement

840-10-35-4

If at any time the lessee and lessor agree to change the provisions of the lease, other than by renewing the lease or extending its term, in a manner that would have resulted in a different classification of the lease under the lease classification criteria in paragraphs 840-10-25-1 and 840-10-25-42 had the changed terms been in effect at **lease inception**, the revised agreement shall be considered as a new agreement over its term, and the lease classification criteria in paragraphs 840-10-25-1 and 840-10-25-42 shall be applied for purposes of classifying the new lease. Likewise, except if a guarantee or **penalty** is rendered inoperative as described in paragraphs 840-30-35-8 and 840-30-35-23, any action that extends the lease beyond the expiration of the existing lease term, such as the exercise of a lease renewal option other than those already included in the lease term, shall be considered as a new agreement, which shall be classified according to the guidance in Section 840-10-25. Changes in estimates (for example, changes in estimates of the economic life or of the residual value of the leased property) or changes in circumstances (for example, default by the lessee) shall not give rise to a new classification of a lease for accounting purposes.

840-10-35-5

The classification of a lease in accordance with the criteria in this Subtopic shall not be changed as a result of a business combination or an **acquisition by a not-for-profit entity** unless the provisions of the lease are modified. At the acquisition date, an acquirer may contemplate renegotiating and modifying leases of the business or **nonprofit activity** acquired. Modifications made after the acquisition date, including those that were planned at the time of the combination, are postcombination events that shall be accounted for separately by the acquirer in accordance with the provisions of this Topic. If in connection with a business combination or an acquisition by a not-for-profit entity the provisions of a lease are modified in a way that would require the revised agreement to be considered a new agreement under the preceding paragraph, the new lease shall be classified by the combined entity according to the criteria set forth in this Subtopic, based on conditions as of the date of the modification of the lease. After the recording of the amounts called for by Subtopic 805-20, the leases shall be accounted for in accordance with this Subtopic. Subtopic 840-30 explains the application of this paragraph to a **leveraged lease** by an entity that acquires a lessor. This Subtopic does not address the subsequent accounting for amounts recorded for favorable or unfavorable **operating leases**.

The classification of a lease is required to be determined at its inception. Thus, a business combination does not result in the reconsideration of the original classification determination unless the provisions of the lease are modified as part of a business combination in a way that would require the revised agreement to be considered a new agreement.[44] ASC 805 only requires the valuation of the existing assets and obligations of the acquired company, including assets and obligations pertaining to leases. Subsequent to the recording of any adjustments required by the application of acquisition accounting, the leases would be accounted for in accordance with ASC 840 (see our FRD, ***Lease accounting: Accounting Standards Codification 840,* Leases**, for additional guidance).

According to ASC 840-10-35-4, once the classification of a lease is determined, that classification is not changed unless either:

- Both parties to the lease agree to a revision that would have resulted in a different classification had the changed terms been in effect at the inception of the lease.
- The lease is extended or renewed beyond the existing lease term.

Lease agreements that are not modified in connection with a business combination are discussed in sections 4.4.4.3.1 and 4.4.4.3.2 below. Lease agreements that are modified in connection with a business combination are discussed in section 4.4.4.3.4 below.

Excerpt from Accounting Standards Codification

Business Combinations — Identifiable Assets and Liabilities, and Any Noncontrolling Interest

Recognition

805-20-25-11

The acquirer shall recognize no assets or liabilities related to an operating lease in which the acquiree is the lessee except as required by paragraphs 805-20-25-12 through 25-13.

[44] In paragraph 7 of FASB Interpretation No. 21 (FIN 21), the FASB said that it does not believe that a business combination requires reconsideration, at the time of purchase, of the classification of existing leases that are already classified in conformity with lease classification criteria (i.e., ASC 840-10-25).

805-20-25-12

Regardless of whether the acquiree is the lessee or the lessor, the acquirer shall determine whether the terms of each of an acquiree's operating leases are favorable or unfavorable compared with the market terms of leases of the same or similar items at the acquisition date. The acquirer shall recognize an intangible asset if the terms of an operating lease are favorable relative to market terms and a liability if the terms are unfavorable relative to market terms.

805-20-25-13

An identifiable intangible asset may be associated with an operating lease, which may be evidenced by market participants' willingness to pay a price for the lease even if it is at market terms. For example, a lease of gates at an airport or of retail space in a prime shopping area might provide entry into a market or other future economic benefits that qualify as identifiable intangible assets, such as a customer relationship. In that situation, the acquirer shall recognize the associated identifiable intangible asset(s) in accordance with paragraph 805-20-25-10.

Initial Measurement

805-20-30-5

The acquirer shall measure the acquisition-date fair value of an asset, such as a building or a patent or other intangible asset, that is subject to an operating lease in which the acquiree is the lessor separately from the lease contract. In other words, the fair value of the asset shall be the same regardless of whether it is subject to an operating lease. In accordance with paragraph 805-20-25-12, the acquirer separately recognizes an asset or a liability if the terms of the lease are favorable or unfavorable relative to market terms.

The principles governing the recognition of assets and liabilities in a business combination apply to acquired lease arrangements. That is, fair value is the basis for recognition of acquired lease assets and obligations. Also, the principles discussed below are relevant whether the acquired business is a lessor or lessee. Subsequent to recognizing and measuring the assets acquired and liabilities assumed related to leases acquired in a business combination in accordance with ASC 805, the leases would be accounted for in accordance with ASC 840. See our FRD, ***Lease accounting: Accounting Standards Codification 840,* Leases**, for additional guidance.

The following table summarizes the items in an assumed lease contract that typically give rise to an asset or liability in the business combination.

Target lease classification	Asset	Liability
Lessee in an operating lease	▸ Favorable lease terms relative to market (including favorable purchase or renewal options) ▸ Leasehold improvements	▸ Unfavorable lease terms relative to market
Lessee of a capital lease	▸ Property under capital lease ▸ Leasehold improvements	▸ Capital lease obligation
Lessor in an operating lease	▸ Favorable lease terms relative to market ▸ In-place lease value ▸ Leased asset (including tenant improvements) ▸ Customer relationship intangible asset	▸ Unfavorable lease terms relative to market (including unfavorable purchase or renewal options)
Lessor in a sales-type or direct finance lease	▸ Lease receivable (including any guaranteed residual value and the payments that would be received upon the exercise of any purchase or renewal option that is reasonably assured of exercise) and any unguaranteed residual value ▸ In-place lease value ▸ Customer relationship intangible asset	

4.4.4.3.1 Lessee accounting

Operating leases — Acquired operating leases should be assessed to determine if the lease terms are favorable or unfavorable given market conditions on the acquisition date. To the extent the lease arrangement is favorable or unfavorable relative to market on the acquisition date or has an inherent value, an asset or liability, respectively, is recognized at fair value in the business combination. The estimate of fair value considers all provisions of the lease (term, purchase options, renewal options, termination penalties, residual value guarantees, etc.) from the perspective of a market participant. An acquirer would not recognize any deferred rent previously recognized by the acquired entity because the lease is recognized at its acquisition-date fair value and the acquiree's deferred rent does not meet the definition of an asset or liability at the acquisition date. Generally, the recognized asset or liability is amortized to rental expense over the remaining term of the lease to reflect a market rental cost per period based on market conditions at the acquisition date (absent provisions that could result in fluctuating rent expense — e.g., contingent rent provisions). However, if a portion of the fair value relates to a lease purchase option, we believe the fair value attributed to the lease purchase option, provided it is likely to be exercised, would not be amortized over the term of the lease, but rather would affect the recognized value of the asset upon exercise of the purchase option. For example, if the acquired purchase option on the leased asset is in-the-money on the acquisition date, the accounting basis of the subject asset upon exercise of the purchase option would be the sum of the exercise price plus the fair value of the acquired purchase option on the acquisition date. Additionally, if a portion of the fair value relates to a renewal option that was not included in the original lease term, provided it is determined that it is likely the option will be exercised (e.g., because of favorable market conditions), the value attributed to the renewal would not be amortized over the term of the lease, but rather would be amortized over the renewal period. Furthermore, the fair value of any leasehold improvements would be recognized the same as other plant and equipment assets acquired. See section 4.2.4 for further discussion of accounting for plant and equipment assets acquired in a business combination.

Capital leases — Assets under capital leases and capital lease obligations of acquired companies that are lessees are recognized at fair value as of the acquisition date in a business combination. The fair value of a capital lease obligation is measured similar to assumed debt. Similarly, the fair value of assets acquired under capital leases is measured and recognized based on the concepts discussed for measuring and recognizing assets acquired, as described in section 4.2.4. In general, a separate intangible asset or liability would not be recognized for the fair value of the lease contract. That is, any value in the lease (e.g., favorable or unfavorable lease terms relative to market or the in-place lease value) would be reflected in the measurement of the assets under capital lease and the capital lease obligation.

4.4.4.3.1.1 Measurement of property under capital lease

In measuring the amount to recognize for an acquired asset under a capital lease, the acquirer should consider why the lease was originally classified as a capital lease. That is, if the acquired lease was capitalized by the acquiree because the lease met one of the first two criteria set forth in ASC 840-10-25-1 (i.e., (a) title transfers to the acquiree or (b) the lease contains a bargain purchase option at the end of the lease term), the asset is recognized and measured by the acquirer at its acquisition-date fair value of the underlying asset. If it is not anticipated that the acquirer will obtain ownership of the leased asset (meaning the acquired leased asset was capitalized because (c) the lease term is equal to 75% or more of the estimated economic life of the leased property or (d) the present value of the minimum lease payments equals or exceeds 90% of the fair value of the leased property) or the acquirer does not intend to exercise any in-place bargain purchase option, the asset underlying the lease would be recognized and measured by the acquirer at the fair value of the leasehold interest (i.e., the value of the right to use the property for the remaining lease term and other rights under the lease). Any related leasehold improvements of the acquired entity would be recognized as tangible assets on the acquisition date at their fair value.

The following example illustrates the accounting for a capital lease acquired in a business combination:

Illustration 4-27: Acquisition of a capital lease in a business combination

Assume an acquired company has a plant that it has leased since 20X0 and which it capitalized in accordance with the provisions of ASC 840-10-25. Also, assume the fair value of the asset and interest rates have increased since 20X0. When the acquisition occurred in 20X9, the applicable amounts were:

	Lessee book value	Acquisition date fair value
Capital lease asset	$ 9,000	$ 11,000
Capital lease obligation	10,000	8,000

In consolidation, the capital lease asset and obligation would be stated at $11,000 and $8,000, respectively. The subsequent accounting would be consistent with the requirements of ASC 840-30-35; that is, the asset would be amortized over the remaining term of the lease (or, if a purchase option exists, the useful life of the asset) and the obligation would be reduced (using the interest method) using the acquirer's effective rate at the date of acquisition.

4.4.4.3.2 *Lessor accounting*

Operating leases — In a business combination that includes assets subject to operating leases, in addition to recognizing the assets subject to the lease at fair value, an assessment is required as to whether the underlying operating lease has an inherent value (i.e., the price a market participant is willing to pay for an at-market contract) and provisions that are off-market, favorable or unfavorable, given market conditions that existed on the date of the acquisition and the terms and conditions of the existing lease. The inherent value may relate to the economic benefit for acquiring an asset with an in-place lease, rather than an asset that is not leased.

The fair value of the assets subject to lease and any asset or liability related to the lease contract are recognized and measured separately. In accordance with paragraph 805-20-25-12, to the extent the lease is favorable or unfavorable, an asset or liability is recognized as part of the business combination, which is amortized to rental income over the term of the lease so that level rental income is recognized over the lease term. An asset recognized for the inherent value of a lease typically also is amortized over the term of the lease. However, if a portion of the fair value adjustment relates to a renewal option that was not included in the original lease term (e.g., a renewal option that is a bargain for the lessee as of the acquisition date) and it is determined that it is likely the option will be exercised, we believe the value attributed to the renewal would not be amortized over the term of the lease, but rather would be amortized over the renewal period.

An acquiring entity also may recognize a customer relationship intangible asset for its contractual relationship with any lessees.

Sales-type or direct finance leases — In a business combination that includes the acquisition of a sales-type or direct finance lease receivable, ASC 820 requires the receivable to be recorded at fair value as of the date of the acquisition. The adjustment to record the receivable at fair value would be based on an adjustment of the implicit rate in the lease to market, as well as any increase in residual value based on market information at the time of the acquisition (it is assumed that downward adjustments of residual value and loan loss reserves were reflected previously by the acquired company).

4.4.4.3.3 *Considerations for valuing in-place leases*

When assets are acquired with in-place leases, some lease contracts may have value for reasons other than terms that are favorable relative to market prices.

In valuing in-place leases, various methods may be used to determine the fair value of the lease. These include the income method, the cost method and the market method. However, when valuing in-place leases, the following components should be considered in the valuation.

- **Direct costs associated with obtaining a new lessee** — The value of an in-place lease would include the direct costs that are avoided by acquiring the lease instead of originating the lease. For example, these costs could include commissions, tenant improvements and other direct costs associated with obtaining a new lessee.
- **Opportunity costs associated with lost rentals** — In general, obtaining a new lessee will take some period of time, and during that period of time the asset owner may not be receiving lease payments. This period, often referred to as the absorption period, represents an opportunity cost to the owner that is avoided if the asset is acquired with an in-place lease.

Consideration also should be given as to whether the lease arrangements create a customer relationship asset under ASC 805. Examples of customer relationship assets might include the value, as a result of a current lease arrangement, associated with the expected renewal of the lease or the increased likelihood of obtaining the lessee as a lessee for other locations owned by the lessor.

In-place leases acquired with an asset (e.g., tenant leases associated with an acquired building) would also meet the recognition criteria under ASC 805; therefore, they must be recognized apart from the acquired asset. As the useful life of an in-place lease is normally shorter than the remaining life of the underlying asset, separate recognition and amortization will affect the net earnings of the acquiring entity.

4.4.4.3.4 Lease modifications in connection with a business combination

Excerpt from Accounting Standards Codification

Leases — Overall

Subsequent Measurement

840-10-35-5

The classification of a lease in accordance with the criteria in this Subtopic shall not be changed as a result of a business combination or an **acquisition by a not-for-profit entity** unless the provisions of the lease are modified. At the acquisition date, an acquirer may contemplate renegotiating and modifying leases of the business or **nonprofit activity** acquired. Modifications made after the acquisition date, including those that were planned at the time of the combination, are postcombination events that shall be accounted for separately by the acquirer in accordance with the provisions of this Topic. If in connection with a business combination or an acquisition by a not-for-profit entity the provisions of a lease are modified in a way that would require the revised agreement to be considered a new agreement under the preceding paragraph, the new lease shall be classified by the combined entity according to the criteria set forth in this Subtopic, based on conditions as of the date of the modification of the lease. After the recording of the amounts called for by Subtopic 805-20, the leases shall be accounted for in accordance with this Subtopic. Subtopic 840-30 explains the application of this paragraph to a **leveraged lease** by an entity that acquires a lessor. This Subtopic does not address the subsequent accounting for amounts recorded for favorable or unfavorable **operating leases**.

If the provisions of a lease are modified in connection with a business combination such that the modified lease qualifies as a new agreement pursuant to ASC 840-10-35-4, the lease is classified, as of the date of the business combination, based on the terms of the modified lease. That is, for a lease modified in connection with a business combination that qualifies as a new lease agreement, the factors and assumptions that are relevant to determining classification of the new lease agreement are those that exist as of the acquisition date. For example, if at the acquisition date, an operating lease of an acquired company is modified such that the lease would have been classified as a capital lease at inception had the modified terms been in effect, the lease is treated as a new lease agreement by the combined entity.

If the provisions of a lease are modified in connection with a business combination such that the modified lease does not qualify as a new agreement pursuant to ASC 840-10-35-4, the modified lease retains its original classification (see section 4.4.4.3 for additional guidance). For example, if the only change in a lease as a result of the business combination consists of changing the identity of the parties because of a business combination, this modification would not represent a new agreement between the lessee and lessor and classification of the lease is not changed. However, the modified provisions are relevant to determining the fair value of the acquired or assumed lease. See our FRD, ***Lease accounting: Accounting Standards Codification 840,*** **Leases**, for further discussion.

4.4.4.3.5 Acquired leasehold improvement

Excerpt from Accounting Standards Codification

Business Combinations — Identifiable Assets and Liabilities, and Any Noncontrolling Interest

Subsequent Measurement

805-20-35-6

Leasehold improvements acquired in a business combination shall be amortized over the shorter of the useful life of the assets or a term that includes required lease periods and renewals that are deemed to be reasonably assured (as used in the definition of **lease term**) at the date of acquisition.

An acquirer amortizes an acquired leasehold improvement over the shorter of the asset's useful life or a term that includes required lease periods and renewals that are deemed to be reasonably assured (as used in the definition of lease term) at the date of acquisition.

4.4.4.3.6 Lease of property from a third party entered into as part of a business combination

In certain business combinations, a third party unrelated to the acquiree or acquirer is inserted into the transaction to acquire a certain asset(s) of the business directly from the acquiree that will in turn be leased by the third party to the acquirer of the business. The question has arisen as to whether such transactions should be accounted for as the acquisition and sale-leaseback of the asset or simply as a lease transaction by the acquirer. In our view, although the transaction may in form be a lease of an asset, it is in substance a sale-leaseback and should be accounted for as such if the asset to be leased is acquired by the third party in contemplation of, or contingent upon, the acquisition of a business by the acquirer-lessee.

4.4.4.3.7 Leveraged lease acquired in a business combination or an acquisition by a not-for-profit entity

Excerpt from Accounting Standards Codification

Leases — Capital Leases

Recognition

840-30-25-10

In a business combination or an **acquisition by a not-for-profit entity**, the acquiring entity shall retain the classification of the acquired entity's investment as a lessor in a leveraged lease at the date of the combination. The net investment of the acquired leveraged lease shall be broken down into its component parts, namely, net rentals receivable, estimated residual value, and unearned income including discount to adjust other components to present value.

Initial Measurement

840-30-30-15

In a business combination or an **acquisition by a not-for-profit entity**, the acquiring entity shall assign an amount to the acquired net investment in the leveraged lease in accordance with the general guidance in Topic 805, based on the remaining future cash flows and giving appropriate recognition to the estimated future tax effects of those cash flows.

Subsequent Measurement

840-30-35-32

In a business combination or an acquisition by a not-for-profit entity, the acquiring entity shall subsequently account for its acquired investment as a lessor in a **leveraged lease** in accordance with the guidance in this Subtopic as for any other leveraged lease. Example 5 (see paragraph 840-30-55-50) illustrates an acquiring entity's accounting for its acquired investment as a lessor in a leveraged lease.

If the acquiree in a business combination or an acquisition by a not-for-profit entity was a lessor in a leveraged lease, the general guidelines of ASC 805 also must be applied in assigning amounts to the net investment in the leveraged lease. The acquirer measures the net investment based on the remaining net future cash flows and gives appropriate recognition to the estimated future tax effects of such cash flows. The net investment is then broken down into its component parts (net rentals receivable, estimated residual value and unearned income, including the discount to adjust the other components to present value) which are recognized in purchase accounting. Subsequent to the acquisition, the investment in the leveraged lease is accounted for by the acquirer in accordance with ASC 840-30 (see section 14 of our FRD, ***Lease accounting: Accounting Standards Codification 840,* Leases**, for further discussion on accounting for leveraged leases).

A detailed illustration of the accounting for a leveraged lease in a business combination, including one way that a lessor's investment in a leveraged lease may be valued by the acquiring entity, follows:

Excerpt from Accounting Standards Codification

Leases — Capital Leases

Implementation Guidance and Illustrations

840-30-55-50

This Example illustrates one way that a lessor's investment in a leveraged lease might be valued by the acquiring entity in a business combination or an **acquisition by a not-for-profit entity** and the subsequent accounting for the investment in accordance with the guidance in this Subtopic. The elements of accounting and reporting illustrated for this Example are as follows:

a. Acquiring entity's cash flow analysis by years (see paragraph 840-30-55-52)

b. Acquiring entity's valuation of investment in the leveraged lease (see paragraph 840-30-55-53)

c. Acquiring entity's allocation of annual cash flow to investment and income (see paragraph 840-30-55-54)

d. Journal entry for recording allocation of purchase price to net investment in the leveraged lease (see paragraph 840-30-55-55)

e. Journal entries for the year ending December 31, 1984 (Year 10 of the lease) (see paragraph 840-30-55-56).

840-30-55-51

This Example has the following terms and assumptions.

Cost of leased asset (equipment)	$1,000,000
Lease term	15 years, dating from January 1, 1975
Lease rental payments	$90,000 per year (payable last day of each year)
Residual value	$200,000 estimated to be realized one year after lease termination

Financing:	
Equity investment by lessor	$400,000
Long-term non-recourse debt	$600,000, bearing interest at 9% and repayable in annual installments (on last day of each year) of $74,435.30
Depreciation allowable to lessor for income tax purposes	Seven-year asset depreciation range life using double-declining-balance method for the first two years (with the half-year convention election applied in the first year) and sum-of-years digits method for remaining life, depreciated to $100,000 salvage value
Lessor's income tax rate (federal and state)	50.4% (assumed to continue in existence throughout the term of the lease)
Investment tax credit	10% of equipment cost or $100,000 (realized by the lessor on last day of first year of lease)
Initial direct costs	For simplicity, initial direct costs have not been included in the illustration
Date of business combination	January 1, 1982
Tax status of business combination	Non-taxable transaction
Appropriate interest rate for valuing net-of-tax return on investment	4 1/2%

840-30-55-52

Acquiring entity's cash flow analysis by years follows.

Year	(1) Gross lease rentals and residual value	(2) Depreciation (for income tax purposes)	(3) Loan interest payments	(4) Taxable income (col. 1-2-3)	(5) Income tax (charges) (col. 4 x 50.4%)	(6) Loan principal payments	(7) Annual cash flow (col. 1-3+5-6)
8	$ 90,000	$ –	$ 37,079	$ 52,921	$ (26,672)	$ 37,357	$ (11,108)
9	90,000	–	33,717	56,283	(28,367)	40,719	(12,803)
10	90,000	–	30,052	59,948	(30,214)	44,383	(14,649)
11	90,000	–	26,058	63,942	(32,227)	48,378	(16,663)
12	90,000	–	21,704	68,296	(34,421)	52,732	(18,857)
13	90,000	–	16,957	73,043	(36,813)	57,478	(21,248)
14	90,000	–	11,785	78,215	(39,420)	62,651	(23,856)
15	90,000	–	6,145	83,855	(42,263)	68,290	(26,698)
16	200,000	100,000	–	100,000	(50,400)	–	149,600
Total	$920,000	$ 100,000	$183,497	$636,503	$ (320,797)	$411,988	$ 3,718

840-30-55-53

Acquiring entity's valuation of investment in the leveraged lease follows.

Cash flow	Present value at 4 1/2% net-of-tax rate
1. Rentals receivable (net of principal and interest on the nonrecourse debt) ($15,564.70 at the end of each year for 8 years)	$ 102,663
2. Estimated residual value ($200,000 realizable at the end of 9 years)	134,581
3. Future tax payments (various amounts payable over 9 years — see the table in the preceding paragraph)	(253,489)
Net present value	$ (16,245)

840-30-55-54

Acquiring entity's allocation of annual cash flow to investment and income follows (see footnote [a]).

	(1)	(2)	(3)	(4)	(5)	(6)
		Annual cash flow			Components of income[b]	
Year	Net investment at beginning of year	Total from col. 7 of the table in para. 840-30-55-52	Allocated to investment	Allocated to income[a]	Pretax income	Tax effect of pretax income
8	$ (16,245)	$ (11,108)	$ (11,108)	$ –	$ –	$ –
9	(5,137)	(12,803)	(12,803)	–	–	–
10	7,666	(14,649)	(14,973)	324	5,530	(5,206)
11	22,639	(16,663)	(17,621)	958	16,353	(15,395)
12	40,260	(18,857)	(20,561)	1,704	29,087	(27,383)
13	60,821	(21,248)	(23,822)	2,574	43,937	(41,363)
14	84,643	(23,856)	(27,439)	3,583	61,160	(57,577)
15	112,082	(26,698)	(31,443)	4,745	80,995	(76,250)
16	143,525	149,600	143,525	6,075	103,698	(97,623)
Totals		$ 3,718	$ (16,245)	$ 19,963	$ 340,760	$ (320,797)

a Lease income is recognized as 4.233% of the unrecovered investment at the beginning of each year in which the net investment is positive. The rate is that rate which, if applied to the net investment in the years in which the net investment is positive, will distribute the net income (net cash flow) to those years.

b Each component is allocated among the years of positive net investment in proportion to the allocation of net income in column 4. Journal Entry 2 in paragraph 840-30-55-56 includes an example of this computation.

840-30-55-55

Illustrative journal entry for recording allocation of purchase price to net investment in the leveraged lease follows.

Rentals receivable (table in paragraph 840-30-55-52, total of column 1 minus residual value, minus totals of columns 3 and 6)	$ 124,515	
Estimated residual value (paragraph 840-30-55-51)	200,000	
Purchase price allocation clearing account (paragraph 840-30-55-53, present value)	16,245	
Unearned and deferred income (paragraph 840-30-55-53, present value, minus total of rentals receivable and estimated residual value)		$ 340,760

840-30-55-56

Illustrative journal entries for year ending December 31, 19Y4 follows.

Third year of operation after the business combination (Year 10 of the lease)

Journal Entry 1

Cash	$ 15,565	
Rentals receivable (table in paragraph 840-30-55-52, column 1 minus columns 3 and 6)		$ 15,565
Collection of year's net rental		

Journal Entry 2		
Unearned and deferred income	$ 5,530	
Income from leveraged leases (table in paragraph 840-30-55-54, column 5)		$ 5,530
Recognition of pretax income for the year allocated in the same proportion as the allocation of total income, [computed as follows: ($324 ÷ $19,963 × $340,760 = $5,530)]		
Journal Entry 3		
Deferred taxes (table in paragraph 840-30-55-52, column 5, minus table in paragraph 840-30-55-54, column 6)	$ 25,008	
Income tax expense (table in paragraph 840-30-55-54, column 6)	5,206	
Cash (table in paragraph 840-30-55-52, column 5)		$ 30,214
To record payment of tax for the year		

4.4.4.3.8 Sale-leaseback transactions of the acquiree

A sale-leaseback transaction involves the sale of an asset by an entity (the seller-lessee) to another entity (the buyer-lessor) and the leaseback of the same asset by the seller-lessee (see sections 8 and 9 in our FRD, ***Lease accounting: Accounting Standards Codification 840,* Leases**, for additional guidance on sale-leasebacks not involving and involving real estate). In cases where the transfer of a real estate asset is not a sale (i.e., failed sale-leaseback), the seller-lessee accounts for the transaction as a financing transaction. The seller-lessee retains the real estate subject to the sale-leaseback transaction on its balance sheet and accounts for amounts received as a financing or uses the deposit method in accordance with other US GAAP. See section 9 of our FRD, ***Lease accounting: Accounting Standards Codification 840,* Leases**, for further guidance on subsequent accounting. If the seller-lessee is subsequently acquired in a business combination, we believe the business combination alone is not a triggering event to reevaluate whether the accounting for the transaction is now a sale-leaseback transaction. Rather, the acquirer should carry forward the acquiree's accounting as a failed-sale leaseback transaction and continue to follow ASC 840's sale-leaseback guidance to determine if and when a sale of the real estate may occur.

4.4.4.4 Leases (after the adoption of ASC 842)

A lease agreement conveys the right to use an identified asset (i.e., property, plant or equipment) for a period of time in exchange for consideration. Under a lease, the party obtaining the right to use the leased property is referred to as a lessee and the party conveying the right to use the property is referred to as a lessor. Accounting guidance for lease arrangements for both lessees and lessors under US GAAP is primarily contained in ASC 842 (after the adoption of ASC 842) and is applicable to all entities (see ASC 842-10-15 and our FRD, ***Lease accounting: Accounting Standards Codification 842,* Leases**, for additional guidance on evaluating whether an arrangement is or contains a lease).

In February 2016, the FASB issued a new leases standard (ASU 2016-02). ASU 2016-02 will supersede ASC 840 on the accounting for leases. ASU 2016-02 amends the guidance in ASC 805 and changes the accounting for acquired leases in a business combination. The new guidance requires the acquirer to recognize and measure certain lease-related assets and lease liabilities in accordance with ASC 842 when the acquirer is a lessee or lessor, whereas before the adoption of ASU 2016-02 all lease-related assets and lease liabilities are recognized and measured at fair value in accordance with ASC 805.

ASU 2016-02 is currently effective for PBEs and both of the following:

- Not-for-profit (NFP) entities that have issued or are conduit bond obligors for securities that are traded, listed or quoted on an exchange or an over-the-counter market (public NFPs)
- Employee benefit plans that file or furnish financial statements with or to the SEC

In June 2020, the FASB issued ASU 2020-05 to defer the effective date of the new leases standard by one year for private companies, private NFPs and certain public NFPs.

Private companies and private NFP entities are now required to adopt the new leases standard for annual reporting periods beginning after 15 December 2021 and interim reporting periods in annual reporting periods beginning after 15 December 2022.

Public NFPs that had not issued (or made available for issuance) financial statements that reflected adoption of the new standard as of 3 June 2020 (e.g., a 31 March year-end public NFP that had not issued its year-end financial statements for 2019 as of 3 June 2020) were required to adopt the standard for annual reporting periods beginning after 15 December 2019 and interim reporting periods within those annual reporting periods.

Early adoption, including adoption in an interim period, is permitted.

4.4.4.4.1 Classification of acquired leases

Excerpt from Accounting Standards Codification

Pending Content:

Transition Date: *(P) December 16, 2018; (N) December 16, 2021* | **Transition Guidance:** 842-10-65-1

Implementation Guidance and Illustrations

Lease of an Acquiree

842-10-55-11

In a **business combination** or an **acquisition by a not-for-profit entity**, the acquiring entity should retain the previous **lease** classification in accordance with this Subtopic unless there is a **lease modification** and that modification is not accounted for as a separate **contract** in accordance with paragraph 842-10-25-8.

Under ASC 842, the acquiring entity in a business combination (or acquisition by a not-for-profit entity) does not change the acquiree's existing lease classification unless the lease is modified and the modification is not accounted for as a separate contract. Refer to section 4.6, *Lease modifications*, and section 5.6, *Lease modifications*, of our FRD, ***Lease accounting: Accounting Standards Codification 842,* Leases**, for a discussion of lessee and lessor modifications, respectively. If a lease is modified, and the modified lease is accounted for as a separate contract, the acquirer classifies the new lease based on ASC 842's lease classification guidance.

If a lease is modified in connection with the business combination and is not accounted for as a separate contract, the acquirer remeasures and reallocates the remaining consideration in the contract and reassesses the lease classification using the modified terms and conditions and facts and circumstances as of the effective date of the lease modification as discussed in section 4.6.3, *Lessee accounting for a modification that is not accounted for a separate contract*, and section 5.6.3, *Lessor accounting for a modification that is not accounted for a separate contract*, for lessees and lessors, respectively, of our FRD, ***Lease accounting: Accounting Standards Codification 842,* Leases**. After determining the classification of the modified lease, the acquirer accounts for the modified lease in accordance with the guidance in ASC 805 discussed in the remainder of this section.

An unmodified lease is accounted for in accordance with the guidance in the remainder of this section. If the only change in a lease as a result of the business combination is a change in the identity of the parties, the change would not represent a lease modification because there is no change to the terms and conditions of the contract that results in a change in the scope of or consideration for the lease. As such, the classification of the lease does not change.

The provisions of ASC 842-10-55-11 apply to both lessees and lessors in a business combination. The accounting for a lease in an asset acquisition is discussed in sections A.3.1.3 and A.3.1.3.1.

4.4.4.4.2 Recognition and measurement of acquired leases

Excerpt from Accounting Standards Codification

Pending Content:

Transition Date: *(P) December 16, 2018; (N) December 16, 2021* | **Transition Guidance:** 842-10-65-1

Business combinations — Identifiable Assets and Liabilities, and Any Noncontrolling Interest

Recognition

805-20-25-10A

An identifiable intangible asset may be associated with a **lease**, which may be evidenced by market participants' willingness to pay a price for the lease even if it is at market terms. For example, a lease of gates at an airport or of retail space in a prime shopping area might provide entry into a market or other future economic benefits that qualify as identifiable intangible assets, such as a customer relationship. In that situation, the acquirer shall recognize the associated identifiable intangible asset(s) in accordance with paragraph 805-20-25-10.

805-20-25-11

The acquirer shall recognize assets or liabilities related to an **operating lease** in which the acquiree is the **lessee** as required by paragraphs 805-20-25-10A and 805-20-25-28A.

805-20-25-12

Regardless of whether the acquiree is the lessee or the **lessor**, the acquirer shall determine whether the terms of each of an acquiree's operating leases are favorable or unfavorable compared with the market terms of leases of the same or similar items at the acquisition date. If the acquiree is a lessor, the acquirer shall recognize an intangible asset if the terms of an operating lease are favorable relative to market terms and a liability if the terms are unfavorable relative to market terms. If the acquiree is a lessee, the acquirer shall adjust the measurement of the acquired **right-of-use asset** for any favorable or unfavorable terms in accordance with paragraph 805-20-30-24.

805-20-25-28A

The acquirer shall recognize assets and liabilities arising from leases of an acquiree in accordance with Topic 842 on leases (taking into account the requirements in paragraph 805-20-25-8(a)).

805-20-25-28B

For leases for which the acquiree is a lessee, the acquirer may elect, as an accounting policy election by class of underlying asset and applicable to all of the entity's acquisitions, not to recognize assets or liabilities at the acquisition date for leases that, at the acquisition date, have a remaining lease term of 12 months or less. This includes not recognizing an intangible asset if the terms of an operating lease are favorable relative to market terms or a liability if the terms are unfavorable relative to market terms.

The acquirer separately recognizes identifiable intangible assets associated with the inherent value of the lease (i.e., the price market participants are willing to pay for an at-market lease). The inherent value may relate to the economic benefit of acquiring an asset with an in-place lease versus one that is not leased. Refer to section 4.4.4.4.3 for considerations for valuing in-place leases. An intangible asset is identifiable if it meets either the separability criterion or the contractual-legal criterion as described further in section 4.2.5.

As discussed in section 3.4.2, ASC 805 requires all assets acquired, liabilities assumed and any noncontrolling interests to be recognized and measured at fair value on the acquisition date, with limited exceptions. Certain lease-related assets and liabilities are an exception to the general recognition and measurement principles under ASC 805. Instead, the acquirer in a business combination applies ASC 842's initial recognition and measurement provisions to recognize those lease-related assets and lease liabilities when the acquiree is a lessee or a lessor.

The following table summarizes the items in an acquired lease that typically give rise to an asset or liability in a business combination.

	Lease classification	Asset	Liability	Section reference
Acquiree is a lessee	Finance or operating lease	▸ Right-of-use asset** ▸ Leasehold improvements* ▸ In-place lease value*	▸ Lease liability**	4.4.4.4.2.1
Acquiree is a lessor	Sales-type or direct finance lease	▸ Net investment in lease which is the sum of lease receivable and unguaranteed residual asset** ▸ In-place lease value* ▸ Customer relationship intangible asset*	▸ Not applicable	4.4.4.4.2.2
Acquiree is a lessor	Operating lease	▸ Favorable lease terms relative to market* ▸ Leased asset (including lessor-owned tenant improvements)* ▸ In-place lease value* ▸ Customer relationship intangible asset*	▸ Unfavorable lease terms relative to market*	4.4.4.4.2.3

* Recognized and measured at fair value in accordance with the general principles of ASC 805

** Recognized and measured in accordance with ASC 842

Leases with a remaining lease term of 12 months or less

If the acquiree is a lessee, the acquirer can elect to apply the same accounting policy election by class of underlying asset for all business combinations to not recognize assets and liabilities for leases that at the acquisition date have a remaining lease term of 12 months or less. ASC 805-20-25-28B states that such an election includes not recognizing an intangible asset if the terms of an operating lease are favorable relative to market terms or a liability if the terms are unfavorable relative to market terms.

4.4.4.4.2.1 *Acquiree in a business combination is a lessee in a finance or operating lease*

Excerpt from Accounting Standards Codification

Pending Content:

Transition Date: *(P) December 16, 2018; (N) December 16, 2021* | **Transition Guidance:** 842-10-65-1

Business combinations — Identifiable Assets and Liabilities, and Any Noncontrolling Interest

Initial Measurement

805-20-30-24

For **leases** in which the acquiree is a **lessee**, the acquirer shall measure the **lease liability** at the present value of the remaining **lease payments**, as if the acquired lease were a new lease of the acquirer at the acquisition date. The acquirer shall measure the **right-of-use asset** at the same amount as the lease liability as adjusted to reflect favorable or unfavorable terms of the lease when compared with market terms.

Subsequent Measurement

805-20-35-6

Leasehold improvements acquired in a business combination shall be amortized over the shorter of the useful life of the assets and the remaining **lease term** at the date of acquisition. However, if the lease transfers ownership of the underlying asset to the lessee, or the lessee is reasonably certain to exercise an option to purchase the underlying asset, the lessee shall amortize the leasehold improvements to the end of their useful life.

When the acquiree in a business combination is a lessee, the acquirer initially measures the lease liability and right-of-use asset for acquired finance and operating leases as if the leases are new at the acquisition date. That is, ASC 805's governing principle to recognize assets and liabilities at fair value is not applied to these assets and liabilities. As a reminder, in a business combination or acquisition by a not-for-profit, the acquiring entity does not change the acquiree's existing lease classification unless the lease is modified and the modified lease is not accounted for as a separate contract as discussed in section 4.4.4.4.1. The FASB indicated in paragraph BC415 of the Basis for Conclusions that measuring the acquired lease as if it were a new lease includes assessing the following:

- The lease term
- Any lessee options to purchase the underlying asset
- Lease payments
- The discount rate for the lease

The lease liability is initially measured at the present value of the remaining lease payments using the concepts described in section 2 of our FRD, ***Lease accounting: Accounting Standards Codification 842, Leases***, to determine the lease term, lease payments and discount rate as of the acquisition date. The right-of-use asset is initially measured at an amount equal to the lease liability, adjusted for favorable or unfavorable terms of the lease (including favorable and unfavorable purchase or renewal options) when compared with market terms. Therefore, the acquirer does not separately recognize an intangible asset or liability for favorable or unfavorable lease terms relative to market terms.

As a result, an acquirer does not separately recognize any prepaid or accrued rent previously recognized by the acquired entity for the lease payments that are uneven throughout the lease term because the acquiree's prepaid or accrued rent does not meet the definition of an asset or liability. Instead, an acquirer would consider the effect of the acquiree's prepaid or accrued rent on its measurement of the right-of-use asset.

An acquirer separately recognizes, at fair value, any other identifiable intangible assets associated with the lease, which may be evidenced by market participants' willingness to pay for the lease even if it is at market terms. For example, ASC 805-20-25-10A indicates that a lease of gates at an airport or a lease of retail space in a prime shopping area might provide entry into a market or other future economic benefits that qualify as an identifiable intangible asset. An intangible asset is identifiable if it meets either the separability criterion or the contractual-legal criterion as described further in section 4.2.5.

The subsequent measurement of an acquired lease liability and right-of-use asset is determined using the lessee subsequent measurement guidance under ASC 842. Refer to section 4 of our FRD, ***Lease accounting: Accounting Standards Codification 842,*** **Leases**.

The acquirer also recognizes leasehold improvements acquired in a business combination at fair value in accordance with ASC 805 and amortizes the assets over the shorter of the useful life of the assets or the remaining lease term at the date of acquisition. However, if the lease transfers ownership of the underlying asset to the lessee, or the lessee is reasonably certain to exercise an option to purchase the underlying asset, the lessee amortizes the leasehold improvements to the end of their useful life.

4.4.4.4.2.2 *Acquiree in a business combination is a lessor in a sales-type or direct financing lease*

Excerpt from Accounting Standards Codification

Pending Content:

Transition Date: *(P) December 16, 2018; (N) December 16, 2021* | **Transition Guidance:** 842-10-65-1

Business combinations — Identifiable Assets and Liabilities, and Any Noncontrolling Interest

Initial Measurement

805-20-30-25

For leases in which the acquiree is a lessor of a **sales-type lease** or a **direct financing lease**, the acquirer shall measure its **net investment in the lease** as the sum of both of the following (which will equal the fair value of the **underlying asset** at the acquisition date):

a. The **lease receivable** at the present value, discounted using the rate implicit in the lease, of the following, as if the acquired lease were a new lease at the acquisition date:

   1. The remaining lease payments

   2. The amount the lessor expects to derive from the underlying asset following the end of the lease term that is guaranteed by the lessee or any other third party unrelated to the lessor.

b. The **unguaranteed residual asset** as the difference between the fair value of the underlying asset at the acquisition date and the carrying amount of the lease receivable, as determined in accordance with (a), at that date.

The acquirer shall take into account the terms and conditions of the lease in calculating the acquisition-date fair value of an underlying asset that is subject to a sales-type lease or a direct financing lease by the acquiree-lessor.

When the acquiree in a business combination is a lessor in a sales-type or direct financing lease, the acquirer recognizes and measures the net investment in the lease, which includes the lease receivable and the unguaranteed residual asset at the acquisition date. As a reminder, in a business combination or acquisition by a not-for-profit entity, the acquiring entity does not change the acquiree's existing lease classification unless the lease is modified and the modified lease is not accounted for as a separate contract as discussed in section 4.4.4.4.1.

The lease receivable is measured assuming the lease is a new lease at the acquisition date. This includes assessing the lease term, any lessee options to purchase the underlying asset, lease payments and the discount rate for the lease. The acquirer measures the lease receivable at the present value of the remaining lease payments and any guaranteed residual asset, using the concepts described in section 2 of our FRD, ***Lease accounting: Accounting Standards Codification 842,*** **Leases**, to determine the lease term, lease payments and rate implicit in the lease.

The unguaranteed residual asset is initially measured as the difference between the acquisition-date fair value of the underlying asset and the lease receivable (as determined above) on the acquisition date. The acquirer takes into consideration the terms and conditions of the lease (e.g., off-market terms, purchase options, renewal options, termination penalties, residual value guarantees) when calculating the acquisition-date fair value of the underlying asset. Consequently, any lease terms that are favorable or unfavorable relative to market terms result in adjustments to the measurement of the acquisition-date fair value of the underlying asset that is used to measure the unguaranteed residual asset. Further, an acquirer does not separately recognize an intangible asset for off-market terms for sales-type or direct financing leases of a lessor.

However, an acquirer does separately recognize identifiable intangible assets associated with the inherent value of the lease (i.e., the price market participants are willing to pay for an at-market lease). The inherent value may relate to the economic benefit of acquiring an asset with an in-place lease versus one that is not leased. Refer to section 4.4.4.4.3 for considerations for valuing in-place leases.

The subsequent measurement of the net investment in a sales-type or direct financing lease is determined using the lessor subsequent measurement guidance under ASC 842. Refer to section 5 of our FRD, ***Lease accounting: Accounting Standards Codification 842,*** **Leases**.

4.4.4.4.2.3 Acquiree in a business combination is a lessor in an operating lease

Underlying assets subject to operating leases remain on the lessor's balance sheet. Therefore, when an acquiree is a lessor, an underlying asset subject to an operating lease is recognized on the acquirer's balance sheet and initially measured at its acquisition-date fair value in accordance with ASC 805. The subsequent measurement of the underlying asset subject to an operating lease is determined under ASC 360.

The acquirer separately recognizes an intangible asset if the terms of an operating lease are favorable compared with market terms and a liability if the terms are unfavorable compared with market terms. The acquirer also separately recognizes any identifiable intangible assets, such as an identifiable intangible asset associated with the inherent value of the lease (i.e., the price market participants are willing to pay for an at-market lease) or a customer-related intangible asset for its contractual relationship with any lessees.

The intangible asset or liability (e.g., favorable/unfavorable lease terms relative to market) that is recognized as part of the business combination is generally amortized to rental income over the term of the lease so that level rental income is recorded over the lease term. An asset recognized for the inherent value of a lease typically also is amortized over the term of the lease.

After the business combination, the acquirer follows the accounting for any operating lease as described in section 5.4 of our FRD, ***Lease accounting: Accounting Standards Codification 842,*** **Leases**.

4.4.4.4.3 Considerations for valuing in-place leases

When assets are acquired with in-place leases, some lease contracts may have value for reasons other than terms that are favorable relative to market prices.

In valuing in-place leases, various methods may be used to determine the fair value of the lease. These include the income method, the cost method and the market method. However, when valuing in-place leases, the following components should be considered in the valuation.

- **Direct costs associated with obtaining a new lessee** — The value of an in-place lease would include the direct costs that are avoided by acquiring the lease instead of originating the lease. For example, these costs could include commissions, tenant improvements and other direct costs associated with obtaining a new lessee.
- **Opportunity costs associated with lost rentals** — In general, obtaining a new lessee will take some period of time, and during that period of time the asset owner may not be receiving lease payments. This period, often referred to as the absorption period, represents an opportunity cost to the owner that is avoided if the asset is acquired with an in-place lease.

Consideration also should be given as to whether the lease arrangements create a customer relationship asset under ASC 805. Examples of customer relationship assets might include the value, as a result of a current lease arrangement, associated with the expected renewal of the lease or the increased likelihood of obtaining the lessee as a lessee for other locations owned by the lessor.

In-place leases acquired with an asset (e.g., tenant leases associated with an acquired building) would also meet the recognition criteria under ASC 805; therefore, they must be recognized apart from the acquired asset. As the useful life of an in-place lease is normally shorter than the remaining life of the underlying asset, separate recognition and amortization will affect the net earnings of the acquiring entity.

4.4.4.4.4 Acquired leasehold improvement

Excerpt from Accounting Standards Codification

Pending Content:

Transition Date: *(P) December 16, 2018; (N) December 16, 2021* | **Transition Guidance:** 842-10-65-1

Leases — Lessee

Subsequent Measurement

842-20-35-13

Leasehold improvements acquired in a **business combination** or an **acquisition by a not-for-profit entity** shall be amortized over the shorter of the useful life of the assets and the remaining lease term at the date of acquisition.

Business Combinations — Identifiable Assets and Liabilities, and Any Noncontrolling Interest

Subsequent Measurement

805-20-35-6

Leasehold improvements acquired in a business combination shall be amortized over the shorter of the useful life of the assets and the remaining **lease term** at the date of acquisition. However, if the lease transfers ownership of the underlying asset to the lessee, or the lessee is reasonably certain to exercise an option to purchase the underlying asset, the lessee shall amortize the leasehold improvements to the end of their useful life.

A leasehold improvement acquired in a business combination should be amortized over the shorter of the useful life or the lease term (determined at the date the business combination is recorded) that includes renewals that are reasonably certain to be exercised. However, if the lease transfers ownership of the underlying asset to the lessee, or the lessee is reasonably certain to exercise an option to purchase the underlying asset, the lessee will amortize the leasehold improvements to the end of their useful life.

4.4.4.4.5 *Lease of property from a third party entered into as part of a business combination*

In certain business combinations, a third party unrelated to the acquiree or acquirer is inserted into the transaction to acquire certain assets of the business directly from the acquiree that will in turn be leased by the third party to the acquirer of the business. The question has arisen as to whether such transactions should be accounted for as the acquisition, sale and leaseback of the assets or simply as a lease transaction by the acquirer. In our view, although the transaction may in form be a lease of assets, it is in substance a sale-leaseback and should be accounted for as such by both the acquirer-lessee and the third-party buyer-lessor if the assets to be leased are acquired by the third party in contemplation of, or contingent upon, the acquisition of a business by the acquirer-lessee. See section 4.4.4.4.7 for further guidance.

4.4.4.4.6 *Leveraged lease acquired in a business combination or an acquisition by a not-for-profit entity*

Excerpt from Accounting Standards Codification

Pending Content:

Transition Date: *(P) December 16, 2018; (N) December 16, 2021* | **Transition Guidance:** 842-10-65-1

Leases—Leveraged Lease Arrangements

Recognition

842-50-25-2

In a business combination or an **acquisition by a not-for-profit entity**, the acquiring entity shall retain the classification of the acquired entity's investment as a **lessor** in a **leveraged lease** at the date of the combination. The net investment of the acquired leveraged lease shall be disaggregated into its component parts, namely net rentals receivable, **estimated residual value**, and unearned income including discount to adjust other components to present value.

Initial Measurement

842-50-30-2

In a business combination or an **acquisition by a not-for-profit entity**, the acquiring entity shall assign an amount to the acquired net investment in the **leveraged lease** in accordance with the general guidance in Topic 805 on business combinations, based on the remaining future cash flows and giving appropriate recognition to the estimated future tax effects of those cash flows.

Subsequent Measurement

842-50-35-1

In a business combination or an **acquisition by a not-for-profit entity**, the acquiring entity shall subsequently account for its acquired investment as a **lessor** in a **leveraged lease** in accordance with the guidance in this Subtopic as it would for any other leveraged lease.

ASU 2016-02 eliminates leveraged lease accounting for new leases on its effective date. That is, after the effective date, lessors account for all new leases, including those that would have qualified as leveraged leases under ASC 840, using the classification guidance in ASC 842.

A leveraged lease acquired after the effective date in a business combination or an acquisition by a not-for-profit entity, that existed and was classified as a leveraged lease before the effective date, is grandfathered, and the acquirer continues to follow the recognition, measurement, presentation and disclosure guidance for leveraged leases that was carried forward to ASC 842-50. If the acquired leveraged lease is modified by the acquirer on or after the effective date of the new guidance, the acquired leveraged lease would be reclassified using the lease classification guidance in ASC 842. Refer to sections 3.2 and 11.4.5 of our FRD, *Lease accounting: Accounting Standards Codification 842,* Leases.

If the only change in a leveraged lease as a result of the business combination is a change in the identity of the lessor (i.e., change from the name of the acquiree to the name of the acquirer), the change would not represent a lease modification because there is no change to the terms and conditions of a contract that results in a change in the scope of or consideration for the lease. As such, the classification of the leveraged lease would not change.

If the acquiree in a business combination or an acquisition by a not-for-profit entity is a lessor in a leveraged lease that was classified and accounted for under ASC 840 prior to the effective date of ASC 842, and the business combination occurred after the acquirer's effective date of ASC 842, the general guidance of ASC 805 also must be applied in assigning amounts to the net investment in the leveraged lease. The acquirer measures the net investment based on the remaining net future cash flows and gives appropriate recognition to the estimated future tax effects of such cash flows. The net investment is then broken down into its component parts (net rentals receivable, estimated residual value and unearned income, including the discount to adjust the other components to present value) which are recognized in purchase accounting. Subsequent to the acquisition, the investment in the leveraged lease is accounted for by the acquirer in accordance with ASC 842-50 (refer to section 10 of our FRD, ***Lease accounting: Accounting Standards Codification 842,* Leases**, for further discussion on accounting for leveraged leases).

A detailed illustration of the accounting for a leveraged lease acquired in a business combination or an acquisition by a not-for-profit entity, including one way that a lessor's investment in a leveraged lease may be valued by the acquiring entity, follows:

Excerpt from Accounting Standards Codification

Pending Content:

Transition Date: *(P) December 16, 2018; (N) December 16, 2021* | **Transition Guidance:** 842-10-65-1

Leases—Leveraged Lease Arrangements

Implementation Guidance and Illustrations

842-50-55-27

This Example illustrates one way that a lessor's investment in a leveraged lease might be valued by the acquiring entity in a business combination or an acquisition by a not-for-profit entity and the subsequent accounting for the investment in accordance with the guidance in this Subtopic. The elements of accounting and reporting illustrated for this Example are as follows:

a. Acquiring entity's cash flow analysis by years (see paragraph 842-50-55-29)

b. Acquiring entity's valuation of investment in the leveraged lease (see paragraph 842-50-55-30)

c. Acquiring entity's allocation of annual cash flow to investment and income (see paragraph 842-50-55-31)

d. Journal entry for recording allocation of purchase price to net investment in the leveraged lease (see paragraph 842-50-55-32)

e. Journal entries for the year ending December 31, 1984 (Year 10 of the lease) (see paragraph 842-50-55-33).

842-50-55-28

This Example has the following terms and assumptions.

Cost of leased asset (equipment)	$1,000,000
Lease term	15 years, dating from January 1, 1975
Lease rental payments	$90,000 per year (payable last day of each year)
Residual value	$200,000 estimated to be realized 1 year after lease termination
Financing:	
Equity investment by lessor	$400,000
Long-term non-recourse debt	$600,000, bearing interest at 9% and repayable in annual installments (on last day of each year) of $74,435.30
Depreciation allowable to lessor for income tax purposes	7-year asset depreciation range life using double-declining-balance method for the first 2 years (with the half-year convention election applied in the first year) and sum-of-years digits method for remaining life, depreciated to $100,000 salvage value
Lessor's income tax rate (federal and state)	50.4% (assumed to continue in existence throughout the term of the lease)
Investment tax credit	10% of equipment cost or $100,000 (realized by the lessor on last day of first year of lease)
Initial direct costs	For simplicity, initial direct costs have not been included in the illustration
Date of business combination	January 1, 1982
Tax status of business combination	Non-taxable transaction
Appropriate interest rate for valuing net-of-tax return on investment	4 ½%

842-50-55-29

Acquiring entity's cash flow analysis by years follows.

Year	(1) Gross Lease Rentals and Residual Value	(2) Depreciation (for Income Tax Purposes)	(3) Loan Interest Payments	(4) Taxable Income (Col. 1-2-3)	(5) Income Tax (Charges) (Col. 4 x 50.4%)	(6) Loan Principal Payments	(7) Annual Cash Flow (Col. 1-3+5-6)
8	$ 90,000	$ –	$ 37,079	$ 52,921	$ (26,672)	$ 37,357	$ (11,108)
9	90,000	–	33,717	56,283	(28,367)	40,719	(12,803)
10	90,000	–	30,052	59,948	(30,214)	44,383	(14,649)
11	90,000	–	26,058	63,942	(32,227)	48,378	(16,663)
12	90,000	–	21,704	68,296	(34,421)	52,732	(18,857)
13	90,000	–	16,957	73,043	(36,813)	57,478	(21,248)
14	90,000	–	11,785	78,215	(39,420)	62,651	(23,856)
15	90,000	–	6,145	83,855	(42,263)	68,290	(26,698)
16	200,000	100,000	–	100,000	(50,400)	–	149,600
Total	$ 920,000	$ 100,000	$ 183,497	$ 636,503	$ (320,797)	$ 411,988	$ 3,718

842-50-55-30

Acquiring entity's valuation of investment in the leveraged lease follows.

Cash Flow	Present Value at 4 ½% Net-of-Tax Rate
1. Rentals receivable (net of principal and interest on the nonrecourse debt) ($15,564.70 at the end of each year for 8 years)	$ 102,663
2. Estimated residual value ($200,000 realizable at the end of 9 years)	134,581
3. Future tax payments (various amounts payable over 9 years — see the table in paragraph 842-50-55-29)	(253,489)
Net present value	$ (16,245)

842-50-55-31

Acquiring entity's allocation of annual cash flow to investment and income follows (see footnote (a)).

	1	2	3	4	5	6
			Annual Cash Flow		Components of Income[b]	
Year	Net Investment at Beginning of Year	Total from Col. 7 of the Table in Paragraph 842-50-55-29	Allocated to Investment	Allocated to Income[a]	Pretax Income	Tax Effect of Pretax Income
8	$ (16,245)	$ (11,108)	$ (11,108)	$ –	$ –	$ –
9	(5,137)	(12,803)	(12,803)	–	–	–
10	7,666	(14,649)	(14,973)	324	5,530	(5,206)
11	22,639	(16,663)	(17,621)	958	16,353	(15,395)
12	40,260	(18,857)	(20,561)	1,704	29,087	(27,383)
13	60,821	(21,248)	(23,822)	2,574	43,937	(41,363)
14	84,643	(23,856)	(27,439)	3,583	61,160	(57,577)
15	112,082	(26,698)	(31,443)	4,745	80,995	(76,250)
16	143,525	149,600	143,525	6,075	103,698	(97,623)
Totals		$ 3,718	$ (16,245)	$ 19,963	$ 340,760	$ (320,797)

(a) Lease income is recognized as 4.233% of the unrecovered investment at the beginning of each year in which the net investment is positive. The rate is that rate which, if applied to the net investment in the years in which the net investment is positive, will distribute the net income (net cash flow) to those years.

(b) Each component is allocated among the years of positive net investment in proportion to the allocation of net income in column 4. Journal Entry 2 in paragraph 842-50-55-33 includes an example of this computation.

842-50-55-32

Illustrative journal entry for recording allocation of purchase price to net investment in the leveraged lease follows.

Rentals receivable (table in paragraph 842-50-55-29, total of column 1 minus residual value, minus totals of columns 3 and 6)	$ 124,515	
Estimated residual value (paragraph 842-50-55-28)	200,000	
Purchase price allocation clearing account (paragraph 842-50-55-30, present value)	16,245	
Unearned and deferred income (paragraph 842-50-55-30, present value, minus total of rentals receivable and estimated residual value)		$ 340,760

842-50-55-33

Illustrative journal entries for year ending December 31,19Y4 follows.

Third Year of Operation after the Business Combination
(Year 10 of the Lease)

Journal Entry 1		
Cash	$ 15,565	
Rentals receivable (table in paragraph 842-50-55-29, column 1 minus columns 3 and 6)		$ 15,565
Collection of year's net rental		
Journal Entry 2		
Unearned and deferred income	$ 5,530	
Income from leveraged leases (table in paragraph 842-50-55-31, column 5)		$ 5,530

Recognition of pretax income for the year allocated in the same proportion as the allocation of total income computed as follows:

([$324 ÷ $19,963] × $340,760 = $5,530)

Journal Entry 3		
Deferred taxes (table in paragraph 842-50-55-29, column 5, minus table in paragraph 842-50-55-31, column 6)	$ 25,008	
Income tax expense (table in paragraph 842-50-55-31, column 6)	5,206	
Cash (table in paragraph 842-50-55-29, column 5)		$ 30,214
To record payment of tax for the year		

4.4.4.4.7 Sale and leaseback transactions of the acquiree

A sale and leaseback transaction involves the sale of an asset by an entity (the seller-lessee) to another entity (the buyer-lessor) and the leaseback of the same asset by the seller-lessee. In cases where the transfer of an asset is not a sale (i.e., sale and leaseback), the seller-lessee and the buyer-lessor account for the transaction as a financing transaction. The seller-lessee retains the asset subject to the sale and leaseback transaction on its balance sheet and accounts for amounts received as a financial liability in accordance with other US GAAP. Similarly, the buyer-lessor does not recognize an asset and instead accounts for the amounts paid as a receivable in accordance with other US GAAP. See section 7 of our FRD, ***Lease accounting: Accounting Standards Codification 842,*** **Leases**, for further guidance on subsequent accounting. If the seller-lessee or buyer-lessor is subsequently acquired in a business combination, we believe the acquisition is not a triggering event to reevaluate whether the accounting for the transaction is now a sale and leaseback transaction. Rather, the acquirer should carry forward the acquiree's accounting as a failed sale and leaseback transaction and continue to follow ASC 842's sale and leaseback guidance to determine if and when a sale occurs.

4.4.4.5 Derivatives

Derivative contracts that are acquired or assumed in a business combination are recognized at fair value in the business combination based on the principles and requirements outlined in ASC 815. As noted in section 3.4.1.3, prior classifications or designations of derivative instruments are reconsidered in connection with their remeasurement in a business combination. To qualify for hedge accounting, the acquirer must designate those derivatives as hedges on or after the date of the business combination. The redesignation requirement extends to all acquired derivative contracts. For example, contracts that qualified for the normal purchases and sales exception or the short-cut method may no longer qualify for these exceptions on the date of the acquisition.

See our FRD, ***Derivatives and hedging***, for a discussion of hedging business combination transactions and the ongoing accounting for derivatives.

4.4.4.6 Employment contracts

Employment contracts, including collective bargaining agreements and those between individual employees and employers, generally meet the contractual-legal criterion and are recognized apart from goodwill as an intangible asset (or potentially as a liability). The value of acquired/assumed employment contracts should be evaluated the same as any other acquired lease or contract agreement; however, measurement of that value might be difficult and affected by the fact that many employees are "at-will" employees (even if subject to collective bargaining arrangements or individual employment contracts). The value of an employment contract should be considered separately from the value of noncompetition agreements, as discussed in section 4.2.5.3.1.1. However, we generally believe that a noncompetition agreement would not have significant value for continuing employees as the employee's decision on whether or not to compete is influenced by the terms of the existing employment agreement as well as many other factors. Further, as a matter of law noncompetition agreements may be unenforceable in certain jurisdictions.

As discussed in section 4.2.5.3.6, ASC 805 precludes recognition of an asset for an assembled workforce, effectively subsuming any assembled workforce value into goodwill. Accordingly, the concept of valuing employment contracts and assigning those values in business combination accounting does not extend to recognizing an intangible asset for an assembled workforce.

4.5 Preexisting relationships between parties to a business combination

Excerpt from Accounting Standards Codification

Business Combinations — Overall

Recognition

805-10-25-20

The acquirer and the acquiree may have a preexisting relationship or other arrangement before negotiations for the business combination began, or they may enter into an arrangement during the negotiations that is separate from the business combination. In either situation, the acquirer shall identify any amounts that are not part of what the acquirer and the acquiree (or its former **owners**) exchanged in the business combination, that is, amounts that are not part of the exchange for the acquiree. The acquirer shall recognize as part of applying the acquisition method only the consideration transferred for the acquiree and the assets acquired and liabilities assumed in the exchange for the acquiree. Separate transactions shall be accounted for in accordance with the relevant generally accepted accounting principles (GAAP).

As discussed in ASC 805-10-25-20 and 25-21, an acquirer must evaluate whether any arrangements entered into in connection with a business combination should be accounted for as part of the combination or outside of the business combination. As such, a business combination between parties that have a preexisting relationship is evaluated to determine if the settlement of a preexisting relationship exists. A business combination between two parties that have a preexisting relationship is a multiple-element transaction with one element being the business combination and the other element being the settlement of the preexisting relationship, as discussed in more depth in sections 4.5.1 through 4.5.4 below.

Excerpt from Accounting Standards Codification

Business Combinations — Overall

Implementation Guidance and Illustrations

805-10-55-20

The acquirer and acquiree may have a relationship that existed before they contemplated the business combination, referred to here as a preexisting relationship. A preexisting relationship between the acquirer and acquiree may be contractual (for example, vendor and customer or licensor and licensee) or noncontractual (for example, plaintiff and defendant).

805-10-55-21

If the business combination in effect settles a preexisting relationship, the acquirer recognizes a gain or loss, measured as follows:

a. For a preexisting noncontractual relationship, such as a lawsuit, fair value

b. For a preexisting contractual relationship, the lesser of the following:

   1. The amount by which the contract is favorable or unfavorable from the perspective of the acquirer when compared with pricing for current market transactions for the same or similar items. An unfavorable contract is a contract that is unfavorable in terms of current market terms. It is not necessarily a loss contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.

2. The amount of any stated settlement provisions in the contract available to the counterparty to whom the contract is unfavorable. If this amount is less than the amount in (b)(1), the difference is included as part of the business combination accounting.

As noted in paragraph ASC 805-10-55-21, the process for determining a settlement gain or loss when a preexisting relationship exists is different for contractual and noncontractual relationships. If the preexisting relationship was documented in a contract, it is considered a contractual relationship. Otherwise, the relationship is considered noncontractual.

4.5.1 Settlements of contractual relationships in a business combination

A settlement gain or loss is recognized by the acquirer in conjunction with the effective settlement of an executory contract in a business combination. The effective settlement gain or loss is measured at the lesser of (1) the amount by which the contract is favorable or unfavorable from the perspective of the acquirer when compared to pricing for current market transactions for the same or similar items or (2) the amount of any stated settlement provisions in the contract available to the counterparty to whom the contract is unfavorable. Note that an unfavorable contract is a contract that is unfavorable in terms of current market terms. As discussed in section 4.4.4.1, it is not necessarily a loss contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.

If a preexisting contract that is settled in connection with a business combination is otherwise cancelable without penalty, the stated settlement provision amount of that contract is zero and no settlement gain or loss would be recognized in connection with the business combination. However, if there are no stated settlement terms and the contract is not cancelable, a settlement gain or loss would be recognized based on the amount by which the contract is favorable or unfavorable to the acquirer (i.e., based on the settled contract's fair value on the date of acquisition).

Because a settlement gain or loss is recognized based on the amount of the stated settlement provision available to the counterparty to which the contract is unfavorable when that stated amount is less than the off-market component of the contract, the amount by which the off-market element of the settled contract exceeds the stated settlement provision effectively is ignored. Conceptually, the counterparty against which the contract is unfavorable could have made a unilateral decision to cancel the contract by invoking the settlement provision and then proceed with the business combination transaction based on an exchange determined without reference to the off-market contract that, by then, would not exist.

4.5.1.1 Examples of settlements of contractual relationships in a business combination

Excerpt from Accounting Standards Codification

Business Combinations — Overall

Implementation Guidance and Illustrations

Example 2: Effective Settlement of a Supply Contract as a Result of a Business Combination

805-10-55-30

This Example illustrates the guidance in paragraphs 805-10-55-20 through 55-21. Acquirer purchases electronic components from Target under a five-year supply contract at fixed rates. Currently, the fixed rates are higher than rates at which Acquirer could purchase similar electronic components from another supplier. The supply contract allows Acquirer to terminate the contract before the end of the initial 5-year term only by paying a $6 million penalty. With 3 years remaining under the supply contract, Acquirer pays $50 million to acquire Target, which is the fair value of Target based on what other market participants would be willing to pay.

805-10-55-31

Included in the total fair value of Target is $8 million related to the fair value of the supply contract with Acquirer. The $8 million represents a $3 million component that is at-market because the pricing is comparable to pricing for current market transactions for the same or similar items (selling effort, customer relationships, and so forth) and a $5 million component for pricing that is unfavorable to Acquirer because it exceeds the price of current market transactions for similar items. Target has no other **identifiable** assets or liabilities related to the supply contract, and Acquirer has not recognized any assets or liabilities related to the supply contract before the business combination.

805-10-55-32

In this Example, Acquirer recognizes a loss of $5 million (the lesser of the $6 million stated settlement amount and the amount by which the contract is unfavorable to the acquirer) separately from the business combination. The $3 million at-market component of the contract is part of goodwill.

Example 3: Effective Settlement of a Contract Between the Acquirer and Acquiree in Which the Acquirer Had Recognized a Liability Before the Business Combination

805-10-55-33

This Example illustrates the guidance in paragraphs 805-10-55-20 through 55-21. Whether Acquirer had previously recognized an amount in its financial statements related to a preexisting relationship will affect the amount recognized as a gain or loss for the effective settlement of the relationship. In Example 2 (see paragraph 805-10-55-30), generally accepted accounting principles (GAAP) might have required Acquirer to recognize a $6 million liability for the supply contract before the business combination. In that situation, Acquirer recognizes a $1 million settlement gain on the contract in earnings at the acquisition date (the $5 million measured loss on the contract less the $6 million loss previously recognized). In other words, Acquirer has in effect settled a recognized liability of $6 million for $5 million, resulting in a gain of $1 million.

In the examples above, because the supply contract is effectively settled as part of the business combination, it would not be appropriate for Acquirer to recognize a separate customer relationship intangible asset for the supply contract with Target (that is, Acquirer cannot have a customer relationship intangible asset with itself).

In addition to the examples included in ASC 805-10-55-30 through 55-33, the following example illustrates the measurement and recognition concepts of accounting for preexisting executory contract relationships between parties to a business combination:

Illustration 4-28: Settlement of a lease contract

Acquirer leases a building to Target under a five-year lease. Currently, market lease rates for similar leases are less than the contractual lease rate, resulting in a lease that is favorable to the Acquirer. The fair value of the off-market lease provisions is $2 million. The lease contract permits Target to terminate the lease for a payment of $3 million. Acquirer purchases Target for $25 million.

The gain on settlement of the executory contract is determined based on the lesser of (1) the $2 million amount by which the lease is favorable to Acquirer, or (2) the $3 million stated settlement provision amount available to the Target. Acquirer would recognize a $2 million gain on settlement of the lease and the consideration transferred in the business combination is $27 million.

4.5.1.2 Settlement provisions that are available only in the future

We believe that when a settlement provision is available, but not until a certain stated amount of time has passed, the amount of the stated settlement provision is determined by adding the off-market component for the period until the settlement provision is exercisable to the present value of the stated settlement amount and comparing that amount to the current off-market component of the entire contract. The lesser of those two amounts is used to recognize a gain or loss on settling the preexisting relationship.

Illustration 4-29: Settlement provisions that are available only in the future

Assume that Acquirer and Target enter an agreement under which Target markets Acquirer's telecommunication services to consumers. The agreement has a 50-year term and is cancelable by Target after 20 years if Target pays $40 to Acquirer. Acquirer buys Target for $500 five years after the inception of the telecommunication services marketing agreement (i.e., 45 years remain in the term of the marketing agreement). On the acquisition date:

- The fair value of the remaining 45 years of payment obligations under the marketing agreement is $140. Of that amount, $60 relates to the 15-year period between the acquisition date and the date at which Target can exercise its cancellation option and $80 relates to the 30-year period after the date that the cancellation option is exercisable.
- The fair value of the marketing agreement on the acquisition date, without considering payments due in the future, is $100. Of that amount, $30 relates to the 15-year period between the acquisition date and the date at which Target can exercise its cancellation option and $70 relates to the 30-year period after the date that the cancellation option is exercisable.
- The agreement is thus unfavorable to the Target by $40 [$140–$100].
- The present value of the cancellation option on the date of acquisition is $20.

On the acquisition date, Acquirer would recognize a $40 gain on the settlement of the marketing agreement. The gain is determined as the lesser of:

a. The amount by which the settled marketing contract is either favorable or unfavorable to the Acquirer. In this example the contract is favorable by $40, or

b. The settlement provision available to the party to which the agreement is unfavorable. In this example, the settlement provision is the sum of the off-market amount until the date the settlement provisions can be exercised plus the net value of the settlement provision [($60–$30) + $20 = $50].

Acquirer includes $540, which equals the sum of the consideration transferred plus the settlement gain, as the consideration transferred in the business combination. The settlement gain is added to the consideration transferred because had the settlement not occurred Acquirer would have had to pay $40 more for Target.

4.5.1.3 Settlements of preexisting relationships for which an acquirer had previously recognized assets or liabilities

Excerpt from Accounting Standards Codification

Business Combinations — Overall

Implementation Guidance and Illustrations

805-10-55-22

Examples 2 and 3 (see paragraphs 805-10-55-30 through 55-33) illustrate the accounting for the effective settlement of a preexisting relationship as a result of a business combination. As indicated in Example 3 (see paragraph 805-10-55-33), the amount of gain or loss recognized may depend in part on whether the acquirer had previously recognized a related asset or liability, and the reported gain or loss therefore may differ from the amount calculated by applying paragraph 805-10-55-21.

The amount recognized as a settlement gain or loss might differ from the amount measured in cases in which an acquirer had previously recognized an amount in its financial statements related to the preexisting relationship.

Illustration 4-30: Settlement of accounts receivable balance

Assume Company A has a $15 accounts receivable from Company B and Company B has a corresponding $15 accounts payable to Company A. Company A acquires all the outstanding stock of Company B for $100.

Analysis

As a result of the acquisition of Company B, the accounts receivable/accounts payable between Company A and Company B is effectively settled. As a result, Company A adjusts the consideration transferred by $15 for a total consideration of $115. Because the accounts receivable balance was settled at the recorded amount, there is no impact on Company A's income statement as a result of the settlement.

Illustration 4-31: Settlement of a supply contract

Assume Acquirer has a $9 liability relating to a supply contract with Target B. This liability was recognized when Acquirer purchased Target A in a business combination and assumed an unfavorable supply contract between Target A and Target B. Subsequently, Acquirer purchases Target B, the supplier to Target A. At the date of the acquisition of Target B, the supply contract is unfavorable to Acquirer by $10 and includes no settlement provisions. Assume that on the date the Acquirer acquires Target B the unfavorable supply contract liability has been adjusted to $8.

Analysis

As a result of the acquisition of Target B, Acquirer would recognize a $2 loss (the $10 unfavorable measurement of the supply contract on the date of the Target B acquisition less the $8 accrual previously recognized) in its statement of income and the consideration transferred to target B's shareholders would be reduced by the $10 effective settlement of the supply contract.

4.5.2 Settlement of debt

A business combination may result in the effective extinguishment of debt issued by the acquirer to the acquiree. If the debt is settled (extinguished) as a result of the business combination, the guidance in ASC 470 must be applied. That is, an extinguishment gain or loss could be recognized if the reacquisition price (fair value or stated settlement amount) differs from the net carrying amount of the debt.

If the debt is issued by the acquiree to the acquirer, the acquirer would be effectively settling a receivable and would apply the guidance in ASC 805-10-55-21.

Illustration 4-32: Settlement of debt

On 1 June 2009, Company A issues debt securities of $10 to Company B. On 1 June 2011, Company A acquires all of the outstanding stock of Company B for $100 and there is no other separate agreement to settle the debt. Assume that on the acquisition date, the carrying value and fair value of the debt recorded on Company A's books was $10 and $12, respectively.

Analysis

As a result of the acquisition of Company B, Company A would recognize a $2 loss associated with the extinguishment of the debt securities held by Company B. The $2 loss represents the amount by which the fair value of the debt exceeds the net carrying amount. The consideration transferred in this illustration would be $88, calculated as the purchase price of $100 less the fair value of the debt of $12.

4.5.3 Settlement of a noncontractual relationship (e.g., a lawsuit) in a business combination

A settlement gain or loss is recognized in conjunction with the effective settlement of a lawsuit (including threatened litigation) in a business combination, unless otherwise specified in existing authoritative literature. The amount recognized as a settlement gain or loss may differ from the amount (if any) the acquirer had previously recognized in its financial statements related to the preexisting relationship (e.g., when the acquirer had previously recognized a liability under ASC 450 related to the matters effectively settled by the acquirer's acquisition of target). The effective settlement of a lawsuit in a business combination is measured at fair value.

Illustration 4-33: Settlement of a noncontractual relationship (e.g., a lawsuit) in a business combination

Target is suing Acquirer for patent infringement. Acquirer has recognized a $60 million liability related to the lawsuit in accordance with the provisions of ASC 450. Acquirer pays $800 million to acquire Target. The fair value of Target includes a $100 million fair value associated with its lawsuit against Acquirer.

In a business combination, Acquirer would recognize a settlement loss of $40 million in connection with the effective settlement of the lawsuit with Target ($100 million fair value less the previously recognized liability of $60 million) and the remaining $700 million ($800 million of acquisition consideration less the $100 million fair value of the lawsuit) would be included as consideration transferred in the business combination.

4.5.4 Reacquired rights in a business combination

Excerpt from Accounting Standards Codification

Business Combinations — Overall

Implementation Guidance and Illustrations

805-10-55-23

A preexisting relationship may be a contract that the acquirer recognizes as a reacquired right in accordance with paragraph 805-20-25-14. If the contract includes terms that are favorable or unfavorable when compared with pricing for current market transactions for the same or similar items, the acquirer recognizes, separately from the business combination, a gain or loss for the effective settlement of the contract, measured in accordance with paragraph 805-10-55-21.

The acquisition of a right the acquirer had previously granted to the acquired entity to use the acquirer's recognized or unrecognized intangible assets (e.g., rights to the acquirer's trade name under a franchise agreement or rights to the acquirer's technology under a technology licensing agreement, hereinafter referred to as a "reacquired right") is included as part of the business combination. If the contract giving rise to the reacquired right includes terms that are favorable or unfavorable when compared to pricing (e.g., royalty rates) for current market transactions for the same or similar items, an entity recognizes, a settlement gain or loss measured as the lesser of (1) the amount by which the contract is favorable or unfavorable to market terms from the perspective of the acquirer or (2) the amount of any stated settlement provisions of the contract available to the counterparty to whom the contract is unfavorable.

This is the same measurement approach as described in section 4.5.1 for measuring settlement gains and losses relating to executory contracts. As noted in section 4.2.5.3.7, a reacquired right is recognized as an intangible asset apart from goodwill with an assigned amortizable life limited to the remaining contractual term (i.e., not including any renewal periods). Further, the value assigned to the reacquired right would exclude any amounts recognized as a settlement gain or loss and would be limited to the value associated with the remaining contractual term and current market terms. In certain circumstances, the acquirer may have recognized deferred revenue as of the acquisition date related to a right previously granted to

the acquiree under the terms of a pre-existing arrangement. In such circumstances, the settlement gain or loss related to the reacquired right is increased or decreased, respectively, by the amount of the deferred revenue.[45]

To account for a reacquired right in accordance with the guidance in ASC 805, a determination must be made that the overall transaction is, in fact, a business combination and not simply a cancellation or rescission of the contract under which the reacquired right was granted to the presumed acquiree. If the transaction is substantially determined to be a cancellation or rescission of a contract and not a business combination, the accounting is based on the principles discussed in ASC 606. See section 3.2, *Contract enforceability and termination clauses*, of our FRD, ***Revenue from contracts with customers (ASC 606)***, for guidance on how to account for a contract with a customer that includes a termination provision.

At the 2005 AICPA National Conference on Current SEC and PCAOB Developments, the SEC staff discussed issues relating to the valuation of reacquired rights when an acquirer reacquires rights previously granted to the acquiree (e.g., rights to a trade name pursuant to a franchise agreement or rights to technology under a licensing agreement). The SEC staff indicated that the fair value of reacquired rights should be estimated as if the registrant were purchasing a right that it previously did not own. Valuation of reacquired rights is difficult as the rights often are not transacted on a standalone basis after the initial sale. For example, assume that a restaurant franchisee develops a business using a trade name granted under a franchise agreement. Later, the franchisor acquires the franchisee's business, an operating restaurant. In these cases, the SEC staff recommended that registrants consider the drivers of value in the transaction. For example, even though a mature franchise right such as in the preceding example might intuitively seem to be worth more than a new franchise right, the SEC staff observed that the value of the restaurant business may be driven by other assets, such as customer relationship intangible assets related to catering contracts, appreciated real estate, and a strong workforce, which is a component of goodwill.

The following examples illustrate the measurement and recognition concepts for the acquisition of rights previously granted to an acquired entity by an acquirer to use the acquirer's recognized or unrecognized intangible assets:

Illustration 4-34: Reacquired rights in a business combination

Acquirer purchases the business of its fast food franchisee, Target. Acquirer pays $100 million to acquire Target. Assume that included in the fair value of Target is an intangible asset with a fair value of $40 million related to the exclusive rights previously granted to Target by Acquirer to use Acquirer's trade name in a specified territory. Assume that the fair value of Target's intangible exclusive rights asset includes a $10 million "off-market" component that relates to a below-market revenue-based royalty rate paid by Target to Acquirer that is therefore favorable to Target. Further, assume that the terms of the franchise agreement state that if Acquirer terminates the arrangement without cause, Acquirer would be required to pay a $15 million termination penalty to Target. Also assume, for simplicity, that Target has no other identifiable assets or liabilities related to the franchise agreement and that Acquirer has not recognized any assets or liabilities related to the franchise agreement.

Acquirer would recognize a settlement loss of $10 million, which is the lesser of (1) the amount by which the agreement is unfavorable from the perspective of Acquirer when compared to pricing for current market transactions for the same or similar items (i.e., the "the off-market" component) of $10 million, or (2) the stated settlement provisions in the agreement available to Acquirer (the counterparty to which the contract is unfavorable) of $15 million. The remaining fair value of the reacquired right ($30 million), which is limited to the fair value associated with the remaining contractual term assuming an at-market royalty rate, would be recognized as an intangible asset apart from goodwill and amortized over the remaining contractual term.

[45] An acquirer may use a different term to describe deferred revenue (e.g., contract liability), but the guidance on how that liability affects the settlement gain or loss related to the reacquired right remains the same.

Illustration 4-35: Reacquired rights in a business combination

Acquirer enters into a contract with Target, a customer, and promises to grant a franchise license that provides Target with the right to use Acquirer's trade name and sell Acquirer's products for five years. In exchange for granting the license, Acquirer receives a fixed fee of $500 at inception and a sales-based royalty of 5% of Target's sales during the term of the license. When applying ASC 606 to the contract, Acquirer concludes it granted a license to symbolic IP. Consequently, the license provides Target the right to access Acquirer's IP, and Acquirer's performance obligation to transfer the license is satisfied over time. Acquirer recognizes the $500 fixed payment to revenue ratably over the five-year term of the license and recognizes the sales-based royalty as revenue as sales occur. The arrangement between Acquirer and Target contains no settlement provisions. After the first year of the license agreement, Acquirer purchases Target for $5,000.

On the acquisition date:

- Acquirer has recognized $100 of revenue and has deferred $400 of revenue.
- From a market participant's perspective, in assessing Target's use of the license, the fair value of the license agreement is $2,000, which is comprised of a $1,000 "at market" component and a $1,000 "off-market" component. That is, the license agreement is favorable to Target (and unfavorable to Acquirer) as royalty rates in comparable current market arrangements have increased since the inception of the arrangement with Target.

Acquirer would recognize a settlement loss on the reacquisition of the right equal to the amount by which the agreement is unfavorable to Acquirer on the acquisition date as there are no settlement provisions; however, the loss would be reduced to the extent the Acquirer already has an amount recorded on its balance sheet related to the arrangement. In this example, the loss on settlement would equal $600, which is the difference between the off-market component of the fair value of the license agreement and the remaining contract liability [$1,000 − $400 = $600]. The reacquired license right would be recognized at its fair value, $1,000, and amortized over the remaining contractual life (four years). The $400 of revenue that previously was deferred will never be recognized as revenue by Acquirer, but rather reduces the amount of the settlement loss.

4.6 Noncontrolling interests

Excerpt from Accounting Standards Codification

Business Combinations — Identifiable Assets and Liabilities, and Any Noncontrolling Interest

Initial Measurement

805-20-30-7

Paragraph 805-20-30-1 requires the acquirer to measure a noncontrolling interest in the acquiree at its fair value at the acquisition date. An acquirer sometimes will be able to measure the acquisition-date fair value of a noncontrolling interest on the basis of a quoted price in an active market for the equity shares (that is, those not held by the acquirer). In other situations, however, a quoted price in an active market for the equity shares will not be available. In those situations, the acquirer would measure the fair value of the noncontrolling interest using another valuation technique.

805-20-30-8

The fair values of the acquirer's interest in the acquiree and the noncontrolling interest on a per-share basis might differ. The main difference is likely to be the inclusion of a control premium in the per-share fair value of the acquirer's interest in the acquiree or, conversely, the inclusion of a discount for lack of control (also referred to as a noncontrolling interest discount) in the per-share fair value of the noncontrolling interest if market participants would take into account such a premium or discount when pricing the noncontrolling interest.

If an acquirer obtains control of a business through the acquisition (at once or in steps) of less than 100% of the business' ownership interests, noncontrolling interests remain in the acquired entity. Based on the guidance in ASC 805, noncontrolling interests are recognized in an initial consolidation by an acquirer and measured at acquisition-date fair value.[46]

4.6.1 What is noncontrolling interest?

The Master Glossary in ASC 805 defines noncontrolling interest as "the portion of equity (net assets) in a subsidiary not attributable, directly or indirectly, to a parent." This might include vested interests in common stock, options, warrants or preferred stock. The guidance in ASC 810 clarifies that only a financial instrument issued by a subsidiary that is classified as equity in the subsidiary's financial statements can be a noncontrolling interest in the consolidated financial statements. A financial instrument issued by a subsidiary that is classified as a liability in the subsidiary's financial statements (based on the guidance in other standards) is not a noncontrolling interest because it is not an equity interest. However, irrespective of whether an outstanding interest in the subsidiary is classified as a liability or noncontrolling interest, the interest is required to be recognized and measured at fair value on the acquisition date.

4.6.2 Estimating the fair value of a noncontrolling interest

When the target is a public company, determining the fair value of any noncontrolling interest generally is straightforward. In these situations, the fair value of the noncontrolling interest typically is determined directly based on the observable quoted share price of the target as of the acquisition date times the quantity of shares that constitute the noncontrolling interest.

However, when the target is a private company, determining the fair value of the noncontrolling interest often requires further consideration as quoted share prices generally are not available for the equity instruments that make up the NCI. When active markets and observable prices do not exist, valuation techniques, as described in greater depth in ASC 820 and our FRD, ***Fair value measurement***, are needed to estimate the fair value of the noncontrolling interest. In certain instances, companies may undertake more than one valuation approach (e.g., both a market approach and an income approach) as ASC 820 indicates valuation techniques that are appropriate in the circumstances and for which sufficient data is available should be used in determining fair value. The choice as to which approach or approaches to use should consider the availability of relevant inputs and their relative subjectivity.

While the use of valuation techniques to determine the fair value of a noncontrolling interest in a private company involves significant judgment, the transaction price paid by the acquirer for the controlling interest can provide information regarding the equity value of the target company as a whole, which may be useful in estimating the fair value of the noncontrolling interest. However, in order to properly consider the transaction price paid for the controlling interest when estimating the fair value of noncontrolling interest in a private company, one must have a detailed understanding of the transaction, including whether (1) the price paid for the controlling interest includes a premium, (2) the noncontrolling interest would also benefit from the acquirer obtaining control and (3) the shares purchased by the acquirer have additional features or rights that are not shared by the NCI.

ASC 805-20-30-8 acknowledges that "the fair values of the acquirer's interest in the acquiree and the noncontrolling interest on a per-share basis might differ. The main difference is likely to be the inclusion of a control premium in the per-share fair value of the acquirer's interest in the acquiree or, conversely, the inclusion of a discount for lack of control (also referred to as a noncontrolling interest discount) in the per-share fair value of the noncontrolling interest if market participants would take into account such a premium or discount when pricing the noncontrolling interest."

---

[46] As noted in Appendix H, under IFRS 3(R), the IASB permits an alternative to the recognition of 100% of residual goodwill, allowing the acquirer to recognize components of noncontrolling interest that are present ownership interests and entitle their holders to a proportionate share of the acquiree's net assets in the event of liquidation at either full fair value or its proportionate share of the fair value of the identifiable net assets. This is not permitted under US GAAP.

A control premium commonly is defined as "an amount or a percentage by which the pro rata value of a controlling interest exceeds the pro rata value of a non-controlling interest in a business enterprise to reflect the power of control."[47]

In contrast, an acquisition premium can be thought of more broadly as the amount or percentage by which the pro-rata value of a controlling interest under the acquirer (i.e., new controlling shareholder(s)) exceeds its value when measured with respect to the current stewardship of the enterprise.

The notion of an acquisition premium serves to highlight the following key considerations:

- The ability to exercise control generally is deemed to have value only to the extent that it enhances the economic benefits available to the owners of the enterprise.
- In certain instances, it may be appropriate to conclude that the pro-rata fair value of a controlling and noncontrolling interest are the same.

When the price paid by an acquirer for a controlling interest exceeds the value of those shares under the stewardship of existing management, the acquirer is deemed to have paid an acquisition premium. This might be the case when the exercise of control by the acquirer is expected to enhance the acquired entity's cash flows or reduce its risk. Unlike a control premium, the inclusion of an acquisition premium does not necessarily mean the fair value of the controlling interest exceeds the fair value of the noncontrolling interest on a per-share basis. By definition, a control premium exists only when the pro-rata fair value of the controlling interest exceeds that of the noncontrolling interest.

Synergies and other economic benefits expected from the acquirer's exercise of control often benefit the acquired entity as a whole and, therefore, can affect the fair value of a noncontrolling interest in the acquiree. For example, this may be the case when the acquirer has complementary products or services that are expected to increase the sales of the acquired entity or when operational synergies are expected to reduce the costs of the acquired entity. If the noncontrolling interest would share ratably in all of the benefits expected to be generated by the acquirer exercising its control (i.e., the controlling interest is not entitled to any disproportionate return), it may be appropriate to conclude that the fair value of the controlling and noncontrolling interests are the same on a pro-rata basis. In this example, the transaction price paid by the acquirer would reflect an acquisition premium, but not a control premium.

In contrast, there may be situations where the noncontrolling interest would not share in any of the benefits expected to be generated by the acquirer exercising its control. For example, this may be the case when the synergies or economic benefits of the acquisition inure to a legacy subsidiary of the acquirer in which the noncontrolling interest holders do not participate. When the noncontrolling interest is not expected to share ratably in any of the benefits expected to be generated by the acquirer, the fair value of the noncontrolling interest reflects a reduction in value from the per-share price paid for the controlling interest. In this example, the transaction price paid by the acquirer would reflect a control premium.

It is also important to note that when the shares that constitute the controlling interest in a private company include additional features or rights that are not available to the noncontrolling interest, the fair value of the noncontrolling interest likely would differ from the per-share price paid by the acquirer. Due to these differences, market participants acquiring the noncontrolling interest likely would use different assumptions regarding expected cash flows, required rate of return, or both than the assumptions used by the acquirer. For example, absent certain information rights, market participants acquiring the noncontrolling interest may have a higher required rate of return when compared to the acquirer, which would result in a lower fair value for the noncontrolling interest as compared to the per-share price paid by the acquirer.

---

[47] As defined in the International Glossary of Business Valuation Terms of the AICPA's Statement on Standards for Valuation Services No.1.

Given the considerations noted above, it generally is not appropriate to estimate the fair value of the noncontrolling interest in a private company as simply the noncontrolling percentage of the equity value determined from grossing up the consideration transferred by the percentage of the company obtained by the acquirer. For example, if an acquirer paid $100 million for an 80% controlling stake in a private company, it would not be appropriate to assume that the fair value of the 20% noncontrolling interest is $25 million (i.e., 20% of an equity value calculated as $100 million divided by the 80% interest acquired). Additional analysis and valuation procedures are required.

4.6.2.1 Noncontrolling interest's share of goodwill

As discussed in section 7.4, in a partial acquisition accounted for in accordance with the guidance in ASC 805, an acquirer recognizes and consolidates assets acquired, liabilities assumed, and any noncontrolling interest at 100% of their fair values as of that date (regardless of the acquirer's percentage ownership in the acquiree). As goodwill is calculated as a residual, all goodwill of the acquired business, not just the acquirer's share, is recognized under this "full-goodwill" approach.

Recognized goodwill is allocated between the controlling and noncontrolling interests. Although this allocation is not presented separately on the acquirer's balance sheet, it is necessary so that a goodwill impairment charge recognized in a period following the business combination by an acquirer is appropriately allocated between controlling and noncontrolling interests. The portion of goodwill initially allocated to the controlling and noncontrolling interests may not be equal to the total recognized goodwill multiplied by the respective ownership percentages in the acquiree (e.g., when the acquirer pays a premium to acquire the controlling interest in the subsidiary). See our FRD, ***Intangibles — goodwill and other***, for a discussion of the allocation of goodwill between the controlling and noncontrolling interests.

4.6.3 Accounting for put options, call options or forward contracts entered over NCI in a business combination

See our FRDs, ***Issuer's accounting for debt and equity financings (before the adoption of ASU 2020-06, Accounting for Convertible Instruments and Contracts in an Entity's Own Equity)*** and ***Issuer's accounting for debt and equity financings (after the adoption of ASU 2020-06, Accounting for Convertible Instruments and Contracts in an Entity's Own Equity)***, for guidance on accounting for put options, call options or forward contracts over NCI in a business combination.

4.6.4 Accounting for noncontrolling interest after the business combination

Consistent with the economic entity concept that noncontrolling interest is part of the equity of the consolidated group, changes in a parent's controlling ownership interest that do not result in a loss of control of the subsidiary are accounted for in accordance with the guidance in ASC 810 as transactions among shareholders in the consolidated entity.

Under ASC 810, the loss of control of a subsidiary is considered to be a significant economic event that changes the nature of the underlying investment. The parent-subsidiary relationship ceases to exist (as does accounting consolidation) and, if a noncontrolling equity investment is retained, a new investor/investee relationship begins. The significance of that economic change is considered to warrant a new basis recognition event that results in remeasurement of the retained interest and a resulting gain or loss.

See our FRD, ***Consolidation***, for further discussion of the subsequent accounting for noncontrolling interests.

4.6.4.1 Acquisition of noncontrolling interest in connection with a business combination

In some situations, a business combination will result in the indirect acquisition of a noncontrolling interest (i.e., the acquiree is the owner of a noncontrolling interest in an acquirer's existing subsidiary). In such situations, we believe that the transaction consists of the following two elements that require separate accounting: (1) the acquisition of a business under ASC 805 and (2) the acquisition of a noncontrolling interest under ASC 810. We believe that the fair value of the consideration transferred should be allocated to each element on a relative fair value basis. Because the acquirer retains control of its existing subsidiary, the indirect acquisition of the noncontrolling interest is accounted for as an equity transaction. That is, any difference between the fair value of the allocated consideration transferred and the carrying amount of the noncontrolling interest is recognized as an adjustment to equity on the acquirer's consolidated financial statements.

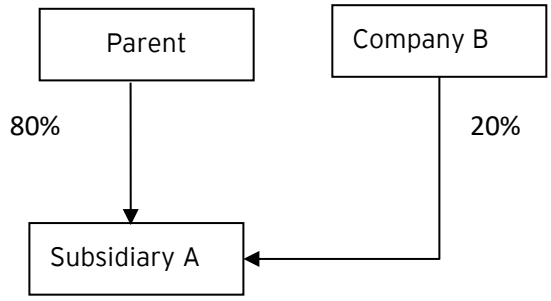
The following illustration demonstrates this concept. See our FRD, ***Consolidation***, for further analysis of transactions with a noncontrolling interest holder.

Illustration 4-36: Indirect acquisition of noncontrolling interest in connection with a business combination

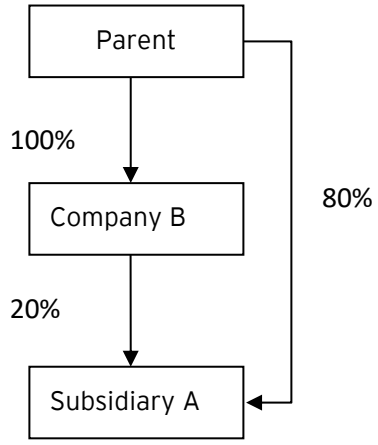
Parent owns an 80% controlling interest in Subsidiary A. Company B holds the remaining 20% noncontrolling interest in Subsidiary A. Parent pays $600 million in cash to acquire all of the outstanding shares of Company B.

The following diagram depicts the corporate structure before and after the transaction:

Before:



After:



Relevant fair value and book value information (in millions) is as follows:

Fair value of noncontrolling interest in Subsidiary A	$120
Book value of noncontrolling interest in Parent's financial statements	80
Fair value of Company B (inclusive of goodwill)	480
Fair value of Company B's net identifiable assets acquired (excluding goodwill)	460

Analysis

When a business combination results in the indirect acquisition of a noncontrolling interest, we believe that the transaction consists of the following two elements that require separate accounting: (1) the acquisition of a business under ASC 805 and (2) the acquisition of a noncontrolling interest under ASC 810. We believe that the fair value of the consideration transferred should be allocated to each element on a relative fair value basis. In this example, Parent would allocate $480[a] million of the consideration transferred to the acquisition of Company B and $120[b] million of the consideration transferred to the acquisition of the noncontrolling interest in Subsidiary A.

[a] Calculated as follows: ($480 million / $600 million) * $600 million

[b] Calculated as follows: ($120 million / $600 million) * $600 million

Accounting under ASC 805

Pursuant to ASC 805, Parent would calculate goodwill relating to the acquisition of Company B as follows (amounts in millions):

Consideration transferred	$	480
Fair value of Company B's net identifiable assets acquired (excluding goodwill)		460
Goodwill	$	20

Accounting under ASC 810

Pursuant to ASC 810, the increase in Parent's ownership interest in Subsidiary A from 80% to 100% is accounted for as an equity transaction. As a result, the carrying amounts of the controlling and non-controlling interests are adjusted to reflect the changes in their relative interests in Subsidiary A. Any difference between the fair value of the consideration transferred and the carrying amount of the noncontrolling interest is recognized directly in equity and attributed to Parent. Parent would calculate the adjustment to recognize in equity for the difference between the fair value and carrying amount of the noncontrolling interest as follows (amounts in millions):

Consideration transferred for acquisition of noncontrolling interest	$	120
Less: book value of noncontrolling interest		80
Adjustment to controlling interest (Parent)	$	40

Consolidation Entry

Parent would record the following journal entry to account for the transaction (in millions):

Net assets acquired	$	460		
Goodwill		20		
Noncontrolling interest		80		
Common stock and APIC — controlling interest		40		
Cash			$	600

4.7 Subsequent accounting for assets acquired and liabilities assumed in a business combination

Excerpt from Accounting Standards Codification

Business Combinations — Overall

Subsequent Measurement

805-10-35-1

In general, an **acquirer** shall subsequently measure and account for assets acquired, liabilities assumed or incurred, and equity instruments issued in a **business combination** in accordance with other applicable generally accepted accounting principles (GAAP) for those items, depending on their nature. However, this Topic provides guidance on subsequently measuring and accounting for any of the following assets acquired, liabilities assumed or incurred, and equity instruments issued in a business combination:

a. Reacquired rights (see paragraph 805-20-35-2)

b. Assets and liabilities arising from contingencies recognized as of the **acquisition date** (see paragraph 805-20-35-3)

c. Indemnification assets (see paragraph 805-20-35-4)

d. **Contingent consideration** (see paragraph 805-30-35-1)

e. Contingent consideration arrangements of an acquiree assumed by the acquirer (see paragraph 805-30-35-1A).

Business Combinations — Identifiable Assets and Liabilities, and Any Noncontrolling Interest

Subsequent Measurement

805-20-35-5

Additional guidance on subsequently measuring and accounting for assets acquired in a business combination is addressed in Subtopic 350-30, which prescribes the accounting for **identifiable intangible assets** acquired in a business combination, including recognition of intangible assets used in research and development activities, regardless of whether those assets have an alternative future use, and their classification as indefinite-lived until the completion or abandonment of the associated research and development efforts.

805-20-35-7

Topic 944 on insurance provides guidance on the subsequent accounting for an insurance or **reinsurance** contract acquired in a business combination.

805-20-35-8

Additional guidance on accounting for changes in a parent's ownership interest in a subsidiary after **control** is obtained is provided in paragraphs 810-10-45-22 through 45-24 and Example 1 (see paragraph 810-10-55-4B).

805-30-35-2

The subsequent measurement of goodwill is addressed in Subtopic 350-20.

805-30-35-3

Topic 718 provides guidance on subsequent measurement and accounting for the portion of replacement share-based payment awards issued by an acquirer that is attributable to future goods or services.

ASC 805 provides guidance on accounting for certain acquired assets and assumed liabilities after the business combination. The post-acquisition accounting guidance provided in ASC 805 primarily relates to assets acquired and liabilities assumed that are not addressed in other GAAP (e.g., contingent consideration that does not meet the definition of a derivative), or those for which the fair value measurement model in ASC 805 requires an exception to other GAAP. These assets and liabilities are discussed in other sections of this document and include the following:

- Reacquired rights (section 4.2.5.3.7)
- Preacquisition contingencies (section 4.4.1)
- Indemnification assets (section 4.2.7)
- Contingent consideration (section 6.4)

Unless specific post-acquisition accounting guidance is provided in ASC 805, other existing GAAP prescribes the subsequent accounting for assets acquired and liabilities assumed in business combinations.

5 Income tax considerations

The accounting for income taxes is described in ASC 740. The application of ASC 740 to the assets and liabilities recognized in a business combination are described in our FRD, ***Income taxes***.

6 Consideration transferred

6.1 Measurement of consideration transferred

Excerpt from Accounting Standards Codification

Business Combinations — Goodwill or Gain from Bargain Purchase, Including Consideration Transferred

Initial Measurement

805-30-30-7

The consideration transferred in a business combination shall be measured at fair value, which shall be calculated as the sum of the acquisition-date fair values of the assets transferred by the acquirer, the liabilities incurred by the acquirer to former owners of the acquiree, and the equity interests issued by the acquirer. (However, any portion of the acquirer's share-based payment awards exchanged for awards held by the acquiree's grantees that is included in consideration transferred in the business combination shall be measured in accordance with paragraph 805-20-30-21 rather than at fair value.) Examples of potential forms of consideration include the following:

a. Cash

b. Other assets

c. A **business** or a subsidiary of the acquirer

d. **Contingent consideration** (see paragraphs 805-30-25-5 through 25-7)

e. Common or preferred equity instruments

f. Options

g. Warrants

h. Member interests of mutual entities.

6.1.1 Items included in consideration transferred

Consideration transferred may take many forms, including cash, tangible and intangible assets, a business or subsidiary of the acquiring entity, instruments of the acquiring entity (e.g., common stock, preferred stock, options, warrants and debt instruments) or other promised future payments of the acquiring entity, including contingent payments.

As discussed in section 3.4.1.2, an acquirer must assess whether any portion of the consideration transferred involves a transaction separate from the business combination. In doing so, an acquirer must consider several factors, which include (1) the reasons for the transaction, (2) who initiated the transaction and (3) the timing of the transaction (see further discussion in section 3.4.1.2). Examples of transactions generally recognized separately from the business combination are settlements of preexisting relationships, compensation to employees for future services and reimbursement of the acquiree for payment of transaction costs on behalf of the acquirer.

Question 6.1 **Acquirer purchases Target in a business combination and enters into financial instruments (e.g., derivatives) to hedge risks associated with the transactions (e.g., foreign currency risks associated with the consideration that will be paid by the acquirer, risks of changes in the value of the acquiree's net assets, etc.). Should the acquirer account for such financial instruments as a part of the business combination?**

While these financial instruments may be used as economic hedges of various risks related to the business combination, they generally are not eligible for hedge accounting (ASC 815-20-25-12, ASC 815-20-25-43 and ASC 815-20-25-15(g)). Rather, these instruments are treated as freestanding financial instruments on the acquirer's books. Accordingly, the costs of and proceeds from entering into these instruments (including subsequent gains and losses) are not part of the consideration transferred in the business combination. Instead, the costs and proceeds are accounted for in accordance with other applicable GAAP (e.g., ASC 815). For example, if a derivative is executed in connection with a business combination to economically hedge the foreign currency risk associated with the consideration to be paid, the acquirer initially recognizes the derivative at fair value, with subsequent changes in the derivative's fair value recorded in earnings.

6.1.2 Equity instruments issued (including measurement date)

If the acquirer issues equity instruments to the acquiree in the business combination, then the acquirer measures the fair value of the issued equity instruments on the acquisition date and includes that amount as part of consideration transferred. The fair value of the equity instruments must be measured in accordance with the guidance in ASC 820. If the equity instruments of the acquirer are marketable, the fair value is determined based on quoted market prices. If the shares are not marketable (e.g., nonpublic shares), the acquirer determines the fair value of the equity instruments based on quoted market prices of shares with similar characteristics or by using valuation techniques (in accordance with the provisions of ASC 820). Our FRD, ***Fair value measurement***, provides an analysis of the requirements of ASC 820 and further interpretive guidance.

An acquirer measures all forms of consideration transferred, including equity instruments issued, as of the acquisition date[48] — the same date that the assets acquired and liabilities assumed are measured. Measuring the fair value of equity instruments issued as of a different date or over a "reasonable period of time" (i.e., a few days) before and after the terms of the acquisition are agreed to and announced is not permitted.

6.1.2.1 Issuance of preferred shares as consideration (updated June 2022)

Preferred shares issued as consideration in a business combination must be measured at fair value in accordance with the guidance in ASC 820. When there is no quoted market for preferred shares issued in a business combination, an acquirer considers all characteristics of the preferred shares in determining their value. Similar to debt instruments without a quoted market price, the best estimate of fair value might be based on the quoted market price of preferred shares with similar characteristics (i.e., dividend rates, conversion or redemption features and voting rights) or require the use of valuation techniques.

[48] For public entities, we believe that the method used to determine the acquisition date fair value (e.g., the high, low or average trading price on the acquisition date) is an accounting policy election pursuant to ASC 235. Irrespective of the policy elected, the acquirer must determine the value on the acquisition date.

If equity-classified preferred shares issued in a business combination are convertible into common shares of the acquiring entity, the acquiring entity should determine whether the conversion feature needs to be bifurcated as a derivative pursuant to ASC 815. Before the adoption of ASU 2020-06, if the conversion feature does not require bifurcation, the acquirer should further evaluate whether it is beneficial to the acquiree at the acquisition date and thus requires recognition of a beneficial conversion feature (a separate component of equity). ASU 2020-06 eliminates the beneficial conversion feature accounting model, and therefore, after adoption, this evaluation is no longer required. See section 3.2 of our FRDs, ***Issuer's accounting for debt and equity financings (before the adoption of ASU 2020-06, Accounting for Convertible Instruments and Contracts in an Entity's Own Equity)*** and ***Issuer's accounting for debt and equity financings (after the adoption of ASU 2020-06, Accounting for Convertible Instruments and Contracts in an Entity's Own Equity)***, for further guidance.

6.1.2.2 Issuance of subsidiary shares as consideration

An acquirer could use the stock of a subsidiary as consideration in a business combination. The same measurement principles that apply to the acquirer's equity instruments also apply to the equity instruments of a subsidiary issued in a business combination. On the acquisition date, the fair value of the subsidiary's shares is an element (or all) of the consideration transferred. If the acquirer maintains control of the subsidiary that issues the shares, and the transaction is in the scope of ASC 810, then the acquirer recognizes the issuance of shares as an equity transaction in accordance with ASC 810-10-45-23. Any difference between the carrying amount (that is, the proportionate interest in the net assets of the subsidiary) of the shares and the fair value recognized as consideration in the business combination is recognized as APIC in the acquirer's consolidated financial statements. Refer to sections 18.3 and 18.4 of our FRD, ***Consolidation***, for guidance on changes in a parent's ownership interest in a subsidiary.

Illustration 6-1 provides an example of the accounting when an acquirer issues subsidiary shares as consideration for a controlling interest in another entity.

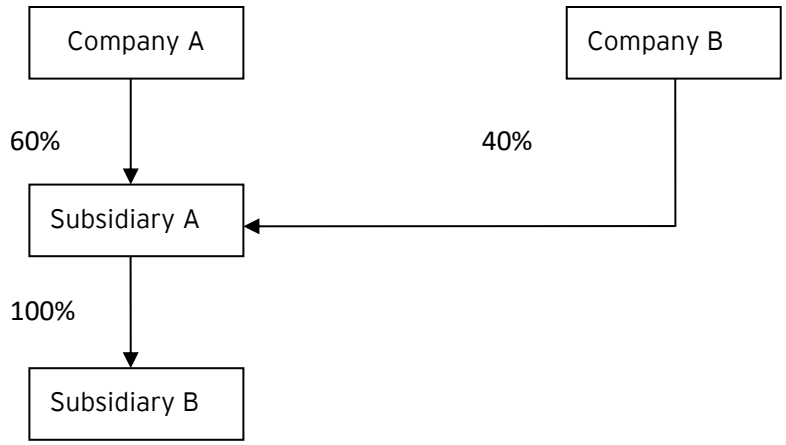
Illustration 6-1: Issuance of subsidiary shares as consideration for a controlling interest in another entity

Subsidiary A and Subsidiary B are wholly-owned subsidiaries of Company A and Company B, respectively. Subsidiary A issues 40% of its common shares to Company B in exchange for 100% of Subsidiary B. Afterwards, Company A owns 60% of Subsidiary A and Company B owns 40% of Subsidiary A. Company A also maintains control of Subsidiary A. For simplicity, this illustration assumes no control premium.

The following diagram depicts the corporate structure before and after the transaction:

Before:

After:



Relevant fair value and book value information for Subsidiary A and Subsidiary B is as follows:

Fair value of Subsidiary A (inclusive of goodwill) immediately prior to the transaction	$	960
Book value of Subsidiary A immediately prior to the transaction		800
Fair value of Subsidiary A shares issued (represents 40% of the fair value of Subsidiary A immediately prior to the transaction)		384
Fair value of Subsidiary B (inclusive of goodwill)		640
Fair value of Subsidiary B's net identifiable assets acquired (excluding goodwill)		600

Analysis

When an acquirer issues shares of a subsidiary to acquire a controlling financial interest in another entity, the transaction consists of the following two elements that require separate accounting: (1) the acquisition of a business under ASC 805 and (2) the issuance of a noncontrolling interest in a subsidiary under ASC 810.

Accounting under ASC 805

Pursuant to ASC 805, Company A would calculate goodwill relating to the acquisition of Subsidiary B as follows:

Consideration transferred (fair value of Subsidiary A shares issued)	$	384
Fair value of noncontrolling interest relating to acquired Subsidiary B ($640 * 40%)		256
Total		640
Fair value of Subsidiary B's net identifiable assets acquired (excluding goodwill)		600
Goodwill	$	40

Accounting under ASC 810

Pursuant to ASC 810, the decrease in Company A's ownership interest in Subsidiary A from 100% to 60% is accounted for as an equity transaction. As a result, the carrying amounts of the controlling and non-controlling interests are adjusted to reflect the changes in their relative interests in Subsidiary A. Any difference between the amount by which the noncontrolling interest is adjusted and the fair value of the consideration received is recognized directly in equity and attributed to Company A. The noncontrolling interest balance would be calculated as follows:

Consideration received ($640 * 60%)	$	384
Noncontrolling interest's (Company B's) share of Subsidiary A's net assets prior to the transaction ($800 * 40%)		320
Adjustment to controlling interest (Company A)	$	64

Consolidation Entry

Company A would record the following entry in consolidation:

Net assets acquired	$	600		
Goodwill		40		
Noncontrolling interest			$	576*
Common stock and APIC — controlling interest				64**

* *Proof of Noncontrolling Interest Balance*

The following is a proof of the total noncontrolling interest balance of $576 ($256 + $320):

Subsidiary A's book value immediately prior to the transaction	$	800
Fair value of business (including goodwill) received by Subsidiary A		640
Subsidiary A's book value immediately after the transaction		1,440
Company B's 40% interest in Subsidiary A's net assets after the transaction		40%
Total noncontrolling interest balance	$	576

** Proof of APIC Balance

The following is a proof of the total APIC balance of $64:

Subsidiary A's book value immediately prior to the transaction	$	800
Fair value of business (including goodwill) received by Subsidiary A		640
Subsidiary A's book value immediately after the transaction		1,440
Company A's 60% interest in Subsidiary A's net assets after the transaction		60%
Company A's investment in Subsidiary A after the transaction		864
Company A's investment in Subsidiary A immediately before the transaction		800
Change in Company's investment in Subsidiary A	$	64

6.1.3 Debt instruments issued

In determining the total measurement of the consideration transferred, the guidance in ASC 805 requires an acquirer to measure liabilities incurred at fair value on the acquisition date. However, this guidance does not specifically discuss how to value debt instruments issued in a business combination.

If the instruments issued are publicly traded, fair value is determined based on quoted market prices. For debt instruments issued in a business combination that are not publicly traded, the best estimate of fair value may be the quoted market price of debt with similar characteristics or determined using valuation techniques (e.g., the present value of estimated future cash flows). If an acquirer uses valuation techniques to value debt issued in a business combination, the acquirer should carefully consider all the assumptions used in the valuation. For example, the acquirer should take into account the credit rating of the issuing entity, the existence of guarantees by other entities (e.g., a parent company), collateral and other credit enhancements in its selection of an appropriate interest rate to discount estimated future cash flows. Any fair value measurements must follow the principles expressed in ASC 820.

6.1.3.1 Issuance of convertible debt and debt issued with warrants (updated June 2022)

If debt issued in a business combination is convertible into common shares of the acquiring entity, the acquiring entity should determine whether the conversion feature needs to be bifurcated as a derivative pursuant to ASC 815. Before the adoption of ASU 2020-06, if the conversion feature does not require bifurcation, the acquirer should further evaluate whether the conversion feature should be recognized as a separate component of equity pursuant to the cash conversion guidance or the beneficial conversion feature guidance in ASC 470-20.

ASU 2020-06 eliminates the cash conversion and beneficial conversion feature accounting models, and therefore, after adoption, this evaluation is no longer required. The acquirer is required to consider the substantial premium model under ASC 470-20, and if it is required to separately account for a conversion feature under that model, the premium is recorded in additional paid-in capital.

See section 2.2 of our FRDs, ***Issuer's accounting for debt and equity financings (before the adoption of ASU 2020-06, Accounting for Convertible Instruments and Contracts in an Entity's Own Equity)*** and ***Issuer's accounting for debt and equity financings (after the adoption of ASU 2020-06, Accounting for Convertible Instruments and Contracts in an Entity's Own Equity)***, for further guidance.

Consistent with the concepts in ASC 470-20-30-2, if debt instruments issued in a business combination include detachable stock warrants that are determined to be "freestanding" from the convertible debt pursuant to ASC 480's definition of "freestanding financial instrument," the debt and warrants are measured separately at their respective fair values in determining the consideration transferred. See section 1.2.1 of our FRDs, ***Issuer's accounting for debt and equity financings (before the adoption of ASU 2020-06, Accounting for Convertible Instruments and Contracts in an Entity's Own Equity)*** and ***Issuer's accounting for debt and equity financings (after the adoption of ASU 2020-06, Accounting for Convertible Instruments and Contracts in an Entity's Own Equity)***, for further guidance on the identification of freestanding financial instruments.

Acquirers also should consider whether the warrants should be classified as a liability or equity, pursuant to the guidance in ASC 480 and ASC 815. Also see section 4.2 of our FRDs, ***Issuer's accounting for debt and equity financings (before the adoption of ASU 2020-06, Accounting for Convertible Instruments and Contracts in an Entity's Own Equity)*** and ***Issuer's accounting for debt and equity financings (after the adoption of ASU 2020-06, Accounting for Convertible Instruments and Contracts in an Entity's Own Equity)***, for further guidance.

6.1.4 Recognizing gains or losses on noncash assets transferred

Excerpt from Accounting Standards Codification

Business Combinations — Goodwill or Gain from Bargain Purchase, Including Consideration Transferred

Initial Measurement

805-30-30-8

The consideration transferred may include assets or liabilities of the acquirer that have carrying amounts that differ from their fair values at the acquisition date (for example, nonmonetary assets or a business of the acquirer). If so, the acquirer shall remeasure the transferred assets or liabilities to their fair values as of the acquisition date and recognize the resulting gains or losses, if any, in earnings. However, sometimes the transferred assets or liabilities remain within the combined entity after the business combination (for example, because the assets or liabilities were transferred to the acquiree rather than to its former owners), and the acquirer therefore retains control of them. In that situation, the acquirer shall measure those assets and liabilities at their carrying amounts immediately before the acquisition date and shall not recognize a gain or loss in earnings on assets or liabilities it controls both before and after the business combination.

A business combination agreement might provide that as purchase consideration the acquirer transfer assets that it previously recognized in its financial statements at historical or amortized historical cost. Common examples of such forms of consideration include, but are not limited to, certain financial instruments, property, inventory and software licenses. Whenever the net carrying value of an asset included in the consideration transferred (that does not remain with the combined company) differs from the acquisition-date fair value of the asset, the acquirer recognizes a gain or a loss at the acquisition date for the difference between the asset's acquisition-date net carrying value and the acquisition-date fair

value. Essentially, the accounting provides for the recognition of gain or loss in the same manner as if the acquirer sold the asset for cash equal to the asset's fair value and transferred the resulting cash in the business combination.

6.1.4.1 Recognizing gains or losses on transfers of assets that remain under the acquirer's control

Under ASC 805, companies are not permitted to recognize gains or losses in the consolidated financial statements on assets transferred as part of the consideration transferred when such assets remain in the combined entity (i.e., those assets that remain under the acquirer's control). This is consistent with the underlying principle of ASC 805 that a change in control is the significant economic event that results in a change in basis. When the assets transferred do not leave the consolidated group, no change in control occurs and the acquirer does not recognize a gain or loss for a change in basis for those assets.

Illustration 6-2: Recognizing gains or losses on noncash assets transferred that do not remain in the combined entity

Acquirer is in the business of licensing the use of the software that it develops. Acquirer purchases a business from Seller in exchange for cash of $100, land (that has a book value of $100 and a fair value of $500) and a software license (with a fair value of $200), none of which remains in the acquired entity. The consideration transferred in the acquisition equals the sum of the cash, the fair value of the land and the fair value of the software license ($800). Acquirer recognizes a gain of $400 on the transfer of the land to Seller and either revenue or a contract liability (e.g., deferred revenue) of $200 for granting the software license.

Illustration 6-3: Recognizing gains or losses on noncash assets transferred that remain in the combined entity

Assume the same facts as in Illustration 6-2, except that the land will remain in the combined entity. The consideration transferred in the acquisition is now the sum of the cash, the book value of the land and the fair value of the software license ($400). Acquirer does not recognize a gain on the transfer of the land to Target and recognizes either revenue or a contract liability (e.g., deferred revenue) of $200 for granting the software license.

6.1.5 Consideration transferred in a business combination achieved without the transfer of consideration

Excerpt from Accounting Standards Codification

Business Combinations — Goodwill or Gain from Bargain Purchase, Including Consideration Transferred

Implementation Guidance and Illustrations

805-30-55-2

In a business combination achieved without the transfer of consideration, the **acquirer** must substitute the acquisition-date **fair value** of its interest in the **acquiree** for the acquisition-date fair value of the consideration transferred to measure goodwill or a gain on a bargain purchase (see paragraphs 805-30-30-1 through 30-4). Subtopic 820-10 provides guidance on using valuation techniques to measure fair value.

Typically, a business combination will include the transfer of consideration (e.g., cash or other assets, equity interests, assumption of liabilities). However, a business combination can also occur without the transfer of consideration, such as by contract or by a lapse in participating rights of a minority shareholder. When there is no consideration transferred, the acquirer must substitute the acquisition-date fair value of its interest in the acquiree for the acquisition-date fair value of the consideration transferred to measure goodwill or a gain on a bargain purchase. See our FRD, ***Fair value measurement***, for additional guidance on valuation techniques to measure fair value.

6.1.5.1 Mutual entities

Mutual entities are organized such that the entity's customers or members are owners of the entity; there are typically no external shareholders. These customers or members derive their rights to profits and votes through the customer or member relationship. Examples of mutual entities include mutual insurance companies, savings and loan institutions and credit unions. In the case of a mutual insurance company, policyholders of the insurance policies have certain ownership rights, including the ability to elect management and participate in the distribution of net assets if the organization were to cease operations.

6.1.5.1.1 Applying the acquisition method to combinations of mutual entities

Excerpt from Accounting Standards Codification

Business Combinations — Goodwill or Gain from Bargain Purchase, Including Consideration Transferred

Implementation Guidance and Illustrations

805-30-55-3

When two mutual entities combine, the fair value of the equity or member interests in the acquiree (or the fair value of the acquiree) may be more reliably measurable than the fair value of the member interests transferred by the acquirer. In that situation, paragraph 805-30-30-2 through 30-3 requires the acquirer to determine the amount of goodwill by using the acquisition-date fair value of the acquiree's equity interests instead of the acquisition-date fair value of the acquirer's equity interests transferred as consideration. In addition, the acquirer in a combination of **mutual entities** shall recognize the acquiree's net assets as a direct addition to capital or equity in its statement of financial position, not as an addition to retained earnings, which is consistent with the way in which other types of entities apply the acquisition method.

805-30-55-4

Although they are similar in many ways to other businesses, mutual entities have distinct characteristics that arise primarily because their members are both customers and owners. Members of mutual entities generally expect to receive benefits for their membership, often in the form of reduced fees charged for goods and services or patronage dividends. The portion of patronage dividends allocated to each member is often based on the amount of business the member did with the mutual entity during the year.

805-30-55-5

A fair value measurement of a mutual entity should include the assumptions that market participants would make about future member benefits as well as any other relevant assumptions market participants would make about the mutual entity. For example, an estimated cash flow model may be used to determine the fair value of a mutual entity. The cash flows used as inputs to the model should be based on the expected cash flows of the mutual entity, which are likely to reflect reductions for member benefits, such as reduced fees charged for goods and services.

In applying the acquisition method to mergers between two or more mutual entities, one of the combining entities must be identified as the acquirer. The acquirer then must determine the fair value of the member interests in the acquiree or the fair value of the target entity as a whole. Normally, no consideration is transferred in a combination between mutual entities. Therefore, the fair value of the target entity as whole could be used as a proxy for the consideration transferred. The resulting fair value is added directly to the acquirer's equity (e.g., the surplus account for a mutual bank), and not its retained earnings. In addition, the target's assets acquired, including identifiable intangible assets, and liabilities assumed must be measured at their fair values in accordance with ASC 820. In a business combination between mutual entities where no consideration is transferred, goodwill is determined based on the amount by which the target's fair value as a whole exceeds the fair value of the target's net assets. The following example illustrates how a mutual entity would consolidate another mutual entity:

Illustration 6-4: Balance Sheet of combined mutual entities at the acquisition date

Assume that Acquirer Mutual Entity acquires Target Mutual Entity in a business combination. The fair value of Target Mutual Entity as a whole is $190.

	Target mutual entity		Acquirer mutual entity	Combined mutual entity
	Book value	*Fair value of net assets*	*Book value*	
		(in millions)		
Assets				
Investments and loans	$ 300	$ 325	$ 600	$ 925
Fixed assets	50	60	100	160
Intangible assets	-	50	-	50
Goodwill	-	-	-	75[1]
Total assets	$ 350	$ 435	$ 700	$ 1,210
Liabilities				
Borrowings	$ 250	$ 320	$ 510	$ 830
Equity				
Unappropriated members' capital	30		75	265[2]
Retained earnings	70		115	115
Total liabilities and equity	$ 350	$ 320	$ 700	$ 1,210

[1] Goodwill is $75 [Fair value of Target Mutual Entity as a whole of $190 less fair value of acquired net assets of $115 ($435-$320)].

[2] Increase in unappropriated members' capital is $190, which is the fair value of Target Mutual Entity

6.2 Acquisition-related costs

Excerpt from Accounting Standards Codification

Business Combinations — Overall

Recognition

805-10-25-23

Acquisition-related costs are costs the acquirer incurs to effect a business combination. Those costs include finder's fees; advisory, legal, accounting, valuation, and other professional or consulting fees; general administrative costs, including the costs of maintaining an internal acquisitions department; and costs of registering and issuing debt and equity securities. The acquirer shall account for acquisition-related costs as expenses in the periods in which the costs are incurred and the services are received, with one exception. The costs to issue debt or equity securities shall be recognized in accordance with other applicable GAAP.

An acquirer incurs various acquisition-related costs in connection with a business combination, including:

- *Direct costs* of the transaction, such as costs for services of lawyers, investment bankers, accountants and other third parties
- *Indirect costs* of the transaction, such as recurring internal costs (e.g., the cost of maintaining an acquisition department)
- *Financing costs*, such as costs to issue debt or equity instruments used to effect the business combination (i.e., issuance costs)

The FASB believes that acquisition-related costs are not part of the fair value exchange between the buyer and seller for the acquired business. Rather, the FASB concluded that acquisition related costs are separate transactions with a service provider. Therefore, the guidance in ASC 805 requires that direct and indirect acquisition-related costs be expensed in the period that the related services are received.

An acquirer does not consider costs incurred to issue debt or equity instruments to effect a business combination to be "costs of the acquisition." Generally, debt issuance costs are reported in the balance sheet as a direct deduction from the face amount of the debt and amortized over the term of the debt in accordance with ASC 835-30-45-1A and ASC 835-30-45-3, while equity issuance costs are deducted from the proceeds of the issuance (i.e., a reduction of equity) in accordance with SAB Topic 5.A.

See sections 2.3 and 4.3 of our FRDs, ***Issuer's accounting for debt and equity financings (before the adoption of ASU 2020-06, Accounting for Convertible Instruments and Contracts in an Entity's Own Equity)*** and ***Issuer's accounting for debt and equity financings (after the adoption of ASU 2020-06, Accounting for Convertible Instruments and Contracts in an Entity's Own Equity)***, for additional guidance on debt and equity issuance costs, respectively.

Question 6.2 **How should a company account for acquisition-related costs relating to the acquisition of an oil and gas property?**

It depends. If the acquired property meets the definition of a business under ASC 805, the acquisition-related costs are expensed as incurred; otherwise, the acquisition-related costs are accounted for under the appropriate oil and gas accounting literature. That is, such costs may be capitalizable for successful efforts companies under ASC 932-360-25-7 and full cost companies under SEC Regulation S-X Article 4-10.

Question 6.3 **How should a company account for fees paid to an investment banker for providing underwriting services to finance a business combination (i.e., expense as acquisition-related costs or capitalize as debt issuance costs)?**

ASC 340-10-S99-2 (SAB Topic 2.A.6) provides the SEC staff's views on the allocation of debt issuance costs for bridge financing and/or underwriting the permanent financing of a purchase business combination. Consistent with our views described above, the SEC staff believes that fees paid to an investment banker for providing bridge financing and/or underwriting permanent financing in connection with a purchase business combination are not direct costs of the acquisition and, therefore, should be reported as debt issuance costs. When an investment banker provides advisory services in connection with a business combination and also provides underwriting services associated with the issuance of debt or equity securities, ASC 340-10-S99-2 requires the acquirer to allocate the total fees incurred between the services received on a relative fair value basis.

6.2.1 Allocating transaction costs to the business combination and financing transactions

As discussed in Question 6.3, if an acquirer pays an investment banker for arranging financing and providing advisory services for the business combination, ASC 340-10-S99-2 (SAB Topic 2.A.6) requires the acquirer to allocate the total fees between debt issuance costs and acquisition-related costs on a relative fair value basis. If the financing element includes both bridge and permanent financing, we believe the acquirer should make a reasonable allocation of fees between those aspects of the acquisition financing. The SEC staff believes that the amount allocated to debt issuance costs attributed to bridge financing and/or permanent financing, as the case may be, normally should result in an effective interest rate on the subject debt that is consistent with an effective market interest rate. After the date of the financing, the acquirer should recognize interest cost using the effective interest method described in ASC 835-30-35 and should make separate disclosure of the amount accounted for as debt issuance costs, if material.

ASC 340-10-S99-2 does not provide specific guidance for achieving a reasonable allocation of fees paid to investment bankers related to bridge and permanent financing. Registrants may consider an investment banker's allocation of its fees, but the SEC staff cautions that it will challenge allocations if they do not appear to be reasonable in relation to fees charged for similar but separately executed financing arrangements. It is advisable to request that investment bankers provide evidence concerning any allocations they make, including their reasonableness in comparison to similar transactions.

The SEC staff requires that debt issuance costs allocated to bridge financing be amortized over the estimated term of the bridge financing (i.e., over the period before permanent financing is expected to replace the bridge financing). This amortization period is required to be used even if that estimated period is shorter than the period until maturity of the bridge financing, unless the underwriter is contractually required to provide the permanent financing (as opposed to through an underwritten offering) and a single commitment letter covers both the bridge and permanent financing. Separate amortization of debt issuance costs is necessary when there are separate costs associated with a bridge loan and permanent financing. Thus, amortization of the cost of the bridge financing and the permanent financing begins on different dates (bridge financing cost amortization begins on the inception date of the bridge financing and the permanent financing cost amortization commences on the date the permanent financing replaces the bridge financing). When an underwriter bills a single amount for fees associated with bridge financing and permanent financing, a reasonable allocation of those costs should be made.

In some situations, bridge financing may be repaid before the end of the originally estimated term used by the registrant for bridge financing issuance cost amortization purposes. At the repayment date, the unamortized portion of the bridge financing debt issuance costs is written off as interest cost in accordance with ASC 340-10-S99.

When bridge financing consists of increasing rate debt and term extending debt (i.e., debt that can be extended upon maturity at the option of the issuer with specified interest rate increases each time the maturity is extended), acquirers should consider the guidance in ASC 470-10-35-1 through 35-2, ASC 815-15, ASC 815-10-55-19 through 55-21, and section 3 of our FRD, ***Derivatives and hedging***.

6.2.2 Equity issuance costs

An acquirer accounts for the cost of registering and issuing equity instruments to effect a business combination as a reduction of the otherwise determined fair value of the equity instruments issued. The acquirer recognizes the reduction as a charge against paid-in capital. As discussed in section 6.2.1, the acquirer makes a reasonable allocation of fees paid to investment bankers that are involved with both completing the underlying business combination transaction and arranging for the equity financing. The acquirer expenses any fees not associated with arranging equity or debt financing as incurred. Question 6.4 illustrates how equity issuance costs are accounted for in determining the consideration transferred in a business combination.

Question 6.4 **Acquirer issues equity instruments with a fair value of $100 to Target as consideration in a business combination and in doing so incurs issuance costs of $10. The fair value of the acquired net assets of Target is $60. Should the equity issuance costs of $10 be included in the consideration transferred?**

No. The equity issuance costs of $10 are not included in the determination of consideration transferred but rather are recognized as reduction to additional paid-in capital separately from the business combination. Acquirer would record the following journal entries:

To record the business combination:				
Net assets	$	60		
Goodwill		40		
Equity			$	100
To record the equity issuance costs:				
APIC	$	10		
Cash			$	10

The Board concluded that events occurring subsequent to the acquisition date should not change the amounts recognized as consideration for the business combination. Thus, any difference between the actual registration costs and the liability recognized on the acquisition date (that are not qualifying measurement-period adjustments; see section 7.3.3), including imputed interest, is recognized in the post-combination statement of operations. All imputed interest is recognized in the post-combination statement of operations, including interest imputed during the measurement period.

6.2.3 Costs incurred by the sellers of an acquired company

In connection with a proposed business combination, the seller (or the acquiree on behalf of the seller) might incur costs for advisory services, appraisals, legal services, accounting and auditing services, printing, etc. Any costs incurred by the seller are expensed in the period incurred.

6.2.3.1 Costs incurred by the sellers of an acquired company on behalf of the acquirer

In an attempt to avoid recognizing acquisition costs as expenses, an acquirer might ask that the seller (or the acquiree on behalf of the seller) incur the acquisition-related expenses that would otherwise be incurred by the acquirer. The acquirer would then increase the price paid to the seller for the acquired business to compensate the seller for the expenses it incurred on behalf of the acquirer (and thus increasing the consideration for the acquired business and goodwill). In order to mitigate such concerns, the guidance in ASC 805 requires an evaluation of all consideration transferred by the acquirer to identify the inclusion of any payments that might be related to goods and services that are separate from the business combination (i.e., not related to the fair value of the acquired business or the assets acquired and liabilities assumed). If the seller has incurred transaction costs on the buyer's behalf, the buyer would recognize those costs as expenses when incurred by the seller, with an offsetting liability to repay the seller. This provision of ASC 805 is discussed further in section 3.4.1.2, and illustrated in the examples below.

Illustration 6-5: Transfer tax incurred by buyer

Acquirer purchases Target in a business combination. As part of the business combination, Acquirer incurs $20 million of transaction costs. In addition, Acquirer is required, based on local regulation, to pay a transfer tax of $3 million on real estate purchased from Target in the business combination.

Acquirer recognizes expense for the transaction costs of $20 million. The acquirer also recognizes expense for the transfer tax of $3 million as a transaction cost.

Illustration 6-6: Transfer tax incurred by seller

Acquirer purchases Target in a business combination. As part of the business combination, Acquirer incurs $20 million of transaction costs. In addition, the jurisdiction where Target is located requires the seller of real estate to pay transfer taxes. This transfer tax amounts to $3 million. Since Target is required to pay the transfer tax, that cost likely was considered by Target in agreeing to a sales price for the business and, implicitly, was paid by Acquirer in the business combination.

Acquirer expenses the transaction costs of $20 million. Since Target (the seller) is required to pay the transfer tax, the tax is not considered a transaction cost of Acquirer. The payment of the transfer tax by Target is considered a separate transaction apart from the business combination and is expensed by Target. There is no accounting for the transfer tax required by Acquirer.

Illustration 6-7: Transfer tax reimbursed by buyer

Acquirer acquires Target in a business combination. As part of the acquisition, Acquirer incurs $20 million of transaction costs. In addition, the jurisdiction where Target is located levies a tax on real estate transfers. The transfer tax is a legal obligation of the buyer. The transfer tax amounts to $3 million. Acquirer negotiates to have Target pay the transfer tax on its behalf, but Acquirer will increase the purchase price by $3 million.

Acquirer expenses the transaction costs of $20 million. Since part of the purchase price is reimbursement for the transfer tax paid by Target on Acquirer's behalf, the $3 million of consideration transferred is determined to be a separate transaction from the business combination. Acquirer reduces the consideration transferred by the $3 million for reimbursement of the transfer tax to Target's shareholders and recognizes it as expense.

6.2.4 Success fee related to a business combination

In some situations, a prospective acquirer or acquiree may have to pay a "success fee" to a third party (e.g., advisors, investment bankers) upon consummation of a business combination. In these circumstances, no payment is due to the counterparty if the business combination is not consummated. Because no obligation exists to pay the success fee until the transaction closes, we generally believe that it would not be appropriate to recognize the success fee as a liability until the acquisition date.

When the success fee is the legal obligation of the acquirer, the success fee is recognized as a separate transaction in the acquirer's post-combination financial statements (and not as a liability assumed as part of the business combination). See section B.7.1.1 for guidance on accounting for success fees related to a business combination in the separate financial statements of an acquiree that applies pushdown accounting.

6.2.5 Costs incurred in connection with asset acquisitions

While an asset acquisition is similar in concept to the acquisition of a business, the ASC 805 requirement to expense all costs of an acquisition does not extend to the acquisition of an asset or group of assets that does not constitute a business. This is because the FASB retained the cost accumulation and allocation model for asset acquisitions. Thus, as discussed further in Appendix A, the consideration transferred allocated to an asset or group of assets includes all direct acquisition costs. Indirect costs are expensed in the period incurred.

6.3 Exchange of share-based payment awards in a business combination

6.3.1 Measurement of share-based payment awards

Excerpt from Accounting Standards Codification

Business Combinations — Identifiable Assets and Liabilities, and Any Noncontrolling Interest

Initial Measurement

805-20-30-21

The acquirer shall measure a liability or an equity instrument related to the replacement of an acquiree's share-based payment awards with share-based payment awards of the acquirer in accordance with the method in Topic 718. The Business Combinations Topic refers to the result of that method as the fair-value-based measure of the award. Paragraphs 805-30-30-9 through 30-13 and 805-30-55-6 through 55-13 provide additional guidance.

In business combinations, share-based payments (stock, stock options and similar instruments) of the target frequently are exchanged for equity instruments of the acquiring company. The equity or liabilities exchanged (of both the former awards in the target and the new awards of the acquiring company) might be vested or unvested. One of the exceptions in ASC 805 to measuring assets acquired and liabilities assumed at fair value, as defined in ASC 820, is the measurement of share-based payment awards. A liability or equity instrument issued to replace the acquiree's share-based payment awards is measured in accordance with the fair value-based measurement provisions of ASC 718. Our FRD, ***Share-based payment***, provides detailed analysis and interpretive guidance on the measurement of share-based payments.

6.3.2 Replacement of share-based payment awards (updated June 2022)

Excerpt from Accounting Standards Codification

Business Combinations — Goodwill or Gain from Bargain Purchase, Including Consideration Transferred

Initial Measurement

805-30-30-9

An acquirer may exchange its share-based payment awards for awards held by grantees of the acquiree. This Topic refers to such awards as replacement awards. Exchanges of share options or other share-based payment awards in conjunction with a business combination are modifications of share-based payment awards in accordance with Topic 718. If the acquirer is obligated to replace the acquiree awards, either all or a portion of the fair-value-based measure of the acquirer's replacement awards shall be included in measuring the consideration transferred in the business combination. The acquirer is obligated to replace the acquiree awards if the acquiree or its grantees have the ability to enforce replacement. For example, for purposes of applying this requirement, the acquirer is obligated to replace the acquiree's awards if replacement is required by any of the following:

a. The terms of the acquisition agreement

b. The terms of the acquiree's awards

c. Applicable laws or regulations.

The guidance in ASC 805 states that exchanges of share-based payments in a business combination are accounted for as modifications in accordance with the provisions of ASC 718. ASC 805 also introduces the concept of an "obligation" in relation to the acquirer's replacement of the acquiree's share-based payment awards. ASC 805-30-30-9 states that all or a portion of the fair value-based measure of the replacement awards is included in the acquirer's measurement of consideration transferred only if the acquirer was obligated to replace the acquiree's awards. That obligation could be required by any of the following:

- The terms of the acquisition agreement

- The terms of the acquiree's awards
- Applicable laws or regulations

Therefore, an acquirer makes a determination as to whether it is obligated to replace the acquiree awards. This determination is made based on whether the acquiree or its grantees have the ability to enforce replacement. If there is no replacement obligation and the acquiree awards would have expired or been terminated on the acquisition date under those awards' original terms, any voluntary replacement of those awards would be considered a new award and the entire fair value-based measure of the new award would be recognized as compensation cost by the acquirer.

On the other hand, if the acquirer voluntarily replaces acquiree share-based payment awards that would not otherwise expire or terminate on the acquisition date under those awards' original terms, in most cases we believe the accounting results will be similar to situations in which a replacement obligation exists (see discussion below).

ASC 805 includes specific guidance on how to allocate replacement awards that are issued to an acquiree's employees and nonemployees in exchange for goods or services between consideration transferred in a business combination and post-combination compensation cost. This guidance is included in section 6.3.2.1 for employee awards and in section 6.3.2.2 for nonemployee awards.

6.3.2.1 Acquirer is obligated to replace acquiree's share-based payment awards issued to employees (updated June 2022)

Excerpt from Accounting Standards Codification

Business Combinations — Goodwill or Gain from Bargain Purchase, Including Consideration Transferred

Initial Measurement

805-30-30-11

To determine the portion of a replacement award that is part of the consideration transferred for the acquiree, the acquirer shall measure both the replacement awards granted by the acquirer and the acquiree awards as of the acquisition date in accordance with Topic 718. The portion of the fair-value-based measure of the replacement award that is part of the consideration transferred in exchange for the acquiree equals the portion of the acquiree award that is attributable to precombination vesting.

805-30-30-12

The acquirer shall attribute a portion of a replacement award to postcombination vesting if it requires postcombination vesting, regardless of whether grantees had rendered all of the service or delivered all of the goods required in exchange for their acquiree awards before the acquisition date. The portion of a nonvested replacement award attributable to postcombination vesting equals the total fair-value-based measure of the replacement award less the amount attributed to precombination vesting. Therefore, the acquirer shall attribute any excess of the fair-value-based measure of the replacement award over the fair value of the acquiree award to postcombination vesting.

805-30-30-13

Paragraphs 805-30-55-6 through 55-13, 805-740-25-10 through 25-11, 805-740-45-5 through 45-6, and Example 2 (see paragraph 805-30-55-17) provide additional guidance and illustrations on distinguishing between the portion of a replacement award that is attributable to precombination vesting, which the acquirer includes in the consideration transferred in the business combination, and the portion that is attributed to postcombination vesting, which the acquirer recognizes as compensation cost in its postcombination financial statements.

Implementation Guidance and Illustrations

805-30-55-8

The portion of an employee replacement award attributable to precombination vesting is the fair-value-based measure of the acquiree award multiplied by the ratio of the precombination employee's service period to the greater of the total service period or the original service period of the acquiree award. (Example 2, Cases C and D [see paragraphs 805-30-55-21 through 55-24] illustrate that calculation.) The total service period is the sum of the following amounts:

a. The part of the employee's **requisite service period** for the acquiree award that was completed before the acquisition date

b. The postcombination employee's requisite service period, if any, for the replacement award.

805-30-55-9

The employee's requisite service period includes explicit, implicit, and derived service periods during which employees are required to provide service in exchange for the award (consistent with the requirements of Topic 718).

805-30-55-10

The portion of a nonvested replacement award (for employee and nonemployee) attributable to postcombination vesting, and therefore recognized as compensation cost in the postcombination financial statements, equals the total fair-value-based measure of the replacement award less the amount attributed to precombination vesting. Therefore, the acquirer attributes any excess of the fair-value-based measure of the replacement award over the fair value of the acquiree award to postcombination vesting and recognizes that excess as compensation cost in the postcombination financial statements.

As discussed in section 3.4.3, share-based payment awards are an exception to the fair value measurement principle of ASC 805. Rather, they are measured using a fair value-based measure of the awards as that term is used in ASC 718. The fair value-based measure of both the original acquiree awards and the replacement awards are measured as of the acquisition date and, if the acquirer is obligated to replace the acquiree's share-based payment awards, allocated between consideration transferred and compensation for post-combination services.

The portion of the replacement award that is included in the consideration transferred is the fair value-based measure, determined at the acquisition date, of the acquiree award attributable to precombination service. The difference between the fair value-based measure of the replacement award and the amount included in consideration transferred is recognized as compensation cost in the acquirer's post-combination financial statements.

The approach of splitting the fair value-based measure of the replacement award into consideration transferred and compensation cost in ASC 805 is intended to preclude recognition of any amounts in excess of what the employees had earned as of the acquisition date as consideration transferred. That is, any excess of the fair value-based measure of the replacement awards over the fair value-based measure of the acquiree awards is recognized as post-combination compensation cost by the acquirer. Also, if the requisite service (i.e., vesting) period is reduced, the effect of such a reduction in service period is recognized as post-combination compensation cost by the acquirer.

To achieve this, the measurement of the portion of the fair value-based measure of the replacement award that is attributed to precombination service (and therefore included in consideration transferred) is calculated based on:

- The acquisition-date fair value-based measure of the acquiree award determined in accordance with the provisions of ASC 718
- The lesser of the portion of the precombination service period completed on the acquisition date under the terms of (1) the acquiree award or (2) the replacement award

Because of the requirement in the first criterion above to measure consideration transferred based on the fair value-based measure of the *acquiree* award, any excess value of the replacement award over the value of the acquiree award is excluded from consideration transferred and, therefore, recognized as post-combination compensation cost.

As discussed above, ASC 805 requires an allocation of the fair value-based measure of the share-based payment to pre- and post-combination service, with the value attributable to precombination service included in the consideration transferred and the value attributable to post-combination service recognized as compensation cost by the acquirer.

The classification of the share-based payment award as either equity or a liability does not affect the attribution of the fair value-based measure of the replacement award to pre- and post-combination service. However, if the share-based payment awards of the acquiree were modified in connection with a business combination, this may result in the reclassification of an equity award to a liability award. See section 8.6.1 of our FRD, ***Share-based payment***, for additional guidance on how to account for a modification that changes the classification of an award from equity to liability.

The portion of the replacement award issued to the acquiree's employees that is attributable to precombination service and, therefore, included in the consideration transferred, is calculated as follows:

$$\text{Acquisition-date fair value-based measure of the acquiree's replaced award} \times \frac{\text{Precombination service period}}{\text{The greater of: (1) the total service period or (2) the original service period of the acquiree's replaced award}} = \text{Amount attributable to precombination services included in consideration transferred}$$

The total service period is calculated as follows:

Requisite service period[49] for the acquiree's replaced award completed before the acquisition date **+** Post-combination requisite service period, if any, for the acquirer's replacement award **=** Total service period

The portion of the fair value-based measure of the replacement award attributable to post-combination service, and therefore included in post-combination compensation cost, is calculated as follows:

Acquisition-date fair value-based measure of the acquirer's replacement awards **−** Amount attributable to precombination service (as calculated above) **=** Post-combination compensation cost

[49] ASC 805-30-55-9 states, "The employee's requisite service period includes explicit, implicit, and derived service periods during which employees are required to provide service in exchange for the award (consistent with the requirements of Topic 718)."

The following example illustrates this concept:

Illustration 6-8:	**Allocation between pre- and post-combination services of acquiree share-based payment exchanged in a business combination**

Assume that an award was granted two years before the acquisition date with a four-year vesting period. The acquiree award was 50% vested on the acquisition date. Assume the fair value-based measure of the acquiree award and the replacement award each is $100 on the acquisition date. Also assume the replacement award is fully vested on the acquisition date. The amount attributable to precombination service and included in consideration transferred would be $50. [$100 acquisition-date fair value-based measure of acquiree's replaced award x (2 years precombination service / 4 years original service period)]. The original service period is used in the attribution calculation because it is greater than the total service period (the total service period is two years because the replacement award is fully vested on the acquisition date). The amount attributable to post-combination service and recorded as post-combination compensation cost by the acquirer would be $50 ($100 acquisition date fair value-based measure of acquirer's replacement award – $50 attributable to precombination service). Because the replacement award is fully vested, the post-combination compensation cost would be recognized fully on the acquisition date by the acquirer.

If the acquiree's employee is required to render service under the terms of a replacement award, the attribution method will result in a portion of the acquisition-date fair value-based measure of the replacement award being allocated to post-combination compensation cost, even if the employee's acquiree award was fully vested as of the acquisition date. The examples in sections 6.3.3.2 through 6.3.3.4 expand on the concepts described in this section.

6.3.2.1.1 Graded vesting

Some share-based payments are subject to "graded vesting," in which each tranche of the award vests over a different requisite service period. For example, an award may be subject to graded annual vesting over four years such that 25% of the award vests each year.

ASC 805-30-55-12 states that "if the replacement award for an employee award has a graded vesting schedule, the acquirer shall recognize the related compensation cost in accordance with its policy election for other awards with graded vesting in accordance with paragraph 718-10-35-8."

Under ASC 718, the cost of awards subject to graded vesting based only on a service condition may be attributed (1) as if each vesting tranche were a separate award (often called the "accelerated method") or (2) on a straight-line basis. For example, if the award subject to four-year annual graded vesting were measured at $400, expense recognition would be as follows:

	Year 1	**Year 2**	**Year 3**	**Year 4**
Accelerated method	$100+$50+$33+$25 = $208[50]	$50+$33+$25 = $108	$33+$25 = $58	$25
Straight-line method	$400÷4 = $100	$400÷4 = $100	$400÷4 = $100	$400÷4 = $100

We believe that an acquirer must use its attribution policy (i.e., the accelerated or straight-line method) for purposes of attributing the cost of a replacement award subject to graded vesting to consideration transferred and post-combination compensation cost.

[50] Calculated as 100% of the year 1 vesting tranche, 50% of the year 2 vesting tranche, 33% of the year three vesting tranche and 25% of the year four vesting tranche. Note that the total of the columns under the accelerated method do not equal $400 due to rounding.

For example, assume that the original share-based payment award in Illustration 6-8 above was subject to graded vesting. If the acquisition date was at the end of year 2 and both the acquirer and the acquiree awards were measured at $400, the split between consideration transferred and post-combination compensation cost would be calculated based on the attribution policy of the acquirer, as follows:

	Consideration transferred	Post-combination compensation cost
Accelerated method	$208 + $108 = $316	$400 – $316 = $84
Straight-line method	$100 + $100 = $200	$400 – $200 = $200

Applying the acquirer's accounting policy for purposes of attributing the total cost of the replacement award to consideration transferred and post-combination compensation cost could result in some compensation cost never being recognized by either party or some compensation cost being recognized by both parties. Using the numbers in the above example, if the acquiree's policy was straight-line and the acquirer's policy was the accelerated method then a portion of the cost of the total award (in this case $116) is subsumed into the consideration transferred and not recognized in either the acquirer's or the acquiree's income statement. Conversely, if the acquiree's policy was the accelerated method and the acquirer's policy was straight-line, there would be $116 of expense recognized in both the acquiree's and acquirer's income statements.

6.3.2.1.2 Accounting for forfeitures (updated June 2022)

Excerpt from Accounting Standards Codification

Business Combinations — Goodwill or Gain from Bargain Purchase, Including Consideration Transferred

Implementation Guidance and Illustrations

805-30-55-11

Regardless of the accounting policy elected in accordance with paragraph 718-10-35-1D or 718-10-35-3, the portion of a nonvested replacement award included in consideration transferred shall reflect the acquirer's estimate of the number of replacement awards for which the service is expected to be rendered or the goods are expected to be delivered (that is, an acquirer that has elected an accounting policy to recognize forfeitures as they occur in accordance with paragraph 718-10-35-1D or 718-10-35-3 should estimate the number of replacement awards for which the service is expected to be rendered or the goods are expected to be delivered when determining the portion of a nonvested replacement award included in consideration transferred). For example, if the fair-value-based measure of the portion of a replacement award attributed to precombination vesting is $100 and the acquirer expects that the service will be rendered for only 95 percent of the instruments awarded, the amount included in consideration transferred in the business combination is $95. Changes in the number of replacement awards for which the service is expected to be rendered or the goods are expected to be delivered are reflected in compensation cost for the periods in which the changes or forfeitures occur—not as adjustments to the consideration transferred in the business combination. If an acquirer's accounting policy is to account for forfeitures as they occur, the amount excluded from consideration transferred (because the service is not expected to be rendered or the goods are not expected to be delivered) should be attributed to the postcombination vesting and recognized in compensation cost over the employee's requisite service period or the nonemployee's vesting period. Recognition of compensation cost for nonemployees should consider the recognition guidance provided in paragraph 718-10-25-2C. That is, recognition of the fair value of the nonemployee share-based payment award should be recognized in the same manner as if the grantor had paid cash for the goods or services instead of paying with or using the share-based payment awards.

805-30-55-12

Similarly, the effects of other events, such as modifications or the ultimate outcome of awards with performance conditions, that occur after the acquisition date are accounted for in accordance with Topic 718 in determining compensation cost for the period in which an event occurs. If the replacement award for an employee award has a graded vesting schedule, the acquirer shall recognize the related compensation cost in accordance with its policy election for other awards with graded vesting in accordance with paragraph 718-10-35-8.

805-30-55-13

The same requirements for determining the portions of a replacement award attributable to precombination and postcombination vesting apply regardless of whether a replacement award is classified as a liability or an equity instrument in accordance with the provisions of paragraphs 718-10-25-6 through 25-19A. All changes in the fair-value-based measure of awards classified as liabilities after the acquisition date and the related income tax effects are recognized in the acquirer's postcombination financial statements in the period(s) in which the changes occur.

An entity may elect to account for forfeitures as they occur (e.g., when an employee leaves the entity) or to estimate expected forfeitures and adjust the estimate when it is likely to change. However, in a business combination, consideration transferred is recognized only for replacement awards expected to vest. For example, if consideration transferred without regard to forfeitures was measured as $100, but only 90% of the awards were expected to vest, only $90 would be recognized as consideration transferred. Any changes subsequent to the acquisition date in expected forfeitures, other than qualifying measurement period adjustments (see further discussion in section 7.3), are recognized in the results of operations as an adjustment to post-combination compensation cost recognized in the financial statements. Such changes in estimate do not result in an adjustment to the accounting for the business combination.

Therefore, regardless of its accounting policy election for forfeitures, the acquirer will reduce the nonvested replacement awards attributable to precombination service and included in consideration transferred for its estimate at the acquisition date of the number of replacement awards that are expected to be forfeited. However, the acquirer's accounting policy election for forfeitures will affect the accounting for post-combination compensation cost as follows:

- An acquirer that elects to estimate forfeitures of awards also will reduce the number of replacement awards attributable to post-combination service for its acquisition date estimate of the number of replacement awards expected to be forfeited. Any changes in expected forfeitures after the acquisition date are recognized in compensation cost for the periods in which the changes in estimates occur rather than as an adjustment to the consideration transferred.
- An acquirer that elects to recognize forfeitures of awards as they occur will attribute the amount excluded from consideration transferred to post-combination service and recognize it in compensation cost over the post-combination service period. Any forfeitures of replacement awards are reflected in compensation cost for the periods in which the forfeitures occur rather than as adjustments to the consideration transferred.

Illustration 6-9:	Accounting for replacement of an acquiree share-based payment award if the acquirer elects to estimate the number of forfeitures expected to occur

Company C acquires Target Company. Company C is obligated to replace a share-based payment award that Target Company granted to its employees three years before the acquisition date and elects to estimate the number of forfeitures expected to occur. The original award has a four-year cliff vesting period. As of the acquisition date, Target Company's employees had rendered three years' service, and the replacement award requires those employees to provide one year of post-combination service. The total fair value of Target Company's awards and the replacement awards each is $200 on the acquisition date. At the acquisition date, Company C estimates that the requisite service period will be rendered for 90% of the awards, and 10% will be forfeited before the end of the requisite service period. Company C estimates expected forfeitures for its share-based payments.

The amount attributable to precombination service and included in consideration transferred is $135 [$200 acquisition date fair value of Target Company's replaced award x (1 - 10% forfeiture rate) x (three years precombination service / four-year service period)].

The amount attributable to post-combination service and recorded as post-combination compensation expense by Company C is $45 [$200 acquisition date fair value of Company C's replacement award x (1 - 10% forfeiture rate) – $135 included in consideration transferred]. The post-combination compensation cost is recognized over the remaining one-year service period. Any changes in the 10% forfeiture estimate are reflected as an adjustment to compensation cost as those changes occur.

Illustration 6-10:	Accounting for replacement of an acquiree share-based payment award if the acquirer elects to account for forfeitures as they occur

Assume the same facts as in illustration 6-9, except that Company C has elected to account for forfeitures as they occur.

The amount attributable to precombination service and included in consideration transferred is $135 [$200 acquisition date fair value of Target Company's replaced award x (1 - 10% forfeiture rate) x (three years precombination service / four-year service period)].

The amount attributable to post-combination service and recorded as post-combination compensation expense by Company C is $65 ($200 acquisition date fair value of its replacement award – $135 included in consideration transferred). The post-combination compensation cost is recognized over the remaining one-year requisite service period. The effects of any forfeitures are reflected as a reduction to compensation cost as they occur.

6.3.2.1.3 Acquiree awards with change-in-control provisions

6.3.2.1.3.1 Preexisting change-in-control provision results in automatic acceleration of vesting

If an acquiree's awards contain a preexisting change-in-control provision that result in the awards automatically fully vesting upon consummation of a business combination (i.e., the terms of the acquiree awards contain change-in-control provisions that automatically accelerate vesting) and the replacement award does not require future service for vesting, then the acquisition-date fair value-based measure of the replaced acquiree awards is recognized as consideration transferred. As noted above, the portion of replacement awards attributable to precombination service is the acquisition-date fair value-based measure of the replaced awards multiplied by the ratio of the precombination service period to the greater of the (1) total service period or (2) original service period of the replaced awards. Because all of the service would have been performed in the precombination period and there would be no requirement for future service (because the awards would be fully vested), the entire fair value-based measure of the replaced acquiree awards would be attributable to precombination service and included in consideration transferred. This is illustrated below.

Illustration 6-11: Original share-based payment award provides for accelerated vesting upon a change in control

Acquirer exchanges replacement awards for Target's awards (both with an acquisition-date fair value-based measure of $200,000). No post-combination service is required for the replacement awards. Target's awards contained a change in control clause, which automatically accelerated vesting in the awards upon closing of an acquisition. When originally granted, Target's awards provided for cliff vesting after a service period of four years. Two years of the original service period had elapsed before the acquisition.

Analysis

Because the terms of the original award provided for accelerated vesting in the event of a change in control, the acquisition results in a reduction in the requisite service period (original service period) from four years to two years. Additionally, because no post-combination service by Target's employees is required, the total service period is two years. Therefore, the entire fair value-based measure of Acquiree's replaced awards is attributable to precombination service and included in the consideration transferred in the business combination [$200,000 = $200,000 x (2 / 2 years)].

If the replacement awards of Acquirer had a fair value-based measure greater than $200,000, any excess would have been recognized immediately as compensation cost in the post-combination financial statements of the combined company.

6.3.2.1.3.2 Change-in-control provisions added to acquiree awards in contemplation of a business combination

In some situations, a modification to share-based payment awards is made that adds a change-in-control provision in contemplation of a business combination. A careful analysis of all of the facts and circumstances related to the terms of the acquiree awards should be performed to determine if the modification should be accounted for separately from the business combination (i.e., as post-combination compensation cost). Factors that may be considered include, but are not limited to, the business purpose of the modification (i.e., who will benefit from the modification to the terms of the award) as well as who initiated the modification (i.e., the acquiree or the acquirer). In general, we believe a modification that is initiated by the acquirer or is subject to the approval of the acquirer is primarily for the benefit of the combined entity and therefore should be accounted for as a separate transaction.

If the modification is initiated by the acquiree, we believe the assessment of whether the modification to add a provision to accelerate vesting upon a change in control should be accounted for as a separate transaction will depend on whether the modification was executed independent of the business combination. If the modification is executed independent of the business combination, that would indicate that the modification is primarily for the benefit of the acquiree and therefore any acceleration of vesting upon the change in control would be accounted for as part of the business combination (see section 6.3.2.1.3.1). On the other hand, if the modification is executed in contemplation of the business combination, we generally believe that the modification is primarily for the benefit of the combined entity and therefore should be accounted for as a separate transaction. In such situations, we believe that generally the acquirer is effectively approving the modification through the terms of the purchase agreement. In addition, absent a valid business purpose for the modification, it will be rare that it will be deemed independent of the business combination.

See further discussion on what is considered a part of the business combination in section 3.4.1.2.

Illustration 6-12: Original share-based payment award is modified to provide for accelerated vesting upon a change in control

Acquirer exchanges replacement awards for Target's awards (both with an acquisition-date fair value-based measure of $200,000). Shortly before the acquisition, Target modifies its awards to add a change in control clause, which automatically accelerates vesting in the awards upon closing of an acquisition and, therefore, no post-combination service is required for the replacement awards. When originally granted, Target's awards provided for cliff vesting after a service period of four years. Two years of the original service period had elapsed before the acquisition. Acquirer determines that the modification should be accounted for as a transaction separate from the business combination considering the guidance in ASC 805-10-25-20 through 25-23. This illustration excludes the consideration of forfeitures.

Analysis

Because the modification is accounted for as a separate transaction, the amount attributable to precombination service and included in consideration transferred would be $100,000. [$200,000 acquisition date fair value-based measure of acquiree's replaced award x (2 years precombination service / 4 years original service period)]. The original service period is used in the attribution calculation because it is greater than the total service period (the total service period is two years because no post-combination service by Target's employees is required). The amount attributable to post-combination service and recorded as post-combination compensation cost by the acquirer would be $100,000 ($200,000 acquisition date fair value-based measure of acquirer's replacement award – $100,000 attributable to precombination service). Because vesting in the replacement award is accelerated, the entire post-combination compensation cost would be recognized on the acquisition date by the acquirer.

If the replacement awards of Acquirer had a fair value-based measure greater than the acquisition-date fair value-based measure of Target's award of $200,000, any excess would have been recognized immediately as compensation cost in the post-combination financial statements of the combined company.

6.3.2.1.3.3 *Discretionary change-in-control provisions*

When acquiree awards contain a discretionary change-in-control provision, we believe careful consideration should be given to whether a portion of the fair value-based measure of the awards should be recognized as post-combination compensation cost. A change-in-control provision can provide an acquirer with discretion on whether to replace the acquiree awards both by requiring an action or inaction of the acquirer. For example, if the acquiree awards contain a change-in-control provision that accelerates vesting subject to the acquirer's approval, the acquirer recognizes the acceleration of vesting as a transaction separate from the business combination (e.g., post-combination compensation cost). We believe that acquiree awards that have a provision that triggers accelerated vesting if the acquirer doesn't replace the awards should be treated similarly. Although the acquirer didn't approve the accelerated vesting, it implicitly approved the acceleration by electing not to replace the awards.

In addition, if the acquiree awards provide the acquiree with discretion on whether to replace the acquiree awards and the acquiree accelerates vesting in contemplation of the business combination, we believe similar considerations to those discussed in section 6.3.2.1.3.2 would apply. Factors that may be considered include, but are not limited to, the business purpose of the decision to accelerate vesting (i.e., who will benefit from this decision) as well as who decided to accelerate the vesting (i.e., the acquiree or the acquirer). In general, we believe a decision made by the acquirer or that is subject to the approval of the acquirer is primarily for the benefit of the combined entity and therefore should be accounted for as a separate transaction. If the decision is initiated by the acquiree, we believe the assessment also may depend on whether the decision was made independent of the business combination.

6.3.2.1.4 *Acquirer accelerates vesting after the acquisition date*

An acquirer's decision to immediately vest or reduce the future service period of awards held by employees of the acquiree does not affect the portion of the fair value-based measure of the replacement awards that is attributable to post-combination service and therefore included in post-combination compensation cost. Rather, it affects the timing of the recognition of post-combination compensation cost. For example, if the acquirer decides to immediately vest the replacement awards, the portion of the fair value-based measure of the awards attributable to post-combination service would be immediately recognized as compensation cost in the acquirer's post-combination financial statements. This concept is illustrated in section 6.3.3.4.

6.3.2.1.5 *Exchange of awards with performance conditions*

When an acquirer replaces a share-based payment award that has a performance condition with an award that also has a performance condition, the same general guidance for awards with service conditions is followed (as discussed above), except that the probability of the performance condition being achieved is also considered. Consistent with that guidance, any excess value is recognized in the post-combination financial statements. The determination of the fair value-based measure attributable to precombination and post-combination services also is consistent with the analysis performed for awards with service conditions. The amount attributable to precombination services is determined by multiplying the fair value-based measure of the acquiree award by the ratio of the precombination service period completed prior to the exchange to the greater of the total service period of the replacement award or the original service period of the acquiree award. The amount attributable to post-combination services is then calculated by subtracting the portion attributable to precombination services from the total fair value-based measure of the acquirer's replacement award. However, the determination of the total service period for the replacement award includes consideration of the performance condition and the implicit service period in which it is probable that the performance condition will be achieved. The acquirer will need to make a probability assessment at the acquisition date. This concept is illustrated below.

Illustration 6-13: Exchange of an award with a performance condition

Acquirer exchanges replacement awards with a fair value-based measure of $425,000 for Target's awards with a fair value-based measure of $400,000. Acquirer was obligated to issue replacement awards under the terms of the acquisition agreement. Target's original awards cliff vest based on Target's product gaining a specified market share percentage (the replacement awards contain the same performance condition). Prior to the acquisition, Target had assessed the performance condition and concluded it was probable that it would be achieved four years from the grant date. As of the acquisition date, one year has passed since the grant date; therefore, three years remain in the original implicit service period. Acquirer assessed the performance condition on the acquisition date and determined it is probable that the performance condition will be achieved three years from the grant date (two years from the acquisition date).

Similar to an award with only a service condition, the amount of Acquirer's replacement awards attributable to precombination services is equal to the fair value-based measure of Target's awards at the acquisition date, multiplied by the ratio of the precombination service period to the greater of the total service period of the replacement award or the original service period of Target's awards. The original service period of Target's awards was four years. At the acquisition date, Acquirer determined that it is probable the performance condition will be completed in two years; therefore, the awards will have a total service period of three years. Because the original service period (four years) is greater than the total service period (three years), the original service period is used in the attribution calculation. The amount attributable to precombination services is $100,000 [$400,000 acquisition-date fair value-based measure of Target's awards x (one-year precombination service / four-year original service period)]. The amount attributable to post-combination services of $325,000 ($425,000 acquisition-date fair value-based measure of replacement awards – $100,000 amount attributable to precombination service) would be recognized in the post-combination financial statements over the remaining service period of two years.

If, at the acquisition date, it is not probable that the performance conditions will be met for either the acquiree's awards or the acquirer's replacement awards, then no amount is recognized as either pre- or post-combination service. If, in a period subsequent to the acquisition date, it becomes probable that the performance conditions for the replacement awards will be achieved, the acquirer recognizes the related cumulative compensation cost in the post-combination financial statements in which such period falls. That is, the acquirer does not make adjustments to the consideration transferred in the business combination or the compensation cost recognized in the previously issued post-combination financial statements.

6.3.2.1.6 Exchange of awards with market conditions

Similar to exchanges of awards with performance conditions, the accounting for awards with market conditions follows the same guidance as awards with service conditions (as discussed above). Because a market condition is reflected in the fair value-based measure of an award, the market condition should be taken into consideration when calculating the fair value-based measure of the replaced acquiree award and the acquirer's replacement award. Consistent with the guidance for awards with service conditions, any excess value (i.e., the excess of the fair value-based measure of the replacement awards over the replaced acquiree awards) is recognized as compensation cost in the post-combination financial statements. However, unlike awards with performance conditions, provided that the requisite service is rendered, post-combination compensation expense is recognized even if the market condition is not achieved.

The determination of the portion of the fair value-based measure attributable to precombination and post-combination services is consistent with the analysis performed for awards with service conditions. However, the determination of the post-combination service period for the replacement award includes consideration of the market condition and the related explicit or derived service period.

6.3.2.2 Acquirer is obligated to replace acquiree's share-based payment awards issued to nonemployees (updated June 2022)

Excerpt from Accounting Standards Codification

Business Combinations — Goodwill or Gain from Bargain Purchase, Including Consideration Transferred

Initial Measurement

805-30-30-11

To determine the portion of a replacement award that is part of the consideration transferred for the acquiree, the acquirer shall measure both the replacement awards granted by the acquirer and the acquiree awards as of the acquisition date in accordance with Topic 718. The portion of the fair-value-based measure of the replacement award that is part of the consideration transferred in exchange for the acquiree equals the portion of the acquiree award that is attributable to precombination vesting.

805-30-30-12

The acquirer shall attribute a portion of a replacement award to postcombination vesting if it requires postcombination vesting, regardless of whether grantees had rendered all of the service or delivered all of the goods required in exchange for their acquiree awards before the acquisition date. The portion of a nonvested replacement award attributable to postcombination vesting equals the total fair-value-based measure of the replacement award less the amount attributed to precombination vesting. Therefore, the acquirer shall attribute any excess of the fair-value-based measure of the replacement award over the fair value of the acquiree award to postcombination vesting.

805-30-30-13

Paragraphs 805-30-55-6 through 55-13, 805-740-25-10 through 25-11, 805-740-45-5 through 45-6, and Example 2 (see paragraph 805-30-55-17) provide additional guidance and illustrations on distinguishing between the portion of a replacement award that is attributable to precombination vesting, which the acquirer includes in the consideration transferred in the business combination, and the portion that is attributed to postcombination vesting, which the acquirer recognizes as compensation cost in its postcombination financial statements.

Implementation Guidance and Illustrations

805-30-55-9A

The portion of a nonemployee replacement award attributable to precombination vesting is based on the fair-value-based measure of the acquiree award multiplied by the percentage that would have been recognized had the grantor paid cash for the goods or services instead of paying with a nonemployee award. For this calculation, the percentage that would have been recognized is the lower of:

a. The percentage that would have been recognized calculated on the basis of the original vesting requirements of the nonemployee award

b. The percentage that would have been recognized calculated on the basis of the effective vesting requirements. Effective vesting requirements are equal to the services or goods provided before the acquisition date plus any additional postcombination services or goods required by the replacement award.

805-30-55-10

The portion of a nonvested replacement award (for employee and nonemployee) attributable to postcombination vesting, and therefore recognized as compensation cost in the postcombination financial statements, equals the total fair-value-based measure of the replacement award less the amount attributed to precombination vesting. Therefore, the acquirer attributes any excess of the fair-value-based measure of the replacement award over the fair value of the acquiree award to postcombination vesting and recognizes that excess as compensation cost in the postcombination financial statements.

As discussed in section 6.3.1, share-based payment awards issued to nonemployees are an exception to the fair value measurement principle of ASC 805. Rather, they are measured using a fair value-based measure of the awards as that term is used in ASC 718. The fair value-based measure of both the original acquiree awards and the replacement awards are measured as of the acquisition date and, if the acquirer is obligated to replace the acquiree's share-based payment awards, allocated between consideration transferred in the business combination and compensation cost recognized in the post-combination period. ASC 805-30-55-9A specifies how awards to nonemployees should be allocated between consideration transferred and compensation cost. Illustrations for nonemployee share-based payment awards subject to ASC 805 are included in section 6.3.4.

6.3.2.3 Acquirer does not replace acquiree's share-based payment awards (i.e., acquiree awards remain outstanding)

We believe that if the acquiree becomes a subsidiary of the acquirer and the share-based payments classified as equity remain outstanding (i.e., those awards remain an obligation of the new subsidiary), those awards represent noncontrolling interests in the subsidiary. Accordingly, the acquirer remeasures the acquiree's awards, and any other noncontrolling interests, in accordance with the guidance in ASC 805-30-30-1(a)(2) as of the acquisition date.

ASC 805 does not explicitly address the remeasurement of noncontrolling interest that is not fully vested. We believe that, similar to the accounting for replacement awards issued in the business combination, the portion of the acquisition-date fair value-based measure of the share-based payments that is attributable to precombination service (or vesting) is recognized as noncontrolling interest and the portion relating to any remaining post-combination service (or vesting) is recognized as compensation cost[51] in the post-combination financial statements. The following example illustrates the concept of recognizing noncontrolling interests for acquiree awards that are not replaced in a business combination:

[51] As the options vest they may be recognized as noncontrolling interest in the consolidated financial statements. Other alternatives may also be acceptable.

Illustration 6-14: Acquirer does not replace acquiree awards

Acquirer acquires 100% of the outstanding common shares of Target in a business combination. Acquirer does not replace Target's awards. The fair value-based measure of the Target awards on the acquisition date is $180,000. The Target awards vest over five years, and the employees of Target have performed only two years of service under these awards on the acquisition date. This illustration excludes the consideration of forfeitures.

In the business combination, Acquirer recognizes noncontrolling interest for the portion of the fair value-based measure of the Target awards that is attributable to precombination service. This calculation results in $72,000 [$180,000 x (2 / 5 years)] being attributed to precombination services and recognized as noncontrolling interest. The remaining fair value-based measure of the Target awards ($108,000) is attributed to post-combination service and is recognized as compensation cost over the remaining service period (three years) in accordance with ASC 718.[52] If the Acquirer replaces the Target awards with its own awards subsequent to the acquisition date, the replacement is accounted for as a modification in accordance with ASC 718 and the previously recognized noncontrolling interest is reclassified within equity in accordance with ASC 810-10.

If the acquirer replaces the awards subsequent to the acquisition date, the replacement is considered a modification in accordance with the provisions of ASC 718. Upon replacement of an award that the acquirer was not obligated to replace, the acquirer recognizes a transaction with the noncontrolling interest holder in accordance with ASC 810-10 and generally measures additional compensation cost equal to the excess of the fair value-based measure of the replacement award over the fair value-based measure of the acquiree award[53] as of the replacement date in accordance with the requirements of ASC 718 as described in section 8 of our FRD, ***Share-based payment***.

We believe that the approach described above results in similar cost recognition for the acquirer regardless of whether or not the acquirer is obligated to replace the acquiree's share-based payment awards (except in the circumstances described in section 6.3.2.4 below).

6.3.2.4 Acquiree share-based payment awards expire as a result of the business combination

Excerpt from Accounting Standards Codification

Business Combinations — Goodwill or Gain from Bargain Purchase, Including Consideration Transferred

Initial Measurement

805-30-30-10

In situations in which acquiree awards would expire as a consequence of a business combination and the acquirer replaces those awards even though it is not obligated to do so, all of the fair-value-based measure of the replacement awards shall be recognized as compensation cost in the postcombination financial statements. That is, none of the fair-value-based measure of those awards shall be included in measuring the consideration transferred in the business combination.

If the acquiree's share-based payment awards expire as a result of the business combination, and the acquirer chooses to replace the acquiree's awards, the entire amount of the fair value-based measure of the replacement award is recognized as compensation cost in the post-combination financial statements. However, we do not believe it is common for share-based payment awards to expire as a result of a business combination.

---

[52] ASC 805-30-55-9 states, "The employee's requisite service period includes explicit, implicit, and derived service periods during which employees are required to provide service in exchange for the award (consistent with the requirements of Topic 718)."

[53] The portion of the acquisition-date fair value-based measure of the acquiree award that relates to post-combination vesting continues to be recognized as compensation cost.

6.3.2.5 Income tax effects of replacement awards classified as equity (updated June 2022)

Excerpt from Accounting Standards Codification

Business Combinations — Income Taxes

Recognition

805-740-25-10

Paragraph 805-30-30-9 identifies the types of awards that are referred to as replacement awards in the Business Combinations Topic. For a replacement award classified as equity that ordinarily would result in postcombination tax deductions under current tax law, an acquirer shall recognize a deferred tax asset for the deductible temporary difference that relates to the portion of the **fair-value**-based measure attributed to a precombination exchange of goods or services and therefore included in consideration transferred in the business combination.

805-740-25-11

For a replacement award classified as equity that ordinarily would not result in tax deductions under current tax law, an acquirer shall recognize no deferred tax asset for the portion of the fair-value-based measure attributed to precombination vesting and thus included in consideration transferred in the business combination. A future **event**, such as an employee's disqualifying disposition of shares under a tax law, may give rise to a tax deduction for instruments that ordinarily do not result in a tax deduction. The tax effects of such an event shall be recognized only when it occurs.

Other Presentation Matters

805-740-45-5

Paragraph 805-30-30-9 identifies the types of awards that are referred to as replacement awards in this Topic. After the acquisition date, the deduction reported on a tax return for a replacement award classified as equity may be different from the **fair-value**-based measure of the award. The tax effect of that difference shall be recognized as income tax expense or benefit in the income statement of the acquirer.

To the extent that the cost of replacement awards classified as equity in a business combination is considered part of consideration transferred, related deferred taxes are recognized in the business combination if the replacement award is expected to result in a future tax deduction under existing tax law. To the extent that the cost of such replacement awards is recognized as post-combination compensation cost, a deferred tax asset would generally be established (through income tax expense) as that compensation cost is recognized. See section 21.7.1 of our FRD, ***Income taxes***, for further discussion.

6.3.2.6 Cash settlement of acquiree share-based payment awards

Instead of replacing acquiree awards with acquirer awards, an acquirer might settle acquiree share-based payment awards by payment of cash or the issuance of acquirer notes. From the acquirer's perspective, the settlement amount should be accounted for as an element of the consideration transferred unless (1) the fair value of cash paid or notes issued exceeds the fair value-based measure of the settled acquiree awards or (2) the settled acquiree awards were not vested at the acquisition date (i.e., the acquirer settles unvested awards).

If the present value of cash paid or notes issued exceeds the fair value-based measure of the settled acquiree awards, the excess is accounted for by the acquirer as post-combination compensation cost.

If the settled acquiree awards were not fully vested, we believe that the effects of the settlement of the awards should be segregated between consideration transferred and post-combination compensation cost based on the guidance described in section 6.3.2.1 and section 6.3.2.2 above. In these circumstances, the acquirer has effectively accelerated the vesting of the awards by eliminating the post-combination service requirement and settling the awards for cash.

If there are conditions inherent in the settlement arrangement that might result in forfeiture of the settlement amount, those conditions will require that all or a portion of the settlement amount be accounted for as post-combination compensation cost, based on the framework described in sections 6.3.2 and 6.4.5.

If an acquirer directly settles acquiree awards held by employees or nonemployees of the acquiree, we generally do not believe that any resulting compensation cost should be recognized in the acquiree's financial statements during the reporting period that precedes or includes the date of acquisition (i.e., predecessor financial statements). However, if pushdown accounting is applied in the acquiree's financial statements for reporting periods that include or follow the date of acquisition, the acquiree's new basis of accounting will include, in part, the portion of the payment recognized as consideration transferred by the acquirer. Further, if the grantees receiving the consideration that results in compensation cost to the acquirer (e.g., resulting from acceleration of vesting or incremental fair value to the employees or nonemployees) are employed by a subsidiary that presents separate financial statements, that compensation cost generally would be pushed down to the financial statements of the subsidiary.

If the acquiree elects to cash-settle outstanding awards, careful consideration should be given to whether the settlement was arranged primarily for the economic benefit of the acquirer (or the combined entity) or the acquiree. Although the form of the transaction may indicate that the acquiree initiated the cash settlement, it may be determined that, in substance, the acquirer reimbursed the acquiree for the cash settlement (either directly or as part of the consideration transferred for the acquiree). See section 6.3.2.1.3.2 for considerations on whether the modification of a share-based payment award that accelerates vesting upon a change in control is primarily for the economic benefit of the acquirer or the acquiree, and to section 3.4.1.2 for broader guidance on evaluating what is part of the business combination.

Illustration 6-15: Allocation between pre- and post-combination services of acquiree share-based payment cash-settled in a business combination

Acquirer acquires Target (acquiree). Acquiree granted its employees an award two years before the acquisition date with a four-year vesting period. The acquiree award was 50% vested on the acquisition date. The fair value-based measure of the acquiree award is $100 on the acquisition date. Acquirer settles the acquiree award for $102 on the acquisition date. The amount attributable to precombination service and included in consideration transferred would be $50. [$100 acquisition date fair value-based measure of acquiree's settled award x (2 years precombination service / 4 years original service period)]. The original service period is used in the attribution calculation because it is greater than the total service period (the total service period is two years because the award is fully settled on the acquisition date). The amount attributable to post-combination service and recorded as post-combination compensation cost by the acquirer would be $52 ($102 cash paid on the acquisition date – $50 attributable to precombination service). The post-combination compensation cost would be recognized fully on the acquisition date by the acquirer.

6.3.2.7 Share-based payments issued to employees that include last-man-standing arrangements

In connection with a business combination, an acquirer may grant to a group of employees share-based payment awards that are reallocated equally among the remaining employees if any of the employees terminate employment prior to completion of the service period (i.e., prior to the awards vesting). These arrangements often are referred to as "last-man-standing" awards, and the forfeiture and subsequent redistribution of the awards are accounted for as (1) the forfeiture of the original award and (2) the grant of a new award. That is, the acquirer would reverse any compensation cost previously recognized for the forfeited award (based on the grant date fair value-based measure) and then recognize compensation cost for the new award (based on the fair value-based measure on the date the award is redistributed) over the remaining requisite service period.

The following example illustrates a "last-man-standing" arrangement.

Illustration 6-16: Last-man-standing arrangements

On 1 January 20X1, Acquirer acquires Target, and as part of the acquisition agreement, grants 200 new share-based payment awards to each of five key employees of Target. The awards vest at the end of the fourth year of service (cliff-vesting) and each set of awards has a fair value of $2,000 as of the acquisition date (which is also the grant date). The provisions of each award state that if employment is terminated before the end of four years (i.e., the vesting date), the employee's awards are forfeited and redistributed among the remaining employees within the group. The total grant date fair value of the awards as of the acquisition date is $10,000 (5 employees × $2,000 grant date fair value), which is recognized in Acquirer's post-combination financial statements as compensation cost over the four-year service period ($2,500 per year). On 31 December 20X2, one of the employees within the group terminates employment and forfeits his awards. The employee's 200 unvested awards are then redistributed equally to the remaining four employees within the group. At the time of the forfeiture, the fair value of each set of awards is $3,000.

On 31 December 20X2, Acquirer would reverse $1,000 (1 employee × $2,000 grant date fair value × 50% of the service period completed) of previously recognized compensation cost corresponding to the forfeited awards. Acquirer would continue to recognize $2,000 in annual compensation expense over the remaining two years of service for the original awards provided to the remaining employees (4 employees × $2,000 grant date fair value / 4 years). In addition, Acquirer would recognize $1,500 in additional annual compensation cost over the remaining two years of service for the redistributed awards ($3,000 grant date fair value / 2 years of remaining service).

6.3.2.8 Recognition of payroll taxes on options exchanged in a business combination

An employer generally is required to pay payroll taxes on the intrinsic value of nonqualified options on the exercise date, and on the fair value of share awards on the vesting date. In a business combination, the acquirer should not recognize as part of purchase accounting the potential liability for employer payroll taxes on awards exchanged in the business combination if the event that triggers measurement and payment of the tax has not occurred as of the consummation date. For example, for a nonqualified stock option in the United States, the obligating event generally is the exercise of the option. Accordingly, if the stock option is not exercised as of the consummation date, a payroll tax liability is not recognized as part of purchase accounting. Furthermore, if the triggering event occurs after the consummation date, no adjustment should be made to purchase accounting. This guidance is consistent with ASC 718-10-25-22 which stipulates that the liability and corresponding expense for employee payroll taxes on employee stock compensation should not be recognized until the obligating event that triggers measurement and payment of the payroll tax to the taxing authority occurs.

6.3.3 Examples: accounting for share-based payments issued to employees in a business combination

The following examples illustrate the accounting for common share-based payment arrangements in business combinations. The examples (sections 6.3.3.1 through 6.3.3.4) are from ASC 805. The examples do not reflect the possible effects of forfeitures or income taxes.

These examples are in addition to (1) Illustration 6-11 included in section 6.3.2.1.3.1, which illustrates a situation where the original share-based payment awards provided for accelerated vesting upon a change in control; (2) Illustration 6-12 included in section 6.3.2.1.3.2, which illustrates a situation where the original share-based payment award is modified to provide for accelerated vesting upon a change in control; (3) Illustration 6-13 included in section 6.3.2.1.5, which illustrates an exchange of an award with a performance condition; (4) Illustration 6-14 included in section 6.3.2.3, which illustrates a situation

where the acquirer does not replace the awards of the acquired company as of the acquisition date, but replaces the acquiree awards at a later date; (5) Illustration 6-15 included in section 6.3.2.6, which illustrates the allocation between pre- and post-combination services of acquiree share-based payment cash-settled in a business combination; and (6) Illustration 6-16 included in section 6.3.2.7, which illustrates a situation where the acquiree share-based payment awards contain last-man-standing provisions.

6.3.3.1 No required post-combination service, all requisite service for acquiree awards rendered as of acquisition date (updated June 2022)

Excerpt from Accounting Standards Codification

Business Combinations — Goodwill or Gain from Bargain Purchase, Including Consideration Transferred

Implementation Guidance and Illustrations

Case A: No Required Postcombination Service, All Requisite Service for Acquiree Awards Rendered as of Acquisition Date

805-30-55-18

Acquirer issues replacement awards of $110 (fair-value-based measure) at the acquisition date for Target awards of $100 (fair-value-based measure) at the acquisition date. No postcombination vesting is required for the replacement awards, and Target's employees had rendered all of the required service for the acquiree awards as of the acquisition date.

805-30-55-19

The amount attributable to precombination vesting is the fair-value-based measure of Target's awards ($100) at the acquisition date; that amount is included in the consideration transferred in the business combination. The amount attributable to postcombination vesting is $10, which is the difference between the total value of the replacement awards ($110) and the portion attributable to precombination vesting ($100). Because no postcombination vesting is required for the replacement awards, Acquirer immediately recognizes $10 as compensation cost in its postcombination financial statements.

6.3.3.2 Post-combination service required, all requisite service for acquiree awards rendered as of acquisition date (updated June 2022)

Excerpt from Accounting Standards Codification

Business Combinations — Goodwill or Gain from Bargain Purchase, Including Consideration Transferred

Implementation Guidance and Illustrations

Case B: Postcombination Service Required, All Requisite Service for Acquiree Awards Rendered as of Acquisition Date

805-30-55-20

Acquirer exchanges replacement awards that require one year of postcombination vesting for share-based payment awards of Target for which employees had completed the requisite service period before the business combination. The fair-value-based measure of both awards is $100 at the acquisition date. When originally granted, Target's awards had a requisite service period of four years. As of the acquisition date, the Target employees holding unexercised awards had rendered a total of seven years of service since the grant date. Even though Target employees had already rendered all of the requisite service, Acquirer attributes a portion of the replacement award to postcombination compensation cost in accordance with paragraphs 805-30-30-12 through 30-13 because the replacement awards require one year of postcombination vesting. The total service period is five years—the requisite service period for the original acquiree award completed before the acquisition date (four years) plus the requisite service period for the replacement award (one year). The portion attributable to precombination vesting equals the fair-value-based measure of the acquiree award ($100) multiplied by the ratio of the precombination vesting period (4 years) to the total vesting

period (5 years). Thus, $80 ($100 × 4 ÷ 5 years) is attributed to the precombination vesting period and therefore included in the consideration transferred in the business combination. The remaining $20 is attributed to the postcombination vesting period and therefore is recognized as compensation cost in Acquirer's postcombination financial statements in accordance with Topic 718.

6.3.3.3 Post-combination service required, all requisite service for acquiree awards not rendered as of acquisition date (updated June 2022)

Excerpt from Accounting Standards Codification

Business Combinations — Goodwill or Gain from Bargain Purchase, Including Consideration Transferred

Implementation Guidance and Illustrations

Case C: Postcombination Service Required, All Requisite Service for Acquiree Awards Not Rendered as of Acquisition Date

805-30-55-21

Acquirer exchanges replacement awards that require one year of postcombination vesting for share-based payment awards of Target for which employees had not yet rendered all of the required services as of the acquisition date. The fair-value-based measure of both awards is $100 at the acquisition date. When originally granted, the awards of Target had a requisite service period of four years. As of the acquisition date, the Target employees had rendered two years' service, and they would have been required to render two additional years of service after the acquisition date for their awards to vest. Accordingly, only a portion of Target's awards is attributable to precombination vesting.

805-30-55-22

The replacement awards require only one year of postcombination vesting. Because employees have already rendered two years of service, the total requisite service period is three years. The portion attributable to precombination vesting equals the fair-value-based measure of the acquiree award ($100) multiplied by the ratio of the precombination vesting period (2 years) to the greater of the total service period (3 years) or the original service period of Target's award (4 years). Thus, $50 ($100 × 2 ÷ 4 years) is attributable to precombination vesting and therefore included in the consideration transferred for the acquiree. The remaining $50 is attributable to postcombination vesting and therefore recognized as compensation cost in Acquirer's postcombination financial statements in accordance with Topic 718.

6.3.3.4 No required post-combination service, all requisite service for acquiree awards not rendered as of acquisition date (updated June 2022)

Excerpt from Accounting Standards Codification

Business Combinations — Goodwill or Gain from Bargain Purchase, Including Consideration Transferred

Implementation Guidance and Illustrations

Case D: No Required Postcombination Service, All Requisite Service for Acquiree Awards Not Rendered as of Acquisition Date

805-30-55-23

Assume the same facts as in Case C, except that Acquirer exchanges replacement awards that require no postcombination vesting for share-based payment awards of Target for which employees had not yet rendered all of the requisite service as of the acquisition date. The terms of the replaced Target awards did not eliminate any remaining requisite service period upon a change in control. (If the Target awards had included a provision that eliminated any remaining requisite service period upon a change in control, the guidance in Case A would apply.) The fair-value-based measure of both awards is $100. Because employees have already rendered two years of service and the replacement awards do not require any postcombination vesting, the total service period is two years.

805-30-55-24

The portion of the fair-value-based measure of the replacement awards attributable to precombination vesting equals the fair-value-based measure of the acquiree award ($100) multiplied by the ratio of the precombination vesting period (2 years) to the greater of the total service period (2 years) or the original service period of Target's award (4 years). Thus, $50 ($100 × 2 ÷ 4 years) is attributable to precombination vesting and therefore included in the consideration transferred for the acquiree. The remaining $50 is attributable to postcombination vesting. Because no postcombination vesting is required to vest in the replacement award, Acquirer recognizes the entire $50 immediately as compensation cost in the postcombination financial statements.

6.3.4 Examples: accounting for share-based payments issued to nonemployees in a business combination (updated June 2022)

6.3.4.1 No required post-combination vesting, vesting condition for acquiree awards has been met as of acquisition date (updated June 2022)

Excerpt from Accounting Standards Codification

Business Combinations — Goodwill or Gain from Bargain Purchase, Including Consideration Transferred

Implementation Guidance and Illustrations

805-30-55-27

The Cases assume the following:

a. All awards are classified as equity.

b. The only vesting condition included in the awards, if any, involves the delivery of engines.

c. Target and Acquirer typically pay cash as each engine is delivered to their suppliers.

Case A: No Required Postcombination Vesting and the Vesting Condition for Acquiree Awards Has Been Met as of Acquisition Date

805-30-55-28

Acquirer issues replacement awards of $110 (fair-value-based measure) at the acquisition date for Target awards of $100 (fair-value-based measure) at the acquisition date. No postcombination vesting is required for the replacement awards, and Target's grantee has delivered all the engines necessary for the acquiree awards as of the acquisition date.

805-30-55-29

The amount attributable to precombination vesting is the fair-value-based measure of Target's awards ($100) at the acquisition date; that amount is included in the consideration transferred in the business combination. The amount attributable to postcombination vesting is $10, which is the difference between the total value of the replacement awards ($110) and the portion attributable to precombination vesting ($100). Because no postcombination vesting is required for the replacement awards, Acquirer immediately recognizes $10 as compensation cost in its postcombination financial statements.

6.3.4.2 Post-combination vesting required, vesting condition for acquiree awards has been met as of acquisition date (updated June 2022)

Excerpt from Accounting Standards Codification

Business Combinations — Goodwill or Gain from Bargain Purchase, Including Consideration Transferred

Implementation Guidance and Illustrations

Case B: Postcombination Vesting Required and the Vesting Condition for Acquiree Awards Has Been Met as of Acquisition Date

805-30-55-30

Acquirer exchanges replacement awards that require the delivery of another 10 engines postcombination for share-based payment awards of Target for which the grantee had met the necessary vesting condition to deliver 40 engines before the business combination. The fair-value-based measure of both awards is $100 at the acquisition date. Even though the grantee already had met the vesting condition for the acquiree's award, Acquirer attributes a portion of the replacement award to postcombination compensation cost in accordance with paragraphs 805-30-30-12 through 30-13 because the replacement awards require the delivery of an additional 10 engines.

805-30-55-31

The portion attributable to precombination vesting equals the fair-value-based measure of the acquiree award ($100) multiplied by the percentage that would have been recognized for the award. The percentage that would have been recognized is the lower of the calculation on the basis of the original vesting requirements and the percentage that would have been recognized on the basis of the effective vesting requirements as described in paragraph 805-30-55-9A. The percentage that would have been recognized on the basis of the original vesting requirements equals 100 percent, which is calculated as 40 engines delivered divided by 40 engines required to be delivered. The percentage that would have been recognized on the basis of the effective vesting requirements equals 80 percent, which is calculated as 40 engines delivered divided by 50 engines (the sum of 40 engines delivered plus 10 engines required postcombination). Thus, $80 ($100 × 80%) is attributed to the precombination vesting period and therefore is included in the consideration transferred in the business combination. The remaining $20 is attributed to the postcombination vesting period and therefore is recognized as compensation cost in Acquirer's postcombination financial statements in accordance with Topic 718.

6.3.4.3 Post-combination vesting required, vesting condition for acquiree awards has not been met as of acquisition date (updated June 2022)

Excerpt from Accounting Standards Codification

Business Combinations — Goodwill or Gain from Bargain Purchase, Including Consideration Transferred

Implementation Guidance and Illustrations

Case C: Postcombination Vesting Required and the Vesting Condition for Acquiree Awards Has Not Been Met as of Acquisition Date

805-30-55-32

Acquirer exchanges replacement awards that require the delivery of 10 engines postcombination for share-based payment awards of Target for which the grantee had not met the necessary vesting condition to deliver 40 engines before the business combination. The fair-value-based measure of both awards is $100 at the acquisition date. As of the acquisition date, Target grantee has delivered 20 engines, and Target grantee would have been required to deliver an additional 20 engines after the acquisition date for its awards to vest. Accordingly, only a portion of Target's awards is attributable to precombination vesting.

805-30-55-33

The portion attributable to precombination vesting equals the fair-value-based measure of the acquiree award ($100) multiplied by the percentage that would have been recognized on the award. The percentage that would have been recognized is the lower of the percentage that would have been recognized on the basis of the original vesting requirements and the percentage that would have been recognized on the basis of the effective vesting requirements as described in paragraph 805-30-55-9A. The percentage that would have been recognized on the basis of the original vesting requirements equals 50 percent, which is calculated as 20 engines delivered divided by 40 engines required to be delivered. The percentage that would have been recognized on the basis of the effective vesting requirements equals 66.67 percent, which is calculated as 20 engines delivered divided by 30 engines (the sum of 20 engines delivered plus 10 engines required postcombination). Thus, $50 ($100 × 50%) is attributed to precombination vesting and therefore is included in the consideration transferred in the business combination. The remaining $50 is attributed to the postcombination vesting and therefore is recognized as compensation cost in Acquirer's postcombination financial statements in accordance with Topic 718.

6.3.4.4 No required post-combination vesting, vesting condition for acquiree awards has not been met as of acquisition date (updated June 2022)

Excerpt from Accounting Standards Codification

Business Combinations — Goodwill or Gain from Bargain Purchase, Including Consideration Transferred

Implementation Guidance and Illustrations

Case D: No Postcombination Vesting Required and the Vesting Condition for Acquiree Awards Has Not Been Met as of Acquisition Date

805-30-55-34

Assume the same facts as in Case C, except that Acquirer exchanges replacement awards that require no postcombination vesting for share-based payment awards of Target for which the grantee had not met the necessary vesting condition to deliver 40 engines before the business combination. The terms of the replaced Target awards did not eliminate the vesting condition upon a change in control. (If the Target awards had included a provision that eliminated the vesting condition upon a change in control, the guidance in Case A [see paragraph 805-30-55-28] would apply.) The fair-value-based measure of both awards is $100.

805-30-55-35

The portion attributable to precombination vesting equals the fair-value-based measure of the acquiree award ($100) multiplied by the percentage that would have been recognized on the award. The percentage that would have been recognized is the lower of the percentage that would have been recognized on the basis of the original vesting requirements and the percentage that would have been recognized on the basis of the effective vesting requirements as described in paragraph 805-30-55-9A. The percentage that would have been recognized on the basis of the original vesting requirements equals 50 percent, which is calculated as 20 engines delivered divided by 40 engines required to be delivered. The percentage that would have been recognized on the basis of the effective vesting requirements equals 100 percent, which is calculated as 20 engines delivered divided by 20 engines (the sum of 20 engines delivered plus zero engines required postcombination). Thus, $50 ($100 × 50%) is attributed to the precombination vesting and is therefore included in the consideration transferred in the business combination. The remaining $50 is attributed to the postcombination vesting. Because no postcombination vesting is required to vest in the replacement award, Acquirer recognizes the entire $50 immediately as compensation cost in the postcombination financial statements.

6.4 Contingent consideration

6.4.1 Recognition and measurement of contingent consideration

Excerpt from Accounting Standards Codification

Business Combinations — Goodwill or Gain from Bargain Purchase, Including Consideration Transferred

Recognition

805-30-25-5

The consideration the acquirer transfers in exchange for the **acquiree** includes any asset or liability resulting from a **contingent consideration** arrangement. The acquirer shall recognize the acquisition-date **fair value** of contingent consideration as part of the consideration transferred in exchange for the acquiree.

Business combinations often contain provisions for additional consideration to be transferred to the former shareholders in the future if certain future events occur or conditions are met. This additional consideration is referred to as contingent consideration. It is also commonly referred to as an "earn-out" provision. Buyers and sellers commonly use these arrangements when they cannot reach agreement on the consideration for the target business. An acquirer may promise to deliver cash, other assets or additional equity interests to former owners of an acquired business after the acquisition date if certain specified events occur or conditions are met in the future. These contingencies frequently are based on earnings or instrument price changes over specified periods after the date of the acquisition; however, they might be based on other factors. Examples of future events or conditions on which additional contingent consideration might be based are as follows:

- Earnings above an agreed-upon target over a period
- Components of earnings (e.g., revenue; earnings before interest, taxes, depreciation and amortization (EBITDA)) above an agreed-upon target over a period
- The guarantee of an equity security value by a specified date or maintenance of the guaranteed value for a stipulated period of time
- The attainment of product development milestones
- Approval of a patent, license, drug, etc.
- Successful completion of contract negotiations
- Cash flows arising from specified assets over an agreed period

Alternatively, an agreement may have any combination of the above examples or other factors.

The guidance in ASC 805 requires an acquirer to recognize contingent consideration obligations as of the acquisition date as part of the consideration transferred in exchange for the acquired business. The FASB concluded that the recognition event for contingent consideration in a business combination is the agreement to make contingent payments and not the achievement of the contingency. As such, the FASB does not believe that the delayed recognition of contingent consideration fairly represents the economic consideration at the acquisition date. As a result, the initial measurement of contingent consideration obligations is the fair value of the obligations, based on circumstances that exist as of the acquisition date.

ASC 805 requires an acquirer to assess whether any portion of the transaction consideration is in exchange for elements other than the acquired business. While these payments may be negotiated as part of gaining control of another entity, further evaluation is necessary to determine whether it would be appropriate to account for the payments as part of the consideration transferred for the business or as a separate transaction apart from the business combination. Accordingly, an acquirer must carefully evaluate whether the substance of the arrangement is to provide compensation for post-acquisition employee or non-employee services or the ongoing use of property rather than as consideration for the acquired business. For example, in some circumstances payments are made to selling shareholders who will remain as employees of the

business after it is acquired. In this case, depending on the terms of the arrangement, the payment made may be more appropriately accounted for as compensation expense for services provided subsequent to the acquisition date, rather than as part of the consideration transferred for the acquired entity. See section 6.4.5 for guidance on determining whether a contingent consideration arrangement is compensatory.

As another example, a portion of the consideration negotiated between the buyer and seller may include future payments based on product development milestones or based on a percentage of product sales in the post-combination period. Often these payments represent contingent consideration. However, acquirers should carefully evaluate the terms and conditions of the arrangement to determine whether such payments are part of the consideration transferred (i.e., contingent consideration) or are separate transactions from the business combination. In making this evaluation, acquirers should consider the nature of the obligation and whether the seller is providing benefits to the acquirer in exchange for the payments (e.g., the seller has a continuing obligation to provide goods or services). The acquirer accounts for payments that are not part of consideration transferred, but rather relate to providing goods or services subsequent to the acquisition as an executory contract under other applicable US GAAP.

In some situations, an acquirer may be obligated to deliver additional consideration to the seller after the acquisition date that is not contingent on a future event occurring or on conditions being met (i.e., the payment is based solely on the passage of time). In such situations, the obligation is not accounted for as a contingent consideration obligation. Regardless, the initial measurement of this obligation is at fair value on the acquisition date and the deferred payment is included as part of the consideration transferred. However, the subsequent accounting for this non-contingent obligation will be different than the accounting for a contingent consideration arrangement and the classification and subsequent measurement are based on other applicable sections of the Codification depending on the nature of the obligation (e.g., ASC 835). Consider the following examples:

Illustration 6-17: Deferred payment of consideration in cash

Company A acquires all of the outstanding shares of Company B for cash consideration of $3 million. The acquisition agreement includes a provision whereby Company A must pay additional cash consideration of $1 million to the selling shareholders of Company B on the third anniversary of the consummation of the business combination.

Analysis

Because the obligation to transfer additional cash consideration of $1 million is not contingent on a future event occurring or condition being met, the obligation is not accounted for as contingent consideration. The obligation is recorded as a liability and initially measured at fair value at the acquisition date and included in the consideration transferred.

Illustration 6-18: Deferred payment of consideration in shares

Company C acquires all of the outstanding shares of Company D for cash consideration of $3 million. The acquisition agreement includes a provision whereby Company C must transfer additional consideration consisting of 100,000 unregistered shares to the former owners of Company D (currently valued at $20 per share) on the third anniversary of the consummation of the business combination.

Analysis

Because the obligation to transfer additional shares is not contingent on a future event or condition being met (i.e., the payment is based solely on the passage of time), the obligation is not accounted for as contingent consideration. The obligation is initially measured at fair value at the acquisition date and included in the consideration transferred. Company C must then look to other GAAP to determine the classification of (i.e., equity or liability). See section 6.4.3 for further discussion on classification of contingent consideration.

6.4.1.1 Consideration held in escrow for general representations and warranties

Business combination agreements often contain provisions under which the consideration (or a portion thereof) is held in escrow pending the seller's satisfaction of certain general representations and warranties. Because in most cases general representations and warranties would be valid as of the acquisition date (i.e., there is no future event or condition that must occur), we generally believe that the amounts held in escrow for general representations and warranties should not be accounted for as contingent consideration. Instead, it should be included in the consideration transferred by the acquirer. ASC 805-10-20 defines contingent consideration as an obligation of the acquirer to transfer additional assets or equity interests to the former owners of an acquiree as part of the exchange for control of the acquiree if specified *future* events occur or conditions are met. Therefore, subsequent payments of consideration based on facts and circumstances that existed on the acquisition date would not meet this definition.

An acquirer also should carefully evaluate the legal terms of the business combination agreement and escrow agreement to determine whether the amounts held in escrow should be presented as an asset on the balance sheet. If the escrowed cash qualifies as an asset of the buyer, a corresponding liability should be recognized, if the recognition criteria is met, representing the expected payment to the seller.

6.4.2 Determining the unit of account of a contingent consideration arrangement

We believe that a contingent consideration arrangement is required to be analyzed as if it were a separate freestanding instrument. In addition, in certain circumstances, an acquisition may appear to involve multiple contingent consideration arrangements. They may be described in different documents, or in different sections of the same document, or presented within the same section of a document as individual arrangements. Careful consideration of all relevant facts and circumstances will be necessary to determine whether the arrangement represents a single contingent consideration arrangement with multiple triggers (or underlyings) or whether there are multiple contingent consideration arrangements. That determination will require an evaluation of the substance of the arrangements. For example, if there are multiple arrangements in form, but the triggering criteria are related (for example, all based on revenue) and/or the measurement periods overlap (for example, cumulative revenue over several periods), that could be an indication that those arrangements should be treated as a single contingent consideration arrangement. If two or more contingent consideration arrangements were entered into in a single business combination transaction, we believe that companies should consider the following factors (generally described in ASC 815 and certain pre-Codification literature) to determine the appropriate unit of account:

- The contingent consideration arrangements were entered into contemporaneously and in contemplation of one another.
- The contingent consideration arrangements were entered into with the same counterparty.
- The contingent consideration arrangements share the same risk. That is, the arrangements share at least one underlying, and changes in that underlying (holding the other underlyings constant) result in at least one substantially offsetting change in fair value for the arrangements.
- There is no apparent economic need or substantive business purpose for structuring the contingent consideration arrangements separately that could not also have been accomplished in a single contingent consideration arrangement.

The determination of whether the unit of account for a contingent consideration arrangement is a single unit or multiple units will require significant professional judgment.

Illustration 6-19: Unit of account — consecutive periods with independent targets

Company A acquires all of the outstanding shares of Company B in a business combination. Included as part of the agreement is a provision whereby if revenues are greater than X during the one-year period following the acquisition, Company A will deliver 50 shares to the former owners of Company B. The agreement also includes a provision whereby if revenues are greater than Y during the second one-year period following the acquisition, Company A will deliver 100 shares to the former owners of Company B. The payment of the 100 shares is not dependent on the outcome of the one-year period contingency.

Analysis

The arrangements should be considered two separate units of account. Because the first year and second year periods have different risks (i.e., revenues in the one-year period after the acquisition has no bearing on the second one-year period following the acquisition), the arrangement would not be considered one unit of account with a variable outcome. Rather, the arrangement would be treated as two separate units of account because the performance targets are independent of each other. Company A must then look to other GAAP to determine the classification of (i.e., equity or liability). See section 6.4.3 for further discussion on classification of contingent consideration.

Illustration 6-20: Unit of account — multi-year periods with payment dependent on the individual outcomes

Company C acquires all of the outstanding shares of Company D in a business combination. Included as part of the agreement is a provision whereby if revenues are greater than X during the one-year period following the acquisition, Company C will deliver 50 shares to the former owners of Company D. If cumulative revenues (year one and year two) are greater than Y during the two-year period following the acquisition, Company C will deliver 150 shares to the former owners of Company D subject to the outcome of the one-year period contingency (i.e., if the year one revenue target is achieved, the payout at the end of year two will be 100 shares).

Analysis

Because the revenue targets are not independent of one another and they share similar risks, the contingent consideration arrangement is accounted for as a single unit of account. In this illustration, the number of shares to be delivered is based on cumulative revenues over a two-year period, which means that the revenues earned in year one affect the number of shares to be delivered in year two. Company C must then look to other GAAP to determine the classification (i.e., equity or liability). See section 6.4.3 for further discussion on classification of contingent consideration.

6.4.3 Classification of contingent consideration

Excerpt from Accounting Standards Codification

Business Combinations — Goodwill or Gain from Bargain Purchase, Including Consideration Transferred

Recognition

805-30-25-6

The acquirer shall classify an obligation to pay contingent consideration as a liability or as equity in accordance with Subtopics 480-10 and 815-40 or other applicable generally accepted accounting principles (GAAP). For example, Subtopic 480-10 provides guidance on whether to classify as a liability a contingent consideration arrangement that is, in substance, a put option written by the acquirer on the market price of the acquirer's shares issued in the business combination.

805-30-25-7

The acquirer shall classify as an asset a right to the return of previously transferred consideration if specified conditions are met.

While ASC 805 specifies the measurement attribute of contingent consideration (i.e., fair value), it does not address how to determine the appropriate classification of contingent consideration. Rather, it requires the acquirer to look to other applicable GAAP for guidance to determine the appropriate classification. This section does not include comprehensive guidance with respect to the accounting for distinguishing liabilities from equity; rather, it addresses classification considerations based upon traditional business combination transactions. The conclusions reached in this section may not always include a comprehensive analysis of the provision of ASC 480, ASC 815, or other literature and may not be appropriate in all circumstances. All specific facts and circumstances of a particular transaction should be evaluated when determining the appropriate classification of a contingent consideration arrangement. If the contingent consideration arrangement requires the transfer of equity instruments of the acquirer, the classification of the contingent obligation is based on existing accounting standards. ASC 480 and ASC 815 and related guidance generally are applied to contingent consideration in order to determine its classification.

Contingent consideration arrangements will be classified as liabilities (or as an asset if the arrangement involves contingently returnable consideration) when the additional consideration transferred will be other than the acquiring entity's own equity securities (e.g., cash or other assets). This is illustrated in the following examples:

Illustration 6-21: Contingent consideration settled in cash

Company A acquires all of outstanding shares of Company B for $3 million in cash. The agreement includes a provision whereby Company A must pay additional consideration of $1 million in cash if EBITDA exceeds $10 million in the twelve-month period subsequent to the acquisition date.

Analysis

Because Company A is required to settle the contingent consideration arrangement in cash, Company A classifies the contingent consideration arrangement as a liability and measures it at fair value.

Illustration 6-22: Contingent consideration linked to acquisition-date fair value and settled in cash

Company C acquires all of the outstanding shares of Company D for 1 million shares of Company C's equity securities. On the acquisition date, Company C's share price was $50. If the share price on the one-year anniversary of the acquisition date is below $50, the agreement includes a provision whereby Company C must pay additional cash consideration to the former owners of Company D to guarantee a total consideration of $50 million ($50 x 1 million shares).

Analysis

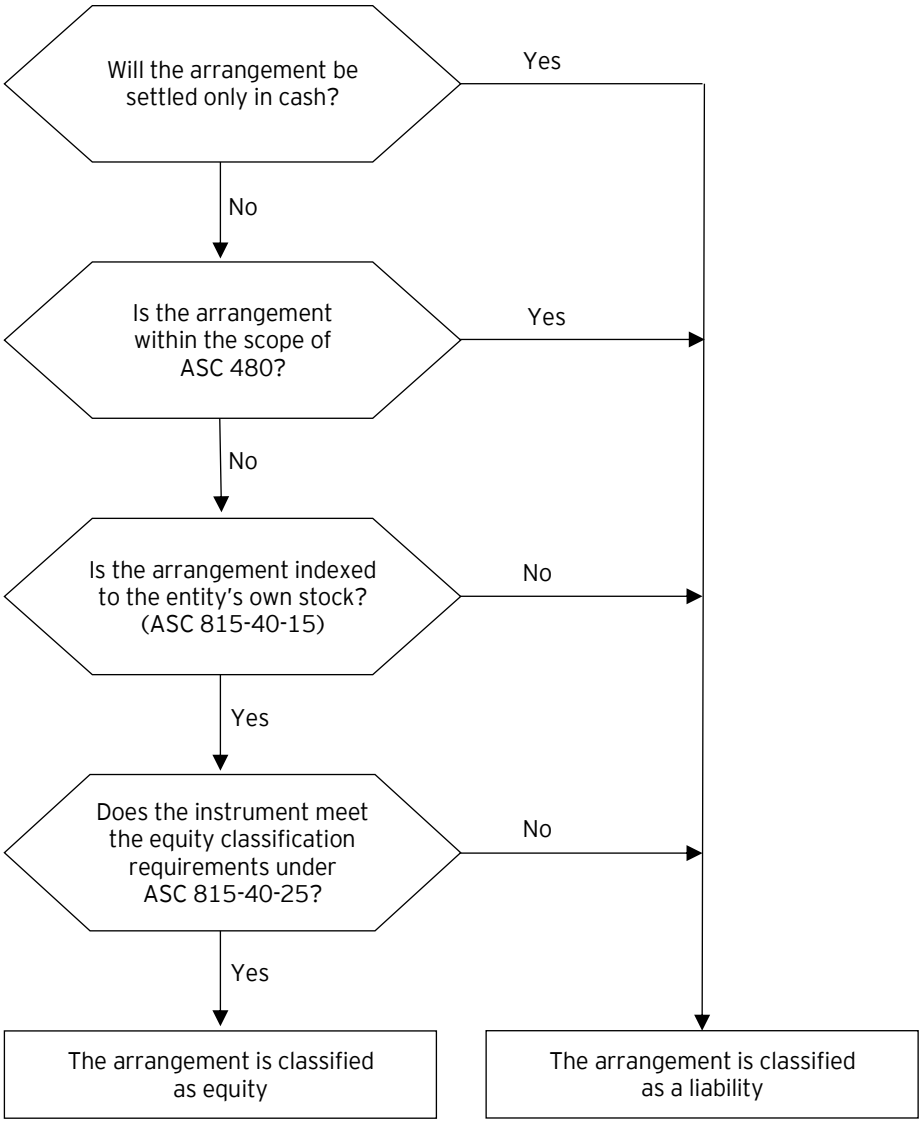
Because Company C is required to settle the contingent consideration arrangement in cash, Company C classifies the contingent consideration arrangement as a liability and measures it at acquisition-date fair value.

A contingent consideration arrangement that requires settlement in the acquirer's shares may be classified as a liability or as equity. Determining the classification of arrangements that require settlement in shares can be complex and often will require the exercise of professional judgment based on the particular facts and circumstances. The criteria that must be met for equity classification are highly restrictive.

Section 6.4.3.1 below includes a flowchart that provides a roadmap for companies to follow as they determine the appropriate classification of such contingent consideration arrangements.

6.4.3.1 The roadmap of applicable sections of the Codification to consider in determining the appropriate classification of contingent consideration

The guidance in ASC 805-30-25-6 states that an acquirer must classify an obligation to pay contingent consideration as a liability or as equity in accordance with ASC 480 and ASC 815, or other applicable sections of the codification. The following flowchart provides a roadmap for companies to follow as they determine the appropriate classification of a contingent consideration arrangement:



The analysis in this flowchart determines the appropriate classification of a contingent consideration arrangement. However, if the arrangement also meets the definition of a derivative, there would be additional considerations regarding disclosure and potential use as a hedging instrument under ASC 815.

As noted earlier, contingent consideration arrangements settled only in cash will be classified as liabilities. If the contingent consideration consists of an entity's own equity securities, the guidance in ASC 480 and ASC 815 generally applies.

We believe that ASC 805 requires that contingent consideration be analyzed as if it were a separate freestanding instrument and a separate unit of account (see section 6.4.2 for guidance on determining the unit of account for a contingent consideration arrangement). ASC 805-30-25-6 requires that an entity separately consider the classification of contingent consideration arrangements using applicable GAAP. As such, we do not believe a contingent consideration arrangement needs to qualify as "legally detachable and separately exercisable" to qualify as "freestanding" under ASC 480. Likewise, we do not believe such an arrangement can be deemed an embedded derivative in the underlying acquisition agreement or related documents under ASC 815-15. Finally, we do not believe a contingent consideration arrangement needs to qualify as a "freestanding derivative instrument" to be accounted for under ASC 815-40-25.

6.4.3.2 Application of ASC 480 to classification of contingent consideration

When a contingent consideration arrangement will result in the delivery of, or is somehow related to, the equity shares of the acquirer, companies should first consider whether the arrangement is within the scope of ASC 480. ASC 480 addresses certain financial instruments with characteristics of both liabilities and equity and establishes criteria for classifying and measuring, as liabilities, certain financial instruments that embody obligations of the issuer.

Financial instruments within the scope of ASC 480 are required to be classified as liabilities. A financial instrument is within the scope of ASC 480 if it embodies an obligation for the issuer to:

- Mandatorily redeem a financial instrument
- Repurchase shares by transferring assets, regardless of whether the instrument is settled on a net-cash or gross physical basis
- Issue a variable number of shares and, at inception, its monetary value is solely or predominately:
  - Fixed (e.g., an obligation to deliver shares with a fair value at settlement equal to $1,000),
  - Derived from an underlying other than the fair value of the issuer's shares (e.g., an obligation to deliver shares with a fair value at settlement equal to the value of one ounce of gold), or
  - Moves inversely to the issuer's shares (e.g., net-share settled written put options).

In practice, contingent consideration arrangements that are settled in stock often involve instruments most similar to those discussed in the third bullet point above (e.g., an arrangement that requires the acquirer to deliver shares and the value of that obligation is predominantly based on whether certain contingencies or target thresholds are met). In that case, we believe the determination of whether the arrangement is within the scope of ASC 480 will depend on whether the arrangement's monetary value, at inception, is based predominately on the exercise contingency (e.g., revenue target) or share price. If the monetary value is based predominately on the exercise contingency, then the arrangement would be classified as a liability under ASC 480. On the other hand, if the monetary value is based predominately on the share price, then the arrangement would be outside the scope of ASC 480 and companies would need to apply the guidance in ASC 815. Further, we believe the determination of whether the arrangement's monetary value, at inception, is based predominately on the exercise contingency (e.g., revenue target) or share price will depend on the particular facts and circumstances. Generally, we believe the more substantive the exercise contingency (i.e., the more difficult it is to reach), the more likely the arrangement is based predominately on the exercise contingency (resulting in liability classification).

Under ASC 480, when addressing the underlying for the contingent consideration, the FASB indicated that instruments that "solely or predominantly" vary with something other than the entity's shares would not qualify for equity treatment.

If liability classification is required under ASC 480, the guidance in section 6.4.6 should be applied for subsequent measurement of the contingent consideration. The guidance in ASC 805 specifically addresses the subsequent measurement of contingent consideration and, therefore, the subsequent measurement guidance in ASC 480 does not apply.

6.4.3.3 Application of ASC 815 to classification of contingent consideration

If the contingent consideration arrangement is not addressed by ASC 480, then the guidance in ASC 815 should be applied. ASC 815-40-15 provides guidance for determining whether an instrument (i.e., the contingent consideration arrangement) is indexed to the issuer's stock and ASC 815-40-25 provides guidance for determining whether an instrument that is indexed to the issuer's stock qualifies for equity classification.

Contingent consideration arrangements that are indexed to the issuer's own stock and qualify for equity classification would be classified as equity at the acquisition date. The contingent consideration arrangement should be assessed at the end of each reporting period to determine whether equity classification is still appropriate. See section 6.4.6 for guidance on the resolution of a contingent consideration arrangement.

6.4.3.3.1 Determining if a contingent consideration arrangement is indexed to the acquirer's own stock

In determining whether a contingent consideration arrangement is indexed to the acquirer's own stock, ASC 815-40-15 requires a two-step test. The first step in ASC 815-40-15 addresses the appropriateness of any exercise contingencies[54] in the instrument. The second step focuses on how the settlement amount is calculated.

A key consideration in applying the first step of ASC 815-40-15 is whether the nature of the contingency precludes equity classification. An exercise contingency is essentially an "on/off" switch. An exercise contingency precludes an instrument (or embedded feature) from being considered indexed to an entity's own stock if it is based on (1) an observable market, other than the market for the issuer's stock (if applicable), or (2) an observable index, other than an index calculated or measured solely by reference to operations (e.g., revenues, EBITDA, net income or total equity of the entity). For example, an exercise contingency based on the Nasdaq increasing by 300 points within a twelve-month period would not be considered indexed to the entity's own stock because the Nasdaq is an observable index and is not an index calculated or measured solely by reference to the entity's operations.

Under the second step, a settlement amount is considered indexed to the issuer's own stock "if its settlement amount will equal the difference between the following: (a) the fair value of a fixed number of the entity's equity shares and (b) a fixed monetary amount or a fixed amount of a debt instrument issued by the entity," which is often referred to as the fixed-for-fixed notion.[55] The indexation literature allows for certain exceptions to the fixed-for-fixed notion. The application of these exceptions in the indexation literature to arrangements that are not literally fixed-for-fixed can be complex and requires careful consideration of the particular provisions.

---

[54] An exercise contingency is defined for the purposes of ASC 815-40-15 as "a provision that entitles the entity (or the counterparty) to exercise an equity-linked financial instrument (or embedded feature) based on changes in an underlying [as further defined], including the occurrence (or nonoccurrence) of a specified event." The definition goes on to clarify that "provisions that accelerate the timing of the entity's (or the counterparty's) ability to exercise an instrument and provisions that extend the length of time that an instrument is exercisable are examples of exercise contingencies."

[55] ASC 815-40-15-7C.

Accordingly, if a qualifying contingency (e.g., revenues, EBITDA or net income of the target) determines whether or not a fixed number of shares will be delivered (i.e., the possible outcomes are binary, either no shares are delivered or a single number of shares are delivered), the guidance in ASC 815-40-15 would not preclude equity classification. However, if a qualifying contingency has the characteristics of modifying the number of shares rather than simply a binary outcome and therefore determines the number of shares (e.g., there are more than two possible outcomes for a settlement, such as zero, 50, 100 or 200 shares depending on the resolution of the contingency), then that contingency now affects the settlement amount. In this scenario, the settlement of the arrangement is not considered fixed-for-fixed, because the number of shares that can be issued is not fixed (i.e., not an "on/off" switch). This arrangement would not be considered indexed to the entity's own stock and equity classification would likely be precluded.

6.4.3.3.2 Determining if a contingent consideration arrangement indexed to the acquirer's own stock should be classified in equity

If the contingent consideration arrangement is deemed to be indexed to the acquirer's own stock under ASC 815-40-15, the arrangement should then be analyzed under ASC 815-40-25 to determine if equity classification is appropriate. That guidance generally requires equity classification for instruments that provide the acquirer with a choice of net-cash settlement or settlement in its own shares (physical settlement or net-share settlement) or the arrangement requires settlement in its own shares (physical settlement or net-share settlement). Contingent consideration arrangements with appropriate settlement provisions should be classified as equity if ***all*** of the following conditions are met:

- The arrangement permits the entity to settle in unregistered shares.
- The entity has sufficient authorized and unissued shares available to settle the arrangement after considering all other commitments that may require the issuance of stock during the maximum period the instrument could remain outstanding.
- The arrangement contains an explicit limit on the number of shares to be delivered upon settlement.
- There are no required cash payments to the counterparty in the event the entity fails to make timely filings with the SEC.
- There are no cash-settled "top-off" or "make-whole" provisions.
- The arrangement does not include provisions that indicate that the counterparty has rights that rank higher than those of a shareholder of the stock underlying the arrangement.
- There is no requirement in the arrangement to post collateral at any point or for any reason.

These criteria are strictly applied and often require detailed knowledge of the contract being analyzed, the issuer's capital structure and the underlying securities laws.

If all of the above criteria are not met, the contingent consideration arrangement must be classified as a liability. In practice, equity classification is sometimes precluded because the company does not have sufficient authorized and unissued shares available to settle the contingent consideration arrangement. In determining whether a sufficient number of shares exist, companies need to consider all outstanding potentially dilutive instruments such as options, convertible debt instruments, convertible preferred stock, warrants, etc. Depending on an entity's policy for allocating authorized shares to settle potentially dilutive instruments, a contingent consideration arrangement (and other potentially dilutive instruments) could be classified as a liability if, after considering other potentially dilutive instruments, sufficient authorized shares are not available to settle the contingent consideration arrangement. As such, a company's policy for allocating authorized shares to potentially dilutive instruments is critical in determining whether a contingent consideration arrangement is classified as equity should there be a shortfall in available shares. ASC 815-40 provides guidance on selecting an acceptable accounting policy for the allocation of unauthorized shares if a shortfall exists.

6.4.3.4 Examples illustrating principles when evaluating classification

The following illustrations provide examples of contingent consideration arrangements and how such arrangements typically would be evaluated under the existing classification guidance. The analysis section in each illustration follows the flowchart depicted in section 6.4.3.1.

Illustration 6-23: Contingent consideration that embodies a security price guarantee and settled in shares

Company A acquires all of the outstanding shares of Company B for 1 million shares of Company A's equity securities. On the acquisition date, Company A's share price was $50. If the share price on the one-year anniversary of the acquisition date is below $50, the agreement includes a provision whereby Company A must deliver additional shares to former owners of Company B to guarantee a total consideration of $50 million ($50 x 1 million shares).

Analysis

Is the arrangement within the scope of ASC 480?

Yes. The contingent consideration arrangement is a liability within the scope of ASC 480 because it creates an obligation for Company A on the acquisition date to settle in a variable number of shares which moves inversely to changes in the fair value of Company A's shares (ASC 480-10-25-14(c)). That is, as Company A's stock price decreases, the monetary value of the variable number of shares to settle the security price guarantee increases.

Illustration 6-24: Revenue contingency settled in a fixed number of shares

Company A acquires all of the outstanding shares of Company B for 100 shares of Company A's equity securities. If revenues are greater than X for the 12 months following the acquisition date, the agreement includes a provision whereby the acquirer will deliver 50 additional shares. If revenues are less than X, no additional shares will be delivered.

Analysis

Is the arrangement within the scope of ASC 480?

When assessing whether this arrangement is considered potentially settled for a variable number of shares (i.e., either zero or 50 shares), alternative views exist in practice. The most commonly held view is that the arrangement is not considered to be settled for a variable number of shares.[1] Under this view, the contingency is considered merely an "on-off switch" that does not affect the monetary amount on settlement. In addition, the monetary value on settlement is neither a fixed dollar amount, nor does it vary inversely with the fair value of the issuer's equity shares. Therefore, the arrangement is outside the scope of ASC 480, regardless of the probability of the trigger being achieved. As a result, the acquirer should look to other guidance to determine the appropriate classification.

If the arrangement is not a liability under ASC 480, is the arrangement indexed to the entity's own stock?

Yes. The arrangement would be considered "indexed to the entity's own stock" under ASC 815-40-15 in which case equity classification is not precluded. The contingency trigger is based on revenue, which is an observable index calculated solely by reference to the entity's operations.

Does the arrangement meet the equity classification requirements in ASC 815-40-25?

This arrangement may qualify for equity classification if all of the criteria in ASC 815-40-25 are met.

[1] Alternatively, the arrangement may be considered to be settled for a variable number of shares (either zero or 50 shares) and the determinants of the monetary value of such an arrangement are (1) the likelihood of reaching the revenue threshold (zero or 50 shares) and (2) price per share at the time such shares are contingently deliverable (value of the 50 shares if that settlement is triggered). If the monetary value is predominantly based on the likelihood of reaching the revenue threshold, the arrangement would be classified as a liability as such value varies in relation to something other than the fair value of the issuer's equity shares [480-10-25-14(b)]. If, however, the value is predominantly based on the value per share (meaning the likelihood of reaching the revenue threshold is relatively high), ASC 480 does not address the classification of this arrangement and Company A would continue to other guidance to determine the appropriate classification.

Illustration 6-25: Revenue contingency settled in shares for a particular monetary amount

Company A acquires all of the outstanding shares of Company B for 100 shares of Company A's equity securities. If revenues are greater than X, the agreement includes a provision whereby Company A will deliver $100 in additional shares.

Analysis

The arrangement would be classified as a liability under ASC 480 provided the monetary value of the obligation, which is known at the inception of the arrangement, is deemed to be the predominant characteristic.

Illustration 6-26: Revenue contingency settled in cash based on fixed number of shares

Company A acquires all of the outstanding shares of Company B for 100 shares of Company A's equity securities. If revenues are greater than X, the agreement includes a provision whereby Company A will deliver cash equal in value to 50 additional shares.

Analysis

This arrangement would be classified as a liability under ASC 815-40-25 because it requires net cash settlement. The fact that the amount of the cash settlement is based on a fixed number of shares is irrelevant for determining the appropriate classification.

6.4.4 Determining the fair value of contingent consideration

Because of the complexity of many contingent consideration arrangements, estimating the fair value of such arrangements is often challenging. In most instances, a contingent consideration arrangement will be valued using an income approach, typically using either a probability-weighted discounted cash flow method (otherwise referred to as a scenario-based method or SBM) or an option pricing method (OPM) to capture the uncertainty in the future payments.

These methodologies are discussed in detail in the Appraisal Foundation's ***Valuations in Financial Reporting Valuation Advisory 4: Valuation of Contingent Consideration*** (Contingent Consideration Advisory) that was issued in February 2019. The Contingent Consideration Advisory provides best practices on the methodology to use based on the nature of the contingent payout and the application of each methodology. This includes how to determine an appropriate discount rate that considers the various components of risk that are often present in such arrangements.

Although the Contingent Consideration Advisory is not authoritative GAAP, there is little other specific guidance on how to determine the fair value of contingent consideration arrangements. We understand that the valuation techniques described in the Contingent Consideration Advisory are generally recognized by the valuation community as acceptable methods for measuring the fair value of contingent consideration.

6.4.5 Contingent payments to employees or selling shareholders

Excerpt from Accounting Standards Codification

Business Combinations — Overall

Implementation Guidance and Illustrations

805-10-55-24

Whether arrangements for contingent payments to employees or selling shareholders are **contingent consideration** in the business combination or are separate transactions depends on the nature of the arrangements. Understanding the reasons why the acquisition agreement includes a provision for contingent payments, who initiated the arrangement, and when the parties entered into the arrangement may be helpful in assessing the nature of the arrangement.

An acquirer evaluates all contingent consideration arrangements to determine if the arrangements are compensatory in nature. If the acquirer determines that a contingent consideration arrangement is compensatory, the acquirer does not recognize a liability at the acquisition date. The acquirer recognizes compensation expense for the arrangement based on other applicable GAAP (e.g., ASC 710-10-25-9).

Illustration 6-27 highlights the factors listed in ASC 805 to determine whether contingent payments to employees or selling shareholders are part of the business combination or separate compensation transactions. Further discussion of each factor is included in the sections that follow.

Illustration 6-27: Classifying payments as compensation or contingent consideration

Leads to conclusion that payments are compensation	Factor	Leads to conclusion that payments are consideration transferred
Payments forfeit on termination	Continuing employment	Payments are not affected by termination
Coincides with or exceeds payment period	Duration of continuing employment	Shorter than the payment period
Not reasonable compared to that of other key employees	Level of compensation	Reasonable compared to that of other key employees
Other non-employee selling shareholders receive lower additional payments (on a per-share basis)	Incremental payments to employees	Other non-employee selling shareholders receive similar additional payments (on a per-share basis)
Selling shareholders remaining as employees own substantially all shares (in substance profit sharing)	Number of shares owned	Selling shareholders remaining as employees own only a small portion of shares
Payment formula consistent with other profit-sharing arrangements	Linkage of payments to valuation of business	Payment formula linked to the valuation approach (i.e., to bridge valuation gap)
Formula is based on a percentage of earnings	Formula for determining contingent consideration	Formula is based on a valuation formula, such as multiple of earnings

6.4.5.1 Continuing employment

Excerpt from Accounting Standards Codification

Business Combinations — Overall

Implementation Guidance and Illustrations

805-10-55-25

If it is not clear whether an arrangement for payments to employees or selling shareholders is part of the exchange for the acquiree or is a transaction separate from the business combination, the acquirer should consider the following indicators:

a. Continuing employment. The terms of continuing employment by the selling shareholders who become key employees may be an indicator of the substance of a contingent consideration arrangement. The relevant terms of continuing employment may be included in an employment

agreement, acquisition agreement, or some other document. A contingent consideration arrangement in which the payments are automatically forfeited if employment terminates is compensation for postcombination services. Arrangements in which the contingent payments are not affected by employment termination may indicate that the contingent payments are additional consideration rather than compensation.

The guidance in ASC 805 requires that any arrangement under which payments are forfeited if employment is terminated be considered compensation for post-combination services.

In a speech at the 2000 AICPA Conference on Current SEC Developments, the SEC staff discussed its views on the application of EITF 95-8 to forfeitable shares issued to employees in a business combination. Because the guidance in ASC 805 largely carried forward the factors from EITF 95-8, we believe that the SEC staff views expressed in the 2000 speech continue to apply.

The SEC staff presented the following example. Consider a business combination where Acquirer purchases Target for cash and stock. All of the shareholders of Target are also Target employees. Acquirer offers continuing employment to all former Target employee-shareholders. Of the shares issued to the former Target employee-shareholders, a portion is held in an irrevocable trust, subject to a three-year vesting requirement. The forfeiture provision requires that if, prior to vesting, a shareholder resigns from employment or is terminated for cause, the shares held in trust and allocable to the employee shareholder are forfeited by the employee. Additionally, any shares actually forfeited are reallocated to the remaining employee-shareholders, based on their interests in the trust, such that all of the shares in the trust ultimately will be issued (in some cases, the trust may provide that if all the employees forfeit their shares, the proceeds of the trust will be distributed to a charitable organization). These structures are often characterized as "last-man-standing" arrangements.

ASC 805 indicates that arrangements in which contingent payments are automatically forfeited if employment terminates requires the contingent payments to be accounted for as compensation for post-combination services. Accordingly, the arrangement must be accounted for as compensation. As discussed further in section 6.3.2.7, in arrangements that include last-man-standing provisions, in which share-based payments are forfeited and reallocated to other grantees, we believe that the forfeiture should be accounted for pursuant to ASC 718. Additionally, the allocation to other employees should be accounted for as a new grant to each employee under ASC 718.

6.4.5.1.1 Evaluating whether there is an in-substance service period

When payments under a contingent consideration arrangement are not forfeited if employment is terminated, we believe the acquirer also should evaluate whether the nature of the arrangement represents an in-substance service period. This evaluation will require the exercise of professional judgment based on the particular facts and circumstances. Factors that an acquirer may consider in determining whether the arrangement represents an in-substance service period include the following:

- The acquired business operates in a very specialized industry with limited other individuals who possess commensurate expertise.
- The employee is integral to the future success of the acquired business.
- The earnings target is not achievable absent the employee's continuing employment.
- The employee has signed an employment agreement that coincides with or is longer than the contingent payment period (see section 6.4.5.2 below).
- The employee has signed a noncompete agreement that coincides with or is longer than the contingent payment period.

- The value of the contingent payment is disproportionately high relative to the up-front payment and, therefore, provides an incentive for the employee to remain employed throughout the contingent payment period.

6.4.5.2 Duration of continuing employment

Excerpt from Accounting Standards Codification

Business Combinations — Overall

Implementation Guidance and Illustrations

805-10-55-25(b)

Duration of continuing employment. If the period of required employment coincides with or is longer than the contingent payment period, that fact may indicate that the contingent payments are, in substance, compensation.

Conversely, the terms of an arrangement might be indicative of a contingent payment arrangement if, for example, a selling shareholder-employee has an employment contract with a term of six months and the contingent payment period is two years. The factors that determine the resolution of the contingency might not be directly or significantly related to the services expected to be provided by the selling shareholder-employee during the contingency period.

6.4.5.3 Level of compensation

Excerpt from Accounting Standards Codification

Business Combinations — Overall

Implementation Guidance and Illustrations

805-10-55-25(c)

Level of compensation. Situations in which employee compensation other than the contingent payments is at a reasonable level in comparison to that of other key employees in the combined entity may indicate that the contingent payments are additional consideration rather than compensation.

If a selling shareholder-employee's compensation (excluding payments that might result from the contingent payment arrangement) is approximately the same as the compensation for an employee of the acquirer who has similar responsibilities, the contingent payment arrangement might be accounted for as contingent consideration in a business combination. However, the usefulness of this factor is often limited by the fact that continuing employees (and selling shareholders) often perform services that are not comparable to or that are in addition to the responsibilities of other employees that ostensibly have similar levels of responsibility or experience.

6.4.5.4 Incremental payments to employees

Excerpt from Accounting Standards Codification

Business Combinations — Overall

Implementation Guidance and Illustrations

805-10-55-25(d)

Incremental payments to employees. If selling shareholders who do not become employees receive lower contingent payments on a per-share basis than the selling shareholders who become employees of the combined entity, that fact may indicate that the incremental amount of contingent payments to the selling shareholders who become employees is compensation.

For example, if the only selling shareholders who are entitled to contingent consideration are those that become employees (or maybe only those selling shareholders that become key employees), that factor is indicative of a compensation arrangement. Further, if there are separate earnings targets such that all selling shareholders would receive an additional payment if a certain target is achieved, but selling shareholders who continue as employees of the combined entity might receive additional payments based on achieving another more challenging target, the incremental payments that might be made to the ongoing employees should be recognized as compensation cost.

6.4.5.5 Relative stock ownership

Excerpt from Accounting Standards Codification

Business Combinations — Overall

Implementation Guidance and Illustrations

805-10-55-25(e)

Number of shares owned. The relative number of shares owned by the selling shareholders who remain as key employees may be an indicator of the substance of the contingent consideration arrangement. For example, if the selling shareholders who owned substantially all of the shares in the acquiree continue as key employees, that fact may indicate that the arrangement is, in substance, a profit-sharing arrangement intended to provide compensation for postcombination services. Alternatively, if selling shareholders who continue as key employees owned only a small number of shares of the acquiree and all selling shareholders receive the same amount of contingent consideration on a per-share basis, that fact may indicate that the contingent payments are additional consideration. The preacquisition ownership interests held by parties related to selling shareholders who continue as key employees, such as family members, also should be considered.

6.4.5.6 Linkage to the valuation

Excerpt from Accounting Standards Codification

Business Combinations — Overall

Implementation Guidance and Illustrations

805-10-55-25(f)

Linkage to the valuation. If the initial consideration transferred at the acquisition date is based on the low end of a range established in the valuation of the acquiree and the contingent formula relates to that valuation approach, that fact may suggest that the contingent payments are additional consideration. Alternatively, if the contingent payment formula is consistent with prior profit-sharing arrangements, that fact may suggest that the substance of the arrangement is to provide compensation.

For example, assume that Acquirer agrees to acquire Target. The acquisition negotiations were based, in part, on a projected cash flow valuation of Target. Acquirer believes that the true value is at the low end or midpoint of the range, whereas the selling Target shareholders believe that the true value of the business is at the high end of the range. In finalizing the purchase arrangements, Acquirer agrees to pay an unconditional amount between the low and midpoint upon closing, and to disburse an additional contingent payment if actual cash flows of Target over the year following the date of acquisition exceed those used as a basis for determining the unconditional consideration, for aggregate possible payments of an amount that is in the range of the mid and high points of the valuation. This arrangement might be an indicator that contingent payments, if any, are additional consideration. However, the contingent payments still could be considered compensation if the continuing employees (selling shareholders) are required to work to receive the contingent payments.

6.4.5.7 Formula for determining contingent consideration

Excerpt from Accounting Standards Codification

Business Combinations — Overall

Implementation Guidance and Illustrations

805-10-55-25(g)

Formula for determining consideration. The formula used to determine the contingent payment may be helpful in assessing the substance of the arrangement. For example, if a contingent payment is determined on the basis of a multiple of earnings, that might suggest that the obligation is contingent consideration in the business combination and that the formula is intended to establish or verify the fair value of the acquiree. In contrast, a contingent payment that is a specified percentage of earnings might suggest that the obligation to employees is a profit-sharing arrangement to compensate employees for services rendered.

6.4.5.8 Other agreements and issues

Excerpt from Accounting Standards Codification

Business Combinations — Overall

Implementation Guidance and Illustrations

805-10-55-25(h)

Other agreements and issues. The terms of other arrangements with selling shareholders (such as noncompete agreements, executory contracts, consulting contracts, and property lease agreements) and the income tax treatment of contingent payments may indicate that contingent payments are attributable to something other than consideration for the acquiree. For example, in connection with the acquisition, the acquirer might enter into a property lease arrangement with a significant selling shareholder. If the lease payments specified in the lease contract are significantly below market, some or all of the contingent payments to the lessor (the selling shareholder) required by a separate arrangement for contingent payments might be, in substance, payments for the use of the leased property that the acquirer should recognize separately in its postcombination financial statements. In contrast, if the lease contract specifies lease payments that are consistent with market terms for the leased property, the arrangement for contingent payments to the selling shareholder may be contingent consideration in the business combination.

A similar example would be a separate arrangement that requires a significant selling shareholder to provide significant consulting services over a transition period for a nominal fee, coupled with a contingent payment arrangement.

While the tax treatment of contingent payment arrangements generally should not affect the accounting treatment, companies should be aware that documenting contingent payments as compensation, perhaps in the form of an employment agreement, in support of tax deductibility of the payments as compensation will indicate the payments represent compensation for accounting purposes.

The determination of the appropriate accounting for contingent payment arrangements described in ASC 805 requires significant judgment in situations in which the payment is not conditional on a specified period of employment. Companies that are involved in acquisitions involving contingent payment arrangements should analyze and document the relevant facts and circumstances carefully before reaching a conclusion about the appropriate accounting for the contingent consideration.

6.4.5.9 Examples of arrangements with contingent payments to employees or selling shareholders

Employment agreements or other arrangements with executives often provide the executives (who also may be shareholders) with a bonus or other payment, payable in cash or shares, if the company is acquired. These arrangements, which commonly are referred to as "change in control provisions" or "golden parachute arrangements," take many forms and have a variety of terms and conditions. Some of these arrangements require minimal or no future service after the business combination is consummated to qualify for the payments, while others require the executive to continue as an employee to qualify for the payment. Other arrangements, such as stay-bonus arrangements, are executed concurrently with the business combination to motivate certain executives or other employees to remain employed at the acquired company for a period of time. An understanding of all facts and circumstances is required to determine the appropriate accounting treatment for these types of arrangements. That is, whether the payments are part of the consideration transferred for the acquiree or are post-combination expense that are accounted for outside of the business combination. The following examples illustrate the accounting for some typical arrangements.

Illustration 6-28: Arrangement for contingent payment to employee (no future service requirement)

Target hired a chief executive officer (CEO) pursuant to a five-year employment contract. The contract requires Target to pay $5 million to the CEO in the event Target is acquired by another company and the CEO remains employed through the acquisition date. The CEO is not obligated to remain employed after the acquisition date. Acquirer acquires Target two years after the employment contract is signed. The CEO was still employed at the acquisition date and will receive the $5 million payment under the existing contract.

Analysis

In this example, Target entered into the employment agreement before the negotiations of the acquisition began, and the purpose of the agreement was to obtain the services of the CEO. Thus, there is no evidence that the agreement was arranged primarily to provide benefits to Acquirer or the combined entity. Additionally, the CEO is not required to provide continuing services to Acquirer to receive the payment. Therefore, the payment is recorded as compensation expense on the acquisition date in Target's preacquisition financial statements and an assumed liability in the combined entity's financial statements.

Illustration 6-29: Arrangement for contingent payment to employee at suggestion of acquirer (no future service requirement)

Assume the same facts as Illustration 6-28, except that the employment contract with the CEO was executed at the suggestion of Acquirer during the negotiations for the business combination.

Analysis

In this example, the primary purpose of the arrangement is assumed to provide severance pay to the CEO, which primarily would benefit Acquirer or the combined company rather than Target or its former owners. If it was determined that the arrangement was to provide severance pay to the CEO, the Acquirer would record the payment as compensation expense in the post-acquisition financial statements of the combined company.

Illustration 6-30: Arrangement for contingent payment to employee based on double trigger (no future service requirement)

Target, a public company, hired an executive pursuant to a five-year employment contract. The contract requires Target to pay $250,000 to the executive in the event that (1) Target is acquired by another entity and (2) the executive's employment is terminated or his responsibilities or salary are reduced significantly (as defined in the employment agreement) by the acquirer subsequent to the acquisition. Acquirer acquires Target two years after the employment contract was signed with Target and on the acquisition date, enters into a new employment contract with the executive which results in his being an executive of a division of a public company (as opposed to an executive of a public company), which is defined in the executive's employment agreement as a significant reduction in the executive's responsibilities. As a result, the executive will receive the $250,000 payment.

Analysis

In this example, Target entered into the employment agreement before the negotiations of the acquisition began, and the purpose of the agreement was to obtain the services of the executive. However, there are two events that must occur in order for the executive to receive the payment (double trigger). In addition to Target being acquired, the executive must be terminated or have his responsibilities or salary significantly reduced by the acquirer. Because the second event (termination of employment or reduction of responsibility or salary)[1] is triggered by an action of the acquirer, we generally believe that the arrangement would be accounted for outside of the business combination and recorded as compensation expense in the post-acquisition financial statements of the combined entity.

[1] In addition to termination of employment, reduction in responsibilities or authority (e.g., a change in job title) or a reduction in salary or other employee benefits (e.g., failure to pay the executive a minimum cash bonus or a material reduction in the executive's ability to participate in savings or retirement plans available to other key executives), other common double-trigger clauses include relocation of executive or office location more than a specified distance and a material reduction in office size or office furnishings.

Illustration 6-31: Arrangement for contingent payments to shareholders/executive officers (future service required)

Acquirer acquires Target, a small, private company. All 5 selling shareholders of Target are also executive officers of the company. The consideration for the business combination is structured such that Target's shareholders will receive future payments if certain future operating results are achieved and the shareholders/executive officers remain employees of the combined entity for a period of two years following the acquisition. However, if a shareholder/executive officer does not remain an employee for the two-year period, that individual's rights to future payments are forfeited.

Analysis

Because the future payments in this example are contingent on the continuing employment of the shareholders/executive officers subsequent to the business combination, the future payments would be recognized as compensation expense in the post-acquisition financial statements of the combined company (over the two-year service period) (ASC 805-10-55-25(a)).

Illustration 6-32: Contingent payment linked to continuing employment unless employee is "good-leaver"

Assume the same facts in Illustration 6-31, except that if any of the five selling shareholders who become employees terminates employment but is considered a "good-leaver" (e.g., the employee is terminated for medical reasons, the employee is fired due to redundancies/not for cause), the employee is still entitled to the contingent payment. If the employee quits voluntarily or is fired for cause, the contingent payment is forfeited. One employee's termination of employment (irrespective of whether the employee is considered a good-leaver) has no effect on whether the other employees are entitled to their payments.

Analysis

Although there are circumstances in which an employee could receive the contingent payments without remaining employed, because the contingent payments are automatically forfeited if an employee quits voluntarily, the introduction of the "good-leaver" clause would not change the conclusion that the contingent consideration arrangement is accounted for as compensation for post-combination services (ASC 805-10-55-25(a)) consistent with the conclusion in Illustration 6-31.

Illustration 6-33: Contingent payment to nonemployee shareholders is linked to continuing employment of shareholders who become employees

Acquirer acquires all of the outstanding shares of Target for $10 million in cash. Before the transaction, Target's CEO owned 10% of Target's outstanding shares. Investor X and Investor Y, who are not employees of Target, each owned a 45% interest. The CEO will become an employee of Acquirer after the transaction.

The consideration for the business combination also includes a contingent payment provision through which each of Target's former shareholders (i.e., the CEO, Investor X and Investor Y) will receive an additional $5 million cash payment if Target's net income for the first year following the acquisition exceeds $20 million. However, each party (including Investor X and Investor Y) is entitled to the contingent payment only if the CEO remains an employee of the combined entity for a period of one year following the acquisition.

Analysis

Because all contingent payments to the selling shareholders automatically forfeit if the employment of the CEO terminates, careful evaluation is necessary to determine whether the contingent payments are accounted for as compensation for post-combination services (ASC 805-10-55-25a). The contingent payment owed to the CEO represents compensation expense that should be recognized over the one-year service period.

Notwithstanding the fact that the two other shareholders are not required to provide any service, because their payment is linked to the CEO's continuing future service, further evaluation of the facts and circumstances underlying the arrangement (including the reasons for linkage to the CEO's ongoing employment, the CEO's smaller ownership interest relative to that of the other shareholders and how the amount of initial consideration paid up front is linked to the valuation of the overall business) is required to determine whether all or a portion of the contingent payment owed to Investor X and Investor Y is compensatory in nature or should be included as part of the consideration transferred to acquire the Target.

This evaluation will require significant judgment and should include consideration of the factors highlighted in Illustration 6-27 above. Depending on the outcome of this evaluation, accounting for a portion or all of the contingent payment to the remaining shareholders as consideration transferred may be appropriate.

Illustration 6-34: Deferred payment to all selling shareholders with incremental payments to shareholders who become employees

Acquirer acquires all of the outstanding shares in Target for cash consideration of $65 million. In addition to the cash consideration, Acquirer is required to make the following two payments on the one-year anniversary of the acquisition date:

- Payout A — A $5 million cash payment to all former Target shareholders, split ratably based on the pre-transaction ownership of Target
- Payout B — An incremental $3 million cash payment to former Target shareholders who become employees of Acquirer ("employee-shareholders"), split ratably based on the pre-transaction ownership of Target

If an employee-shareholder terminates employment prior to the one-year anniversary of the acquisition date, that employee forfeits its share of Payout B, but is still entitled to its share of Payout A.

Analysis

Because each payout operates independently of the other, we believe each payout should be evaluated as a separate unit of account.

Because the obligation to make the $5 million payment for Payout A is not contingent on a future event (i.e., the payment is based solely on the passage of time) and all shareholders of Target participate equally, the obligation does not represent contingent consideration but rather deferred consideration. The deferred consideration liability is initially measured at fair value at the acquisition date and included in the consideration transferred. In substance, Acquirer has financed $5 million of the acquisition price.

Because the contingent payment associated with Payout B automatically forfeits if employment terminates, Payout B is accounted for as compensation for post-combination services (ASC 805-10-55-25a). That is, Acquirer would recognize compensation expense over the one-year service period.

Illustration 6-35: Stay bonus arrangement

In connection with Acquirer's acquisition of Target, Acquirer agrees to provide each of the key officers of Target with a cash payment of $250,000 if they remain with the combined company for a period of one year following the acquisition date. If the officers resign prior to the anniversary of the acquisition date, they forfeit their rights to the payments. A similar arrangement was not included in the officers' employment agreements prior to the acquisition.

Analysis

In this example, the payments to the key officers of Target are structured primarily to benefit the combined company, and the officers forfeit the rights to the payments if they do not provide the service to the combined company for a period of a year. Therefore, the payments are recorded as compensation expense in the post-acquisition financial statements of the combined company (over the one-year service period).

6.4.6 Accounting for contingent consideration after initial recognition

Excerpt from Accounting Standards Codification

Business Combinations — Goodwill or Gain from Bargain Purchase, Including Consideration Transferred

Subsequent Measurement

805-30-35-1

Some changes in the **fair value** of **contingent consideration** that the **acquirer** recognizes after the **acquisition date** may be the result of additional information about facts and circumstances that existed at the acquisition date that the acquirer obtained after that date. Such changes are measurement period adjustments in accordance with paragraphs 805-10-25-13 through 25-18 and Section 805-10-30. However, changes resulting from events after the acquisition date, such as meeting an earnings target, reaching a specified share price, or reaching a milestone on a research and development project, are not measurement period adjustments. The acquirer shall account for changes in the fair value of contingent consideration that are not measurement period adjustments as follows:

a. Contingent consideration classified as equity shall not be remeasured and its subsequent settlement shall be accounted for within equity.

b. Contingent consideration classified as an asset or a liability shall be remeasured to fair value at each reporting date until the contingency is resolved. The changes in fair value shall be recognized in earnings unless the arrangement is a hedging instrument for which Topic 815 requires the changes to be initially recognized in other comprehensive income.

805-30-35-1A

Contingent consideration arrangements of an acquiree assumed by the acquirer in a business combination shall be measured subsequently in accordance with the guidance for contingent consideration arrangements in the preceding paragraph.

6.4.6.1 Contingent consideration classified as equity

If a contingent consideration arrangement meets the criteria to be classified as equity, as discussed in section 6.4.3, the carrying value (i.e., the acquisition date fair value) of the contingent consideration is not remeasured subsequent to the acquisition date unless the adjustments are made during the measurement period to adjust provisional amounts, as discussed in section 7.3.3.

Upon resolution of the contingency, the entry to recognize the issuance of the consideration is based on the form of the consideration ultimately issued. That is, the issuance of equity instruments results in a reclassification among equity accounts (e.g., a reduction to the equity account in which the contingent consideration arrangements was recorded offset by an addition to common stock, based on the par value, with the remainder recorded as additional paid-in capital). However, if the acquirer settles the arrangement in cash, the acquirer offsets the credit to cash with a debit to shareholder's equity.

6.4.6.1.1 Continuous analysis of contingent consideration classified as equity

If an entity concludes that equity classification is appropriate under the applicable guidance, this conclusion must be reassessed at each reporting date.[56] Under ASC 815-40-25, an instrument could be classified as equity only if share settlement is within the control of the entity. As such, at each reporting date an entity must evaluate whether a sufficient number of authorized and unissued shares exist to settle the contingent consideration arrangement. In that evaluation, an entity must compare:

(a) The number of currently authorized but unissued shares, less the maximum number of shares that could be required to be delivered during the contingency period under existing commitments (for example, outstanding convertible debt that is convertible during the contract period, outstanding stock options that are or will become exercisable during the contingency period or other derivative financial instruments indexed to, and potentially settled, in the entity's own stock) with

(b) The maximum number of shares that could be required to be delivered under share settlement (either net-share or physical) of the contingent consideration arrangement

If the amount in (a) above exceeds the amount in (b) and the other criteria in ASC 815-40 are met, the entity controls share settlement and the arrangement continues to be classified as a permanent equity instrument. However, if the amount in (a) above does not exceed the amount in (b), the entity would be required to reclassify the contingent consideration arrangement from an equity instrument to a liability at its then current fair value as of the date of the event that caused the reclassification. The difference between the fair value of the contingent consideration at the date of reclassification and the amount initially recorded in equity should be accounted for as an adjustment to stockholders' equity. At each subsequent reporting date, the acquirer would be required to remeasure the liability at fair value through earnings, as discussed previously. See sections 4.4.5 and B.6 of our FRD, ***Issuer's accounting for debt and equity financings (before the adoption of ASU 2020-06, Accounting for Convertible Instruments and Contracts in an Entity's Own Equity)***, and sections 4.4.4 and B.6 of our FRD, ***Issuer's accounting for debt and equity financings (after the adoption of ASU 2020-06, Accounting for Convertible Instruments and Contracts in an Entity's Own Equity)***, for further details.

6.4.6.2 Contingent consideration classified as liabilities

If a contingent consideration arrangement is classified as a liability, as discussed in section 6.4.3, the carrying value of the contingent consideration must be remeasured at fair value at each reporting date. Except for qualifying measurement period adjustments (as discussed in section 7.3.3), we believe that subsequent changes in the fair value of the contingent consideration arrangement are most appropriately classified as an operating item (i.e., as a component of operating income if presented) in the statement of operations.[57] Refer to section 8.3.2.2 for further discussion on remeasurement and subsequent accounting.

An acquirer must reassess the classification of the contingent consideration at each reporting date. If the classification changes because of events occurring during the reporting period, the instrument is reclassified as of the date of the event that caused the reclassification. If a contract is reclassified from a liability to equity, it is measured at fair value at the date of reclassification and the resulting gain or loss is recorded in earnings. All gains or losses recognized during the period that the contract was classified as a liability shall not be reversed. See section B.6 of our FRDs, ***Issuer's accounting for debt and equity financings (before the adoption of ASU 2020-06, Accounting for Convertible Instruments and Contracts in an Entity's Own Equity)*** and ***Issuer's accounting for debt and equity financings (after the adoption of ASU 2020-06, Accounting for Convertible Instruments and Contracts in an Entity's Own Equity)***, for further details.

---

[56] This evaluation must be performed for all outstanding potentially dilutive arrangements.

[57] This is true unless the arrangement is a hedging instrument for which ASC 815 requires the changes to be initially recognized in other comprehensive income. Our FRD, ***Derivatives and hedging***, provides guidance on determining whether a derivative instrument is in the scope of ASC 815.

6.4.6.3 Changes to contingent consideration arrangements

After a business combination, situations may arise that cause the acquirer and former shareholders of the acquired entity to make changes to a previously established contingent consideration arrangement. ASC 805 does not address the accounting for subsequent changes to a contingent consideration arrangement. We believe that the accounting depends on whether the change represents a dispute over the terms of, or a modification to, the contingent consideration arrangement. Therefore, careful consideration should be given to determine whether the change represents a dispute over the terms of, or a modification to, the contingent consideration arrangement.

6.4.6.3.1 Dispute over the terms of a contingent consideration arrangement

A dispute over the terms of a contingent consideration arrangement typically will arise due to a disagreement between the acquirer and the former shareholders of the acquired entity regarding representations of fact underlying the acquisition or over the value of consideration transferred. If the parties transfer amounts to settle the dispute, the acquirer must determine whether to reflect any amounts paid or received as an adjustment to the consideration transferred or as post-combination expense or income. The acquirer's cost to settle litigation with the acquiree's former shareholders over the value of the consideration transferred is recorded as an expense when incurred unless the settlement occurred during the measurement period and there is a clear and direct link to the consideration transferred based on facts and circumstances that existed as of the acquisition date. In such cases, we believe that the acquirer may adjust the consideration transferred.

In our view, claims asserted that one party misled the other or that a provision of the contingent consideration agreement is unclear are not unique to business combination agreements and do not generally establish a clear and direct link to the consideration transferred. Therefore, unless there is a clear and direct link between the dispute and the amount of consideration transferred based on facts and circumstances that existed as of the acquisition date, we believe that the settlement of such claims should be recognized as a charge to earnings, regardless of whether the measurement period is open.

The following Illustrations highlight these concepts.

Illustration 6-36: Dispute over the terms of contingent consideration arrangement

Company A acquired Company B in a business combination for $100,000 cash and contingent consideration based on the number of Company B's customers that transfer to Company A. The purchase agreement is explicit that each "acquired customer" was worth $1,000 and that no fewer than 1,000 customers would be transferred as of the consummation date. Subsequent to the business combination (but while the measurement period was open), Company A successfully sued the seller of Company B because only 900 of Company B's customers transferred to Company A.

Analysis

Because the litigation settlement occurred during the measurement period and represented a dispute over the terms of the purchase agreement that is clearly and directly linked to the value of the consideration transferred based on facts and circumstances that existed as of the acquisition date, Company A adjusts the consideration transferred (in this case, a reduction of the consideration transferred). The adjustment to the consideration transferred would serve to reduce the contingent consideration liability initially recorded as of the acquisition date. Had the litigation been settled subsequent to the measurement period, the adjustment to the contingent consideration liability would be recorded as post-combination income and would not affect the consideration transferred.

Illustration 6-37: Dispute over the terms of contingent consideration arrangement

Assume the same facts as Illustration 6-36, except that the purchase agreement obligates the seller to put forth its best efforts to retain customers through the acquisition date (rather than stipulating the value and number of customers that will be transferred). Litigation subsequently determines that the seller failed to do so.

Analysis

Although the seller did not comply with the terms of the purchase agreement, the dispute is not clearly and directly linked to the value of the consideration transferred based on facts and circumstances that existed as of the acquisition date. Accordingly, the adjustment to the contingent consideration liability would be recorded as post-combination income and would not affect the consideration transferred.

See section 4.4.1.5.1.1 for further discussion on the settlement of litigation arising from a business combination and establishing a clear and direct link to the consideration transferred.

6.4.6.3.2 Modification to a contingent consideration arrangement

In some situations, the parties to a contingent consideration arrangement may agree to modify the terms of the arrangement. For example, the parties may agree to modify an earnings target to increase the likelihood of it being met. We believe that companies should consider whether the modification results in a transaction that should be accounted for separately from the business combination (see section 3.4.1.2 for further information on what is part of the business combination).

6.4.7 Effect of contingent consideration classified as equity on earnings per share computations

The guidance in ASC 260 addresses the effect of contingently issuable shares on a company's earnings per share computation. A general discussion of the effect of contingent consideration settled in shares on earnings per share calculations follows.

6.4.7.1 Basic earnings per share

Generally, contingent consideration arrangements subject to the guidance in ASC 480 or ASC 815-40 would not affect the acquirer's basic earnings per share (EPS) calculation until the contingency is resolved. Contingently issuable shares are considered outstanding common shares and included in basic EPS as of the date that all necessary conditions have been satisfied (i.e., when issuance of the shares is no longer contingent). In other words, contingently issuable shares are included in basic EPS only when there is no circumstance under which those shares would not be issued.

6.4.7.2 Diluted earnings per share

Contingent consideration arrangements settled in shares may affect the acquirer's diluted EPS calculation prior to resolution of the contingency and inclusion of the shares in basic earnings per share. The number of contingently issuable shares to be included in diluted EPS is based on the number of shares, if any, that would be issuable under the terms of the contingent consideration arrangement if the end of the reporting period were the end of the contingency period. As the contingently issuable share agreement originated on the date of the business combination, the contingently issuable shares are included in the denominator of the diluted EPS calculation as of the beginning of the *interim* period in which the conditions are satisfied, or as of the inception date of the contingent stock arrangement, if later.

If the contingently issuable share arrangements may be settled in common shares or in cash at the election of either the entity or the holder, the determination of whether that contract is included in the computation of diluted EPS is made based on the facts available each period. ASC 260-10-45-45 states that it is presumed that the contract will be settled in common shares and the resulting potential common shares are included in diluted EPS if the effect is more dilutive. The presumption that the contract will be settled in common shares may be overcome if past experience or a stated policy provides a reasonable basis to believe that the contract will be paid partially or wholly in cash. If that presumption is overcome for an instrument that is classified as equity, it may require an adjustment to the numerator for any changes in income or loss that would have resulted if the contract had been reported as an asset or a liability. If the presumption is not overcome and it is assumed that the contract will be settled in common shares, as noted above, the resulting potential common shares are included in diluted EPS if the effect is more dilutive.

If the contingent consideration arrangement is reported as a liability, the calculation of earnings per share may require an adjustment to the numerator for any changes in income or loss that would result if the contract had been reported as an equity instrument during the period.

Additional guidance regarding the impact on earnings per share of contracts that can be settled in shares or cash is included in ASC 260-10-55-32 through 55-36 and in our FRD, ***Earnings per share***.

6.4.8 Assumed contingent consideration arrangements

Excerpt from Accounting Standards Codification

Business Combinations — Identifiable Assets and Liabilities, and Any Noncontrolling Interest

Recognition

805-20-25-15A

Contingent consideration arrangements of an acquiree assumed by the acquirer in a business combination shall be recognized initially at fair value in accordance with the guidance for contingent consideration arrangements in paragraph 805-30-25-5.

Initial Measurement

805-20-30-9A

Contingent consideration arrangements of an acquiree assumed by the acquirer in a business combination shall be measured initially at fair value in accordance with the guidance for contingent consideration arrangements in paragraph 805-30-25-5.

Subsequent Measurement

805-20-35-4C

Contingent consideration arrangements of an acquiree assumed by the acquirer in a business combination shall be measured subsequently in accordance with the guidance for contingent consideration arrangements in paragraph 805-30-35-1.

In some cases, an acquiree may have consummated a prior business combination in which it issued contingent consideration. The FASB believes that the nature of contingent consideration does not change on the subsequent acquisition of one entity by another entity (that is, although the amount of the future payments the acquirer will make or receive is conditional on future events, the obligation to make or right to receive them if the specified future events occur is unconditional). As a result, if an acquirer assumed a preexisting contingent consideration arrangement in a business combination, the acquirer accounts for that arrangement in the same manner as if it had entered into that arrangement with respect to the current business combination. Accordingly, the contingent consideration arrangement of the acquiree assumed by the acquirer in a business combination is initially measured at fair value and classified in accordance with other accounting literature, as discussed in ASC 805-30-25-5 through 25-6

and section 6.4.3 above. The guidance in ASC 805 also requires that contingent consideration arrangements of the acquiree assumed by the acquirer in a business combination be accounted for subsequent to initial recognition pursuant to the requirements for contingent consideration in ASC 805-30-35-1, as discussed above. However, unlike contingent consideration agreed to between the acquirer and acquiree, which is part of the consideration transferred, an existing contingent consideration arrangement of the acquiree is treated as a liability assumed or asset acquired in the acquisition rather than a component of consideration transferred.

6.4.9 Seller accounting for contingent consideration in deconsolidation

The basis for recognition and measurement of contingent consideration in deconsolidation is not addressed in ASC 805. See our FRD, ***Consolidation***, for guidance on the seller's accounting for contingent consideration in deconsolidation.

7 Other matters (including goodwill, measurement period and acquisitions achieved in stages)

7.1 Recognizing and measuring goodwill

7.1.1 Recognition

While deliberating Statement 141(R), the FASB concluded that goodwill is an asset that should be measured as a residual. This conclusion is consistent with the prior accounting treatment under Statement 141.

CON 6, as it existed during Statement 141(R) deliberations, defined an asset as "probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events."[58] The future economic benefit that goodwill provides to an entity is somewhat difficult to define, however the FASB recognized this fact in its basis for conclusions by describing the future economic benefit associated with goodwill as "nebulous." The FASB, nevertheless, maintained its conclusion that goodwill is an asset. This conclusion was primarily based on paragraph 173 of CON 6, which stated that, "anything that is commonly bought and sold has future economic benefit, including the individual items that a buyer obtains and is willing to pay for in a 'basket purchase' of several items or in a business combination." While it is somewhat difficult to grasp the future economic benefit of goodwill as a standalone asset, its future economic benefit becomes clear when goodwill is viewed as an individual asset that market participants are willing to pay for in a "basket purchase."

The FASB made every effort, in deliberating Statement 141(R), to limit the recognition of goodwill to "core goodwill," which is defined as both:

- The fair value of the going-concern element of the acquired business
- The fair value of the expected synergies to be achieved upon consummation of the business combination

To limit goodwill to the two components above, the acquirer in a business combination is required to make every effort to (1) accurately measure the consideration transferred, (2) recognize the identifiable assets and liabilities at fair value and (3) recognize **all** identifiable acquired intangible assets that meet the criteria in the definition of "identifiable" within the Master Glossary in ASC 805. Because goodwill is measured as a residual, if exhaustive efforts are not made to complete these three steps, then goodwill will include components other than "core goodwill." Nonetheless, even after an exhaustive effort to apply the guidance in ASC 805, goodwill likely will not be limited to core goodwill because of items that are not recognized in a business combination (e.g., contingent assets that do not more likely than not meet the definition of an asset, intangible assets like workforce intangibles that do not meet the recognition criteria) and items that are not recognized at fair value (e.g., deferred income taxes).

[58] The FASB issued CON 8.4 to replace CON 6 in December 2021. CON 8.4 defines an asset as "a present right of an entity to an economic benefit."

7.1.2 Measurement

Excerpt from Accounting Standards Codification

Business Combinations — Goodwill or Gain from Bargain Purchase, Including Consideration Transferred

Initial Measurement

805-30-30-1

The **acquirer** shall recognize **goodwill** as of the **acquisition date**, measured as the excess of (a) over (b):

a. The aggregate of the following:

   1. The consideration transferred measured in accordance with this Section, which generally requires acquisition-date **fair value** (see paragraph 805-30-30-7)

   2. The fair value of any **noncontrolling interest** in the **acquiree**

   3. In a **business combination** achieved in stages, the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree.

b. The net of the acquisition-date amounts of the **identifiable** assets acquired and the liabilities assumed measured in accordance with this Topic.

Consistent with previous accounting under Statement 141, the guidance in ASC 805 requires goodwill to be measured as the excess of one amount over another. This results in goodwill being measured as a residual. The measurement occurs on the acquisition-date and, other than qualifying measurement period adjustments, no adjustments are made to goodwill recognized as of the acquisition date until and unless it becomes impaired.

Under Statement 141, the measurement of goodwill was equal to the purchase price less the values assigned of the net identifiable assets of the acquired entity. As discussed in section 1.2, Statement 141 utilized a cost accumulation approach in accounting for a business combination. The guidance in ASC 805, on the other hand, utilizes a new basis approach in which the fair value of the acquired entity is remeasured in its entirety. As a result, goodwill essentially is calculated as the fair value of the entity (rather than the purchase price) less the values assigned to the net identifiable assets of the acquired entity, all measured on the acquisition date. As a consequence of this change, ASC 805 requires:

- The consideration transferred to be measured at fair value on the acquisition date, as discussed in section 6.1.
- Any remaining noncontrolling interest (i.e., shares of the acquired entity that are not owned by the acquirer) to be recognized at fair value, rather than historical cost as was the case under Statement 141. See further discussion in section 4.6.
- The remeasurement of any preexisting investment in the acquired entity in an acquisition achieved in stages. As discussed further in section 7.4, ASC 805 requires any preexisting investment in the acquiree to be remeasured at fair value in the accounting for a business combination achieved in stages. The measurement of goodwill in an acquisition occurring in stages occurs only once on the date that the acquirer gains control of the acquiree. This treatment contrasts with the previous requirement to recognize and measure goodwill at the time that each additional investment was made based on the cost of the additional investment, and the underlying measured amounts of the net assets acquired.

The application of ASC 805 also results in a number of changes in how assets acquired and liabilities assumed in the business combination are measured and recognized. These differences are discussed in section 4.

7.2 Recognizing and measuring a gain from a bargain purchase

Excerpt from Accounting Standards Codification

Business Combinations — Goodwill or Gain from Bargain Purchase, Including Consideration Transferred

Recognition

805-30-25-2

Occasionally, an acquirer will make a *bargain purchase*, which is a **business combination** in which the amount in paragraph 805-30-30-1(b) exceeds the aggregate of the amounts specified in (a) in that paragraph. If that excess remains after applying the requirements in paragraph 805-30-25-4, the acquirer shall recognize the resulting gain in earnings on the acquisition date. The gain shall be attributed to the acquirer. Example 1 (see paragraph 805-30-55-14) provides an illustration of this guidance.

805-30-25-3

A bargain purchase might happen, for example, in a business combination that is a forced sale in which the seller is acting under compulsion. However, the recognition or measurement exceptions for particular items identified in paragraphs 805-20-25-16, and 805-20-30-10 also may result in recognizing a gain (or change the amount of a recognized gain) on a bargain purchase.

Occasionally, the fair value of the net assets acquired in a business combination exceeds the amount of consideration transferred. ASC 805 refers to this situation as a "bargain purchase."

The guidance in ASC 805 requires the acquirer in a business combination resulting in a bargain purchase to recognize a gain for the amount that the values assigned to the net assets acquired exceed the consideration transferred. However, before recognizing a bargain gain, the acquirer must reassess whether it has correctly identified and measured all components of the acquisition.

Because bargain purchases are rare, we believe that an important aspect of the reassessment process is for the acquirer to be able to understand why there is a bargain purchase — why the seller would be willing to sell its business at an amount less than what a market participant would be willing to pay. Usually, a seller acts in an economically rational manner given the fiduciary responsibility that it has to its shareholders. Examples of factors that may individually or in aggregate justify a bargain gain include the following:

- The transaction was a "forced" or "distressed" sale. Bargain purchases are most common when there is a "forced" or "distressed" sale. The example in section 7.2.2 illustrates the accounting for a "forced" sale when the seller is compelled to sell for less than current fair market value.
- The seller was required to sell the business in a less than an optimal period of time.
- The transaction was not subject to a competitive bidding process. Transactions subject to a competitive bidding process generally are less likely to result in a bargain gain because the business typically would be sold at fair value.
- The purchase price was "fixed" prior to the closing date of the transaction and the fair value of the net identifiable assets acquired increased during the intervening period thereby creating the bargain purchase.
- The buyer cannot sell the identifiable net assets acquired immediately after the acquisition at an amount equal to or greater than the acquired set's preliminarily estimated fair value. For example, if the acquirer in a bargain purchase transaction records an asset for $10 because it includes company-specific synergies in the valuation of the asset, but a market participant would pay only $8 if the acquirer were to immediately sell that asset, then that would suggest that the fair value of the asset is really $8. On the other hand, if a market participant would pay $10 for the asset, the acquirer's conclusion that it had a bargain purchase may be appropriate.

Companies should consider these factors as they think about how to disclose the bargain gain in the notes to their financial statements. See section 7.2.1 for further discussion of the required reassessment.

7.2.1 Required reassessment of identification and measurement of all aspects of the transaction

Excerpt from Accounting Standards Codification

Business Combinations — Goodwill or Gain from Bargain Purchase, Including Consideration Transferred

Recognition

805-30-25-4

Before recognizing a gain on a bargain purchase, the acquirer shall reassess whether it has correctly identified all of the assets acquired and all of the liabilities assumed and shall recognize any additional assets or liabilities that are identified in that review. See paragraphs 805-30-30-4 through 30-6 for guidance on the review of measurement procedures in connection with a reassessment required by this paragraph.

Initial Measurement

805-30-30-5

Paragraph 805-30-25-4 requires the acquirer to reassess whether it has correctly identified all of the assets acquired and all of the liabilities assumed before recognizing a gain on a bargain purchase. As part of that required reassessment, the acquirer shall then review the procedures used to measure the amounts this Topic requires to be recognized at the acquisition date for all of the following:

a. The identifiable assets acquired and liabilities assumed

b. The noncontrolling interest in the acquiree, if any

c. For a business combination achieved in stages, the acquirer's previously held equity interest in the acquiree

d. The consideration transferred.

805-30-30-6

The objective of the review is to ensure that the measurements appropriately reflect consideration of all available information as of the acquisition date.

Before recognizing a gain from a bargain purchase, an acquirer is required to reassess its identification of assets acquired and liabilities assumed to validate that all assets and liabilities that the acquirer is able to identify at the acquisition date are properly recognized. In addition, the acquirer must reconsider and challenge all valuations to verify that the consideration paid, assets acquired, liabilities assumed and noncontrolling interests are properly measured. The guidance in ASC 805 requires that this additional reassessment be performed to verify that the identification and measurement of all components of the business combination were consistent with the requirements of ASC 805.

In performing the required reassessment, the acquirer reevaluates all aspects of the transaction, including whether:

- The resulting gain represents management's best estimate of the economic effect of the transaction based on all information that existed as of the acquisition date

- There are any aspects of the transaction that should be accounted for separately from the business combination, such as:
  - Preexisting relationships that were settled as a result of the business combination
  - Transactions (contractual or noncontractual) entered into at or near the same time as the business combination that are primarily for the benefit of the combined entity
  - The payment of transaction costs by the seller on behalf of the acquirer
- All assets acquired were evaluated for any contingencies that could prohibit recognition as of the acquisition date
- All identified intangible assets met either the contractual-legal or separability criterion of ASC 805
- Conclusions reached with respect to assumed pension obligations were appropriate
- Preacquisition contingencies (e.g., legal contingencies or potential tax exposures) of the target were properly identified, measured and recognized
- All leases and other executory contracts were evaluated for any off-market components that should be recognized as of the acquisition date
- Conclusions reached with respect to the accounting for acquired or assumed deferred taxes were appropriate
- The buyer assessed the reasonableness of the fair value determinations by reviewing the procedures performed to measure the fair value of the consideration transferred, assets acquired, liabilities assumed and any noncontrolling interest, including whether:
  - The fair value measurements reflect all available information as of the acquisition date
  - The significant assumptions (e.g., prospective financial information, discount rate, royalty rate, control premium, as applicable) used in the fair value calculation are reasonable and reflect the appropriate level of risk for the transaction (e.g., if management's estimate of the prospective financial information was deemed to be aggressive, then the discount rate should be increased to reflect the additional level of risk)
  - Any entity-specific synergies were inappropriately included in the initial valuation of any assets acquired or liabilities assumed (e.g., could the buyer immediately sell the asset or transfer the liability to a market participant at their recorded values)

The list above is not all-inclusive nor will all considerations in the list apply to all business combinations that potentially could result in a bargain purchase.

If a gain is recognized from a bargain purchase, no goodwill is recognized on that purchase. The assets acquired, liabilities assumed and any noncontrolling interest are recognized at fair value (with certain exceptions), and there is no residual to measure because the consideration transferred is less than the fair value of the net assets acquired.

7.2.2 Bargain purchase example

Illustration 7-1: Bargain purchase example

On 1 January 20X8, Acquirer acquires 70% of the equity interests of Distressed, a private company, in exchange for cash of $350,000. Because the former owners of Distressed were unable to maintain operations with cash on-hand (Distressed's balance sheet is primarily comprised of long-term, difficult to value assets), they had limited time to complete a sale and were unable to market Distressed to multiple potential buyers.

Acquirer measures the assets acquired and the liabilities assumed as of the acquisition date (1 January 20X8). The identifiable assets acquired are measured at $680,000, and the liabilities assumed are measured at $90,000. Acquirer also engages a third-party valuation firm to assist in determining the fair value of the 30% noncontrolling interest. The estimated value of the noncontrolling interest in Distressed is $182,000.

Distressed's identifiable net assets of $590,000 ($680,000 − $90,000) exceeds the sum of the fair value of the consideration transferred and the fair value of the noncontrolling interest in Distressed of $532,000 ($350,000 + $182,000). Because of this, Acquirer performs a comprehensive reassessment of the procedures it used to identify and measure the assets acquired and liabilities assumed, value the noncontrolling interest, and measure the consideration transferred to verify that all of those measurements are appropriate and reasonable (see section 7.2.1).

In its review, Acquirer determines that the procedures performed and resulting values remain appropriate. Therefore, Acquirer measures the gain on its purchase of the 70% interest as follows:

Fair value of net assets acquired	$ 590,000
Less:	
Fair value of consideration transferred	350,000
Fair value of noncontrolling interest	182,000
	532,000
Gain on bargain purchase	$ 58,000

The journal entry to record this acquisition would be as follows:

Net assets acquired	$ 590,000	
Cash		$ 350,000
Gain on bargain purchase		58,000
Noncontrolling interest		182,000

7.2.3 Bargain purchase in an acquisition of less than 100% controlling interest

As noted in 7.2, a bargain purchase is a business combination in which (a) the net of the acquisition-date fair value of the identifiable assets acquired and the liabilities assumed exceeds (b) the aggregate of (i) the fair value of consideration transferred; (ii) the fair value of any noncontrolling interest in the acquiree; and (iii) the acquisition-date fair value of any previously held equity interest in the acquiree. When an entity acquires less than a 100% controlling interest in another entity and that acquisition results in a bargain purchase, we believe that no portion of the gain realized should be allocated to the noncontrolling interest. We believe that this approach is consistent with the guidance in ASC 805-20-30-7 (see section 4.6), which requires the acquirer to measure a noncontrolling interest in the acquiree at its fair value on the acquisition date.

7.3 Measurement period

7.3.1 Measurement period defined

Excerpt from Accounting Standards Codification

Business Combinations — Overall

Recognition

805-10-25-13

If the initial accounting for a business combination is incomplete by the end of the reporting period in which the combination occurs, the acquirer shall report in its financial statements provisional amounts for the items for which the accounting is incomplete. During the measurement period, in accordance with paragraph 805-10-25-17, the acquirer shall adjust the provisional amounts recognized at the acquisition date to reflect new information obtained about facts and circumstances that existed as of the acquisition date that, if known, would have affected the measurement of the amounts recognized as of that date.

805-10-25-14

During the measurement period, the acquirer also shall recognize additional assets or liabilities if new information is obtained about facts and circumstances that existed as of the acquisition date that, if known, would have resulted in the recognition of those assets and liabilities as of that date. The measurement period ends as soon as the acquirer receives the information it was seeking about facts and circumstances that existed as of the acquisition date or learns that more information is not obtainable. However, the measurement period shall not exceed one year from the acquisition date.

805-10-25-15

The measurement period is the period after the acquisition date during which the acquirer may adjust the provisional amounts recognized for a business combination. The measurement period provides the acquirer with a reasonable time to obtain the information necessary to identify and measure any of the following as of the acquisition date in accordance with the requirements of this Topic:

a. The identifiable assets acquired, liabilities assumed, and any noncontrolling interest in the acquiree (see Subtopic 805-20)

b. The consideration transferred for the acquiree (or the other amount used in measuring goodwill in accordance with paragraphs 805-30-30-1 through 30-3)

c. In a business combination achieved in stages, the equity interest in the acquiree previously held by the acquirer (see paragraph 805-30-30-1(a)(3))

d. The resulting goodwill recognized in accordance with paragraph 805-30-30-1 or the gain on a bargain purchase recognized in accordance with paragraph 805-30-25-2.

Initial Measurement

805-10-30-1

Paragraph 805-10-25-15 establishes that the measurement period provides the **acquirer** with a reasonable time to obtain the information necessary to identify and measure various items in a **business combination**.

The measurement period is the time after the acquisition during which the acquirer obtains information necessary to identify and measure **all aspects** of the business combination in accordance with the guidance in ASC 805. Adjustments during the measurement period are not limited to just those relating to assets acquired and liabilities assumed, but apply to all aspects of business combination accounting (e.g., the consideration transferred).

The measurement period is not a fixed period for all business combinations, or even for all aspects of a particular business combination. The measurement period ends once the acquirer is able to determine that it has obtained all necessary information that existed as of the acquisition date or has determined that such information is unavailable. However, the measurement period cannot extend beyond one year from the acquisition date.

We believe that the acquirer determines the information that it is seeking on an item-by-item basis. We believe that the acquirer must document the information that it has not yet obtained, but has arranged to obtain, for each reporting period that the measurement period remains open. The SEC staff has challenged measurement period adjustments when prior disclosures failed to indicate that the acquirer was waiting on the specific information that resulted in the adjustment. In those circumstances, the SEC staff typically expects adjustments to carrying amounts to be recognized in the statement of operations in the current period.

For some acquisitions, the measurement period is relatively short, while complex acquisitions often require a longer period to obtain necessary information to complete the measurement process required by the guidance in ASC 805.

Once the acquirer obtains the information it has arranged to obtain or determines that the information does not exist, then the measurement period is closed. The measurement period is not a fixed twelve-month period during which all changes in carrying values of assets acquired or liabilities assumed are considered adjustments to the business combination accounting. In addition, the period may not be extended to include the time necessary to resolve a contingency or negotiate after the acquisition date with a counterparty to a preacquisition contingency. The one-year limit is in place to prevent the measurement period from extending indefinitely.

7.3.2 Provisional amounts recognized

During the measurement period, the acquirer recognizes provisional amounts based on the acquirer's best estimates using information that it has obtained as of the reporting date. The acquirer discloses that the amounts recognized are provisional and discloses the information that the acquirer has arranged to obtain, but has not yet received. Section 8.5.8 describes the disclosure requirements for provisional amounts recognized and the information that has not been received to finalize those provisional amounts.

ASC 805 does not provide specific guidance on how to determine provisional amounts but those provisional amounts should be determined based on information available as of the acquisition date that is known at the date the financial statements are issued. While the information may be preliminary or may not be readily available at the acquisition date, it would not be appropriate to simply assign a nominal value or no value to particular assets or liabilities simply because the acquirer anticipates receiving (during the measurement period) additional information that will affect the ultimate recognition and measurement of those items.

7.3.3 Adjustments to provisional amounts during the measurement period

Excerpt from Accounting Standards Codification

Business Combinations — Overall

Recognition

805-10-25-16

The acquirer recognizes an increase (decrease) in the provisional amount recognized for an identifiable asset (liability) by means of a decrease (increase) in goodwill. However, new information obtained during the measurement period sometimes may result in an adjustment to the provisional amount of more than one asset or liability. For example, the acquirer might have assumed a liability to pay damages related to an accident in one of the acquiree's facilities, part or all of which are covered by the acquiree's liability insurance policy. If the acquirer obtains new information during the measurement period about the acquisition-date fair value of that liability, the adjustment to goodwill resulting from a change to the provisional amount recognized for the liability would be offset (in whole or in part) by a corresponding adjustment to goodwill resulting from a change to the provisional amount recognized for the claim receivable from the insurer.

805-10-25-18

Paragraphs 805-10-30-2 through 30-3 require consideration of all pertinent factors in determining whether information obtained after the acquisition date should result in an adjustment to the provisional amounts recognized or whether that information results from events that occurred after the acquisition date.

Initial Measurement

805-10-30-2

The acquirer shall consider all pertinent factors in determining whether information obtained after the **acquisition date** should result in an adjustment to the provisional amounts recognized or whether that information results from events that occurred after the acquisition date. Pertinent factors include the time at which additional information is obtained and whether the acquirer can identify a reason for a change to provisional amounts.

805-10-30-3

Information that is obtained shortly after the acquisition date is more likely to reflect circumstances that existed at the acquisition date than is information obtained several months later. For example, unless an intervening event that changed its **fair value** can be identified, the sale of an asset to a third party shortly after the acquisition date for an amount that differs significantly from its provisional fair value determined at that date is likely to indicate an error in the provisional amount.

The acquirer must perform a careful evaluation of any adjustments made to provisional amounts recognized. The acquirer performs this evaluation to determine whether the potential adjustment is the result of information that existed as of the acquisition date or whether the potential adjustment is the result of events occurring subsequent to the acquisition date. This evaluation includes the timing of when the additional information is obtained and whether the acquirer can identify a reason for a change to the provisional amounts. Information that is obtained shortly after the acquisition date is more likely to reflect circumstances that existed at the acquisition date than information obtained several months later.

The acquirer adjusts provisional amounts only for adjustments resulting from facts and circumstances that existed as of the acquisition date.

If the acquirer becomes aware of new information or additional information comes to light during the measurement period about facts and circumstances that existed as of the acquisition date, the provisional amounts recognized at the acquisition date are adjusted only if the new information does one of the following:

- Affects the measurement of items that were initially recognized at the acquisition date
- Establishes that an additional asset was acquired or a liability was assumed that was not recognized in the initial accounting for the acquisition
- Establishes that an asset or a liability that was previously recognized at the acquisition date does not meet the recognition requirements of ASC 805

The acquirer generally adjusts provisional amounts by increasing or decreasing goodwill. However, in some circumstances, new information may result in adjustments to other assets and liabilities. For example, if the acquirer completes its assessment of the fair value of a contingent liability and adjusts the provisional amount recognized for that liability, it also likely would adjust the provisional amount recognized for any related indemnification asset.

The acquirer recognizes changes in carrying amounts of assets and liabilities that are the result of facts and circumstances that did not exist as of acquisition date as part of ongoing operations (generally, as income or expense in the current statement of operations).

Illustration 7-2: New information obtained during the measurement period

On 1 January 20X9, Company A acquired all of the outstanding shares of Company B and accounted for the transaction as a business combination under ASC 805. As of the acquisition date, Company A determined that a potential litigation liability relating to a defective product existed and recorded a provisional liability of $2,000. On 1 March 20X9, Company A obtained additional information from a third-party consultant, which Company A hired to determine the nature of the damages caused by the defective product. Based on information received from the third-party consultant, Company A determined that the damages caused by the defective product were understated and the liability should have been recorded at $3,000 as of the acquisition date.

Analysis

Because the new information received on 1 March 20X9 about the defective product relates to facts and circumstances that existed at the acquisition date, Company A should recognize an increase of $1,000 to the provisional liability and a corresponding increase to goodwill.

Illustration 7-3: New information obtained during the measurement period and information not known at the acquisition date

Assume the same facts in Illustration 7-2 except that Company A did not know about the defective product on the acquisition date. However, on 1 April 20X9 (before the measurement period ended), Company A becomes aware of the damages caused by the defected product that existed as of the acquisition date. Based on this new information, Company A determines that a potentially liability of $3,000 should have been recognized as of the acquisition date.

Analysis

The contingency existed as of the acquisition date, even though Company A did not identify it until new information became available during the measurement period. If Company A was aware of the existence of the defective product on the acquisition date, Company A would have recognized a liability as of that date. Therefore, Company A should adjust the acquisition-date accounting to reflect the $3,000 estimated amount of the liability in accordance with ASC 805-10-25-16 with a corresponding increase to goodwill.

Illustration 7-4: New information obtained during the measurement period with no change to acquisition-date accounting

Assume the same facts in Illustration 7-3 except that the damages caused by the defective product did not exist as of the acquisition date. Based on this new information, Company A determines that a potential liability of $3,000 should be recognized.

Analysis

Because the contingency did not exist as of the acquisition date, there is no adjustment to the acquisition-date accounting to reflect the $3,000 estimated amount of the liability. Rather, the $3,000 liability would be recorded as expense in the current period.

7.3.3.1 Recognition of measurement period adjustments

Excerpt from Accounting Standards Codification

Business Combinations — Overall

Recognition

805-10-25-17

During the measurement period, the acquirer shall recognize adjustments to the provisional amounts with a corresponding adjustment to goodwill in the reporting period in which the adjustments to the provisional amounts are determined. Thus, the acquirer shall adjust its financial statements as needed, including recognizing in its current-period earnings the full effect of changes in depreciation, amortization, or other income effects, by line item, if any, as a result of the change to the provisional amounts calculated as if the accounting had been completed at the acquisition date. Paragraph 805-10-55-16 and Example 1 (see paragraph 805-10-55-27) provide additional guidance.

Acquirers must recognize measurement period adjustments during the period in which they determine the amounts, including the effect on earnings of any amounts they would have recorded in previous periods if the accounting had been completed at the acquisition date.

The acquirer must disclose the amounts and reasons for adjustments to the provisional amounts. The acquirer also must disclose, by line item, the amount of the adjustment reflected in the current-period income statement that would have been recognized in previous periods if the adjustment to provisional amounts had been recognized as of the acquisition date. Alternatively, an acquirer may present those amounts separately on the face of the income statement.

See section F.2 for an illustration of adjustments to provisional amounts and the related disclosures and presentation.

7.3.4 Acquisition accounting subsequent to the measurement period

Excerpt from Accounting Standards Codification

Business Combinations — Overall

Recognition

805-10-25-19

After the measurement period ends, the acquirer shall revise the accounting for a business combination only to correct an error in accordance with Topic 250.

Adjustments to amounts recognized in a business combination that occur after the end of the measurement period are recognized in current period operations. The acquirer does not adjust the accounting for the business combination in such circumstances for anything other than the correction of an error that would

be accounted for in accordance with the guidance in ASC 250 (generally by restating prior periods). The materiality of any such errors should be carefully considered. SAB 108 provides guidance for SEC registrants regarding the assessment of materiality of errors and should also be considered by nonpublic companies.

The SEC staff has also challenged whether adjustments to provisional amounts recognized for assets acquired or liabilities assumed in a business combination qualify as measurement period adjustments, including whether the changes to provisional amounts recognized in the acquisition are properly characterized as measurement period adjustments rather than error corrections.[59]

7.4 Business combinations achieved in stages

Excerpt from Accounting Standards Codification

Business Combinations — Overall

Recognition

805-10-25-9

An acquirer sometimes obtains control of an acquiree in which it held an equity interest immediately before the acquisition date. For example, on December 31, 20X1, Entity A holds a 35 percent noncontrolling equity interest in Entity B. On that date, Entity A purchases an additional 40 percent interest in Entity B, which gives it control of Entity B. This Topic refers to such a transaction as a *business combination achieved in stages,* sometimes also referred to as a step acquisition.

7.4.1 Accounting prior to obtaining control

Any ownership interest held prior to obtaining control is subject to existing accounting literature, as appropriate. If the investor exercises significant influence over the investee, as defined in ASC 323-10-15-6, then the investment is accounted for under the equity method. If the investor is not able to exercise significant influence over the investee, the investment is accounted for as an equity security, generally in accordance with the guidance in ASC 321 or using the cost model in ASC 325-20, as appropriate.

The application of the acquisition model in ASC 805 is based on the acquirer gaining control of the acquired entity. If control is not obtained, then ASC 805 does not apply to the investment.

7.4.2 Accounting for a preexisting investment when control is obtained

An acquirer may obtain control of an acquiree through a series of acquisitions of two or more different investments. Such a transaction is commonly referred to as a "step-acquisition" and in ASC 805, as a "business combination achieved in stages." The act of obtaining control triggers the application of the acquisition model in ASC 805. Prior accounting in accordance with a step-acquisition model, under which each additional investment was recognized in accordance with the provisions of Statement 141, resulted in multiple measurement bases for assets acquired and liabilities assumed, no longer applies when control is obtained. Rather, the preexisting equity interest in the acquired company is remeasured at fair value when the acquirer obtains control (see further discussion in section 7.4.2.1) and the acquired assets and assumed liabilities are measured at their full fair value (or other specified amounts).

After the adoption of the guidance in ASC 805, step-acquisition accounting prescribed in current GAAP continues to be applied to increases in equity investments as long as an investor's interest does not become a controlling interest. Under this accounting, an investor's basis in each increased investment in an acquiree becomes a component of the accumulated basis of the investor's investment. Under Statement 141, this cost accumulation accounting model continued beyond the point of obtaining control.

---

[59] Comments by Jonathan Wiggins, Associate Chief Accountant in the Office of the Chief Accountant at the SEC, at the 2016 AICPA Conference on Current SEC and PCAOB Developments.

7.4.2.1 Remeasurement of previously held interest (updated June 2023)

Excerpt from Accounting Standards Codification

Business Combinations — Overall

Recognition

805-10-25-10

In a business combination achieved in stages, the acquirer shall remeasure its previously held equity interest in the acquiree at its acquisition-date **fair value** and recognize the resulting gain or loss, if any, in earnings. In prior reporting periods, with respect to its previously held equity method investment, the acquirer may have recognized amounts in other comprehensive income in accordance with paragraph 323-10-35-18. If so, the amount that was recognized in other comprehensive income shall be reclassified and included in the calculation of gain or loss as of the acquisition date. If the business combination achieved in stages relates to a previously held equity method investment that is a **foreign entity**, the amount of accumulated other comprehensive income that is reclassified and included in the calculation of gain or loss shall include any foreign currency translation adjustment related to that previously held investment. For guidance on derecognizing foreign currency translation adjustments recorded in accumulated other comprehensive income, see Section 830-30-40.

If the acquirer owns a noncontrolling interest in the acquiree immediately before obtaining control, the acquirer must remeasure that investment at fair value as of the acquisition date. The acquirer recognizes any gains or losses from the remeasurement of the previously held investment in current period earnings. In prior reporting periods, the acquirer may have recognized amounts related to a previously held equity method investment in other comprehensive income (e.g., because the investment is in a foreign entity for which the acquirer has recognized a cumulative translation adjustment amount). If so, the amount that was recognized in other comprehensive income should be reclassified and included in the calculation of gain or loss as of the acquisition date.

The Board believes that a change from holding a noncontrolling equity investment in an entity to obtaining control of that entity is a significant change in the nature of and economic circumstances surrounding that investment. The acquirer exchanges its status as an owner of an investment in an entity for a controlling financial interest in all of the underlying assets and liabilities of that entity and the right to direct how the acquiree and its management use those assets in conducting its operations. In the FASB's view, that exchange warrants fair value recognition of all net assets over which control has been obtained and requires remeasurement through earnings of any previously held noncontrolling interest. Disclosure of the gain or loss recognized in connection with remeasuring the basis in previously held non-controlling interests is required (see Appendix F).

The guidance in ASC 805 is unclear how the preexisting equity interest should be remeasured when control is obtained in a business combination achieved in stages. The question that arises is whether the preexisting noncontrolling interest of the acquirer should be remeasured (1) independent of the acquisition of the controlling interest (i.e., the moment before control is obtained) or (2) in combination with the controlling interest.

Under the first alternative (Alternative 1), the preexisting equity interest is remeasured as a noncontrolling interest independent of the acquired controlling interest. This view is based on the guidance in paragraph ASC 805-30-30-1, which contemplates separate measurement of the consideration transferred and the preexisting *noncontrolling* interest. Accordingly, under this view, no control or acquisition premium would be added to the value of the previously held interest, as any benefit the acquirer expects to receive from exercising control would be captured in accounting for the business combination, not in the derecognition of the preexisting interest.

Under the second alternative (Alternative 2), the entire ownership interest (both new and preexisting) of the acquirer in the acquired company would be valued as a single interest. Under this alternative, any control or acquisition premium could be included in the revaluation of the preexisting noncontrolling interest, which would serve to increase the gain (or reduce the loss) associated with the derecognition of the acquirer's previously held interest in the acquired entity.

We understand that members of the FASB staff and IASB staff discussed this issue at the 23 September 2008 FASB Valuation Resource Group meeting and indicated that they believed Alternative 1 above is consistent with the intent of the respective boards. Accordingly, absent any further guidance from standard setters or regulators, we believe Alternative 1 should be followed such that the revaluation of the preexisting noncontrolling interest does not include any potential control or acquisition premium.

In addition, it is important to note that when a business combination is achieved in stages it may not be appropriate to estimate the equity value of the acquired entity based on the price paid for the shares that gave the acquirer control. Such an approach could overstate the equity value of the acquired entity (as well as the noncontrolling interest) when the price paid by the buyer includes a control or acquisition premium related to both the acquired shares and the buyer's preexisting interest.

For additional information on determining a control premium, refer to the Appraisal Foundation's ***Valuations in Financial Reporting Valuation Advisory 3: The Measurement and Application of Market Participant Acquisition Premiums*** (Valuation Advisory) issued in September 2017. Although this Valuation Advisory is not authoritative guidance, we understand that the valuation techniques described in the guide are generally recognized by the valuation community as acceptable methods for determining a control premium.

Illustration 7-5: Remeasurement of previously held interest

Company A held a 30% preexisting interest in Company B,[1] and on 1 January 20X0, Company A acquired an additional 40% interest in Company B for $135 million, giving Company A a controlling 70% interest in Company B.

The fair value of the net assets of Company B was determined to be $275 million on 1 January 20X0.

Analysis

It would not be appropriate to assume that the fair value of the 30% noncontrolling interest is $101.25 million (i.e., 30% of an equity value calculated as $135 million divided by the 40% interest acquired to gain control). In this case, if the $135 million paid for the additional 40% interest included a 20% acquisition premium related to both the shares acquired and Company A's preexisting interest, the equity value of Company B would be $300 million[2] (not $337.5 million, which one would get by simply dividing the $135 million consideration transferred by the 40% interest acquired to obtain control). In this case, assuming the noncontrolling interest would share ratably in all of the benefits expected to be brought about by Company A exercising its control, and the required rate of return for the noncontrolling interest was consistent with that of the acquirer, the fair value of the 30% noncontrolling interest would be $90 million (30% of the $300 million), which differs from the per-share price paid for the 40% controlling interest. However, the fair value used in determining the gain or loss on the derecognition of Company A's preexisting interest of 30% would be $75 million,[3] since it would not consider the acquisition premium paid by the acquirer.

The goodwill recognized under this business combination achieved in stages would be $25 million:

Net assets	$ 275	
Goodwill	25	
Preexisting interest		$ 75
Noncontrolling interest		90
Cash		135

This is consistent with the goodwill that would have been recognized if Company A had acquired its entire 70% interest in Company B for a price of $210 million in cash (or 70% of the $300 million equity value of Company B under the new ownership).

[1] Company B has 10,000,000 shares outstanding and no outstanding debt.

[2] The $300 million equity value (X) is calculated by using the following formula: $135 million = 40%X + 30%(X − X/120%), where $135 million equals the transaction price paid for the 40% controlling interest (inclusive of a 20% acquisition premium) plus the acquisition premium on the existing 30% interest.

[3] The $75 million is calculated by using the following formula: 30% * ($300 million /120%).

There may be instances in which an entity holds both a current ownership interest and an option to acquire a controlling interest in a business. In these cases, we believe that the acquirer should remeasure its preexisting equity interest, inclusive of its previously held current ownership interest and its option to acquire a controlling interest in the business. Consider the following illustration:

Illustration 7-6: Remeasurement of previously held interest with an option

Company A held a 20% preexisting interest in Company B. Company A also held a fixed price call option to purchase the remaining 80% interest in Company B for $20 per share that it can exercise between 1 January 20X2 and 31 March 20X2. Company A exercised the call option on 1 January 20X2.[1]

On 1 January 20X2, the fair value of the preexisting 20% equity interest was $80 million, the carrying amount of that investment was $26 million, and the fair value of the option was $160 million.[2]

Analysis

On 1 January 20X2, Company A remeasured both its preexisting 20% interest in Company B and the option to purchase the remaining interest at fair value. On 1 January 20X2, Company A recognized a gain of $214 million related to the remeasurement of its previously held interests.

[1] For purposes of this illustration the option did not meet the definition of a derivative prior to exercise, and it was not probable that Company A would exercise the option until immediately before it was exercised. This results in no measurement of the option prior to its exercise.

[2] Acquisition premium has been disregarded to simplify this illustration.

8 Presentation and disclosure

8.1 Gain recognized in a bargain purchase

As noted in section 1.7.1, ASC 805 requires that a gain resulting from a bargain purchase be recognized as of the acquisition date. We believe that bargain purchases will be rare and that any such gain must be disclosed as an unusual or infrequently occurring item in accordance with ASC 220-20-45-1.

When disclosure is made of unusual or infrequently occurring items that are material, the nature and financial effect are disclosed either on the face of the income statement or in the notes to the financial statements. However, such items are not reported on the face of the income statement net of income taxes or in any other manner. Similarly, the earnings per share effects of those items are not disclosed on the face of the income statement.

The net-of-tax effects of the gain may be presented in the notes to the financial statements.

8.2 Cash paid to acquire a business

The cash paid to acquire a business, net of any cash acquired, is presented as a single line in the investing section of the statement of cash flows pursuant to ASC 230-10-45-13. When preparing the statement of cash flows, care should be taken to exclude the effects of the business combination on specific asset and liability accounts from the calculation of other amounts in the statement of cash flows. For example, companies that use the indirect method of presenting cash flows will reconcile net income to operating income. That reconciliation includes changes in the balances of operating assets and liabilities. Those changes must be calculated by excluding the effect of adding the assets acquired or liabilities assumed in the business combination to specific asset or liability accounts. The cash flow statement effects of a business combination are included in the single line in the investing activities section of the statement.

The noncash effects of a business combination, including any noncash consideration included in the purchase consideration and the total effects on the assets and liabilities of the acquirer, also are required to be disclosed. However, such disclosures also are required by the guidance in ASC 805 and generally need not be repeated.

8.3 Other presentation matters

In addition to the disclosures required by ASC 805, questions often arise about the classification of other items that may relate to a business combination including transaction costs, remeasurement of previously held equity interest, remeasurement of contingent consideration, gain on a bargain purchase and restructuring charges. A few of the more significant items are discussed below.

8.3.1 Transaction costs

ASC 805-10-25-23 requires transaction costs to be expensed as incurred. However, ASC 805 does not include, and neither the FASB nor the SEC has issued any additional guidance, on how to classify, in the financial statements, transaction costs incurred in a business combination. As such, no guidance currently exists on the appropriate classification of such costs in either the statement of operations or statement of cash flows.

8.3.1.1 Classification in the statement of operations

Entities should exercise judgment in determining the appropriate financial statement classification of transaction costs incurred in a business combination. Regardless of the classification, ASC 805-10-50-2(f) requires an entity that has consummated a business combination to disclose the amount of acquisition-related costs incurred, the amount recognized as an expense and the line item or items in the statement of operations in which those expenses are recognized.

8.3.1.2 Classification in the statement of cash flows

The cash paid for transaction costs incurred in a business combination, we believe, is most appropriately classified in the operating section of the statement of cash flows. ASC 805 requires transaction costs to be expensed as incurred. Classifying the cash flows as an operating activity would be consistent with the requirement to recognize the costs as an expense. In addition, classification of these costs as an operating activity would be consistent with the guidance that cash flows from operating activities are generally the cash effects of transactions and other events that enter into the determination of net income (ASC 230-10-20).

8.3.2 Contingent consideration

8.3.2.1 Contingent consideration classified as equity

ASC 805-30-25-6 states that an acquirer classifies an obligation to pay contingent consideration as a liability or as equity in accordance with ASC 480 and ASC 815 or other applicable GAAP.

If the analysis indicates the contingent consideration qualifies for classification as equity, we believe the contingent consideration should be classified as a separate line item within the statement of shareholders' equity, with a description indicating that the amount represents contingent consideration. If contingent consideration does not qualify for equity classification, it is classified as a liability (or an asset, if contingently returnable) that would be further segregated between current and non-current in a classified statement of financial position.

8.3.2.2 Remeasurement of contingent consideration classified as a liability or an asset

Contingent consideration arrangements will often be settled at an amount different than the amount initially included in the measurement of the consideration transferred under ASC 805. Under ASC 805-30-35-1, for changes in the fair value of contingent consideration that are not measurement period adjustments, contingent consideration classified as an asset or a liability is remeasured to fair value at each reporting date until the contingency is resolved with the changes in fair value recognized in earnings.[60]

We believe that subsequent changes in the fair value of the contingent consideration arrangement are most appropriately classified as an operating item (i.e., as a component of operating income if presented) in the statement of operations.

8.3.2.2.1 Statement of cash flows classification

Cash payments that are not made soon after (i.e., a relatively short period of time such as three months or less) the consummation of a business combination to settle a contingent consideration liability will be classified as cash outflows for financing and operating activities. The portion of the cash payment up to the acquisition date fair value of the contingent consideration liability (including any measurement period adjustments) will be classified as a financing outflow, and amounts paid in excess of the acquisition date fair value of that liability will be classified as operating outflows. Cash payments made soon after the consummation of a business combination generally will be classified as cash outflows for investing activities. Refer to section 3.6.11.3 of our FRD, ***Statement of cash flows***, for additional information.

---

[60] If the arrangement is a hedging instrument, ASC 815 requires the changes to be initially recognized in other comprehensive income.

8.4 General disclosure requirements

Excerpt from Accounting Standards Codification

Business Combinations — Overall

Disclosure

Business Combinations Occurring During a Current Reporting Period or After the Reporting Date but Before the Financial Statements Are Issued

805-10-50-1

The **acquirer** shall disclose information that enables users of its financial statements to evaluate the nature and financial effect of a **business combination** that occurs either:

a. During the current reporting period

b. After the reporting date but before the financial statements are issued or are available to be issued (as discussed in Section 855-10-25).

805-10-50-2

To meet the objective in the preceding paragraph, the acquirer shall disclose the following information for each business combination that occurs during the reporting period:

a. The name and a description of the **acquiree**

b. The **acquisition date**

c. The percentage of voting **equity interests** acquired

d. The primary reasons for the business combination and a description of how the acquirer obtained **control** of the acquiree

e. For transactions that are recognized separately from the acquisition of assets and assumptions of liabilities in the business combination (see paragraph 805-10-25-20), all of the following:

   1. A description of each transaction

   2. How the acquirer accounted for each transaction

   3. The amounts recognized for each transaction and the line item in the financial statements in which each amount is recognized

   4. If the transaction is the effective settlement of a preexisting relationship, the method used to determine the settlement amount.

f. The disclosure of separately recognized transactions required in (e) shall include the amount of acquisition-related costs, the amount recognized as an expense, and the line item or items in the income statement in which those expenses are recognized. The amount of any issuance costs not recognized as an expense and how they were recognized also shall be disclosed.

g. In a business combination achieved in stages, all of the following:

   1. The acquisition-date **fair value** of the equity interest in the acquiree held by the acquirer immediately before the acquisition date

2. The amount of any gain or loss recognized as a result of remeasuring to fair value the equity interest in the acquiree held by the acquirer immediately before the business combination (see paragraph 805-10-25-10) and the line item in the income statement in which that gain or loss is recognized

3. The valuation technique(s) used to measure the acquisition-date fair value of the equity interest in the acquiree held by the acquirer immediately before the business combination

4. Information that enables users of the acquirer's financial statements to assess the inputs used to develop the fair value measurement of the equity interest in the acquiree held by the acquirer immediately before the business combination.

h. If the acquirer is a **public entity**, all of the following:

1. The amounts of revenue and earnings of the acquiree since the acquisition date included in the consolidated income statement for the reporting period.

2. If comparative financial statements are not presented, the revenue and earnings of the combined entity for the current reporting period as though the acquisition date for all business combinations that occurred during the year had been as of the beginning of the annual reporting period (supplemental pro forma information).

3. If comparative financial statements are presented, the revenue and earnings of the combined entity as though the business combination(s) that occurred during the current year had occurred as of the beginning of the comparable prior annual reporting period (supplemental pro forma information). For example, for a calendar year-end entity, disclosures would be provided for a business combination that occurs in 20X2, as if it occurred on January 1, 20X1. Such disclosures would not be revised if 20X2 is presented for comparative purposes with the 20X3 financial statements (even if 20X2 is the earliest period presented).

4. The nature and amount of any material, nonrecurring pro forma adjustments directly attributable to the business combination(s) included in the reported pro forma revenue and earnings (supplemental pro forma information).

If disclosure of any of the information required by (h) is impracticable, the acquirer shall disclose that fact and explain why the disclosure is impracticable. In this context, the term impracticable has the same meaning as in paragraph 250-10-45-9.

The Financial Effects of Adjustments that Relate to Business Combinations that Occurred in the Current or Previous Reporting Periods

805-10-50-5

The acquirer shall disclose information that enables users of its financial statements to evaluate the financial effects of adjustments recognized in the current reporting period that relate to business combinations that occurred in the current or previous reporting periods.

Other Disclosures

805-10-50-7

If the specific disclosures required by this Subtopic and other generally accepted accounting principles (GAAP) do not meet the objectives set out in paragraphs 805-10-50-1 and 805-10-50-5, the acquirer shall disclose whatever additional information is necessary to meet those objectives.

8.4.1 Overview

The FASB decided to develop overall objectives for disclosure of information related to a business combination. The guidance in ASC 805 indicates that those objectives are for the acquirer to disclose information that enables financial statement users to evaluate:

- The nature and financial effect of business combinations that occur (1) during the current reporting period or (2) after the balance sheet date but before the financial statements are issued
- The financial effects of adjustments to the amounts recognized in a business combination that occur in the current reporting period or in previous reporting periods

ASC 805-10-50-1 through 50-5 provides specific, detailed disclosure requirements that are intended to facilitate meeting these disclosure objectives. However, if these specific disclosure requirements, and those required by other GAAP, do not meet the objectives outlined above, an acquirer discloses any additional information that may be necessary to meet those objectives.

The guidance in ASC 805 also affects the disclosure guidance in other sections of the Codification, as follows:

- ASC 944-805-50-1 extends the disclosure requirements of ASC 350-30-50-1 through 50-3 to intangible assets arising from insurance and reinsurance contracts acquired in a business combination.
- ASC 805-740-50-1 requires that the disclosure of adjustments of the beginning-of-period valuation allowance balance to include any acquisition-date income tax benefits or expense recognized from changes in the acquirer's valuation allowance for its previously existing deferred tax asset as a result of a business combination.
- ASC 350-20-50-1 specifies additional items that must be disclosed in the reconciliation of beginning to end-of-period goodwill carrying amounts.

8.4.2 When to disclose a business combination

ASC 805-10-50 requires the disclosures described in Appendix F for individually material business combinations. Additionally, certain disclosures also are required for individually immaterial business combinations that are collectively material (see section 8.4.3). However, the guidance in ASC 805-10-50 does not include guidance as to what is considered material. While the ultimate conclusion on the materiality of a business combination is a matter of judgment that rests with the acquiring entity, we believe that both quantitative and qualitative factors should be considered in the evaluation. Such quantitative factors should include the following:

- The net assets of the acquiree as a percentage of total shareholders' equity of the acquirer as of the end of the most recent fiscal year
- The total assets of the acquiree as a percentage of total assets of the acquirer as of the end of the most recent fiscal year
- The acquiree's income from continuing operations before income taxes and cumulative effect of a change in accounting principle as a percentage of such income of the acquirer for the most recent fiscal year

A business combination may be considered material due to qualitative factors even though it does not meet an entity's quantitative materiality threshold. For example, disclosure of the business combination in an entity's MD&A or press release, discussion of a business combination on an entity's website or in the CEO's letter in an annual report, suggests that the business combination might be material and thus subject to the disclosure requirements in ASC 805-10-50.

8.4.3 Aggregation of immaterial business combinations

Excerpt from Accounting Standards Codification

Business Combinations — Overall

Disclosure

805-10-50-3

For individually immaterial business combinations occurring during the reporting period that are material collectively, the acquirer shall disclose the information required by (e) through (h) in the preceding paragraph in the aggregate.

Disclosure may still be required for individually immaterial business combinations if they are material in the aggregate. In that circumstance, the disclosures are aggregated for individually immaterial business combinations, and certain disclosures that are not easily aggregated may be omitted. However, the disclosures required by ASC 805-10-50-2 (a)-(d) are not required for individually immaterial acquisitions that are material in the aggregate.

As discussed in section 8.4.2, we believe the evaluation and ultimate conclusion on materiality of a business combination rests with the acquiring entity and that both quantitative and qualitative factors should be considered in that evaluation. Further, we believe a series of individually immaterial business combinations would be considered material in the aggregate if, in total, they meet the threshold of materiality as applied to a single business combination.

8.5 Specific disclosure requirements

A comprehensive illustrative example of the ASC 805-10-50 disclosure requirements is included in Appendix F.

8.5.1 Disclosure requirements for specific assets acquired, liabilities assumed and noncontrolling interest

Excerpt from Accounting Standards Codification

Business Combinations — Identifiable Assets and Liabilities, and Any Noncontrolling Interest

Disclosure

805-20-50-1

Paragraph 805-10-50-1 identifies one of the objectives of disclosures about a **business combination**. To meet that objective, the **acquirer** shall disclose all of the following information for each business combination that occurs during the reporting period:

a. For indemnification assets, all of the following:

   1. The amount recognized as of the **acquisition date**
   2. A description of the arrangement and the basis for determining the amount of the payment
   3. An estimate of the range of outcomes (undiscounted) or, if a range cannot be estimated, that fact and the reasons why a range cannot be estimated. If the maximum amount of the payment is unlimited, the acquirer shall disclose that fact.

b. For acquired receivables not subject to the requirements of Subtopic 310-30, all of the following:

   1. The **fair value** of the receivables
   2. The gross contractual amounts receivable
   3. The best estimate at the acquisition date of the contractual cash flows not expected to be collected.

The disclosures shall be provided by major class of receivable, such as loans, direct financing leases in accordance with Subtopic 840-30, and any other class of receivables.

Pending Content:

Transition Date: *(P) December 16, 2018; (N) December 16, 2021* | **Transition Guidance:** 842-10-65-1

b. For acquired receivables not subject to the requirements of Subtopic 310-30, all of the following:

1. The **fair value** of the receivables (unless those receivables arise from **sales-type leases** or **direct financing leases** by the lessor for which the acquirer shall disclose the amounts recognized as of the acquisition date)
2. The gross contractual amounts receivable
3. The best estimate at the acquisition date of the contractual cash flows not expected to be collected.

The disclosures shall be provided by major class of receivable, such as loans, net investment in sales-type or direct financing leases in accordance with Subtopic 842-30 on leases—lessor, and any other class of receivables.

Pending Content:

Transition Date: *(P) December 16, 2019; (N) December 16, 2022* | **Transition Guidance:** 326-10-65-4

b. For acquired receivables not subject to the requirements of Subtopic 326-20 relating to purchased financial assets with credit deterioration, all of the following:

1. The **fair value** of the receivables (unless those receivables arise from **sales-type leases** or **direct financing leases** by the lessor for which the acquirer shall disclose the amounts recognized as of the acquisition date)
2. The gross contractual amounts receivable
3. The best estimate at the acquisition date of the contractual cash flows not expected to be collected.

The disclosures shall be provided by major class of receivable, such as loans, net investment in sales-type or direct financing leases in accordance with Subtopic 842-30 on leases—lessor, and any other class of receivables.

c. The amounts recognized as of the acquisition date for each major class of assets acquired and liabilities assumed (see Example 5 [paragraph 805-10-55-37]).

d. For contingencies, the following disclosures shall be included in the note that describes the business combination:

1. For assets and liabilities arising from contingencies recognized at the acquisition date:

   i. The amounts recognized at the acquisition date and the measurement basis applied (that is, at fair value or at an amount recognized in accordance with Topic 450 and Section 450-20-25)

   ii. The nature of the contingencies.

An acquirer may aggregate disclosures for assets or liabilities arising from contingencies that are similar in nature.

2. For contingencies that are not recognized at the acquisition date, the disclosures required by Topic 450 if the criteria for disclosures in that Topic are met.

An acquirer may aggregate disclosures for assets and liabilities arising from contingencies that are similar in nature.

e. For each business combination in which the acquirer holds less than 100 percent of the equity interests in the **acquiree** at the acquisition date, both of the following:

1. The fair value of the noncontrolling interest in the acquiree at the acquisition date

2. The valuation technique(s) and significant inputs used to measure the fair value of the noncontrolling interest.

805-20-50-2

For individually immaterial business combinations occurring during the reporting period that are material collectively, the acquirer shall disclose the information required by the preceding paragraph in the aggregate.

8.5.2 Disclosure requirements for goodwill, bargain purchase gains and consideration transferred

Excerpt from Accounting Standards Codification

Business Combinations — Goodwill or Gain from Bargain Purchase, Including Consideration Transferred

Disclosure

805-30-50-1

Paragraph 805-10-50-1 identifies one of the objectives of disclosures about a **business combination**. To meet that objective, the **acquirer** shall disclose all of the following information for each business combination that occurs during the reporting period:

a. A qualitative description of the factors that make up the **goodwill** recognized, such as expected synergies from combining operations of the **acquiree** and the acquirer, intangible assets that do not qualify for separate recognition, or other factors.

b. The acquisition-date **fair value** of the total consideration transferred and the acquisition-date fair value of each major class of consideration, such as the following:

1. Cash

2. Other tangible or intangible assets, including a **business** or subsidiary of the acquirer

3. Liabilities incurred, for example, a liability for **contingent consideration**

4. Equity interests of the acquirer, including the number of instruments or interests issued or issuable and the method of determining the fair value of those instruments or interests.

c. For contingent consideration arrangements, all of the following:

1. The amount recognized as of the **acquisition date**

2. A description of the arrangement and the basis for determining the amount of the payment

3. An estimate of the range of outcomes (undiscounted) or, if a range cannot be estimated, that fact and the reasons why a range cannot be estimated. If the maximum amount of the payment is unlimited, the acquirer shall disclose that fact.

d. The total amount of goodwill that is expected to be deductible for tax purposes.

e. If the acquirer is required to disclose segment information in accordance with Subtopic 280-10, the amount of goodwill by reportable segment. If the assignment of goodwill to reporting units required by paragraphs 350-20-35-41 through 35-44 has not been completed as of the date the financial statements are issued or are available to be issued (as discussed in Section 855-10-25), the acquirer shall disclose that fact.

f. In a bargain purchase (see paragraphs 805-30-25-2 through 25-4), both of the following:

   1. The amount of any gain recognized in accordance with paragraph 805-30-25-2 and the line item in the income statement in which the gain is recognized

   2. A description of the reasons why the transaction resulted in a gain.

805-30-50-2

For individually immaterial business combinations occurring during the reporting period that are material collectively, the acquirer shall disclose the information required by the preceding paragraph in the aggregate.

805-30-50-4

Paragraph 805-10-50-5 identifies the second objective of disclosures about the effects of business combinations that occurred in the current or previous reporting periods. To meet the objective in that paragraph, the acquirer shall disclose the following information for each material business combination or in the aggregate for individually immaterial business combinations that are material collectively:

a. For each reporting period after the acquisition date until the entity collects, sells, or otherwise loses the right to a contingent consideration asset, or until the entity settles a contingent consideration liability or the liability is cancelled or expires, all of the following:

   1. Any changes in the recognized amounts, including any differences arising upon settlement

   2. Any changes in the range of outcomes (undiscounted) and the reasons for those changes

   3. The disclosures required by Section 820-10-50.

b. A reconciliation of the carrying amount of goodwill at the beginning and end of the reporting period as required by paragraph 350-20-50-1...

8.5.3 Intangible assets disclosures in period of acquisition

The acquisition-date disclosure requirements for intangible assets acquired in a business combination are included in ASC 350-30-50-1, as amended, rather than in the disclosure requirements of ASC 805-10-50. These disclosure requirements are outlined below:

Excerpt from Accounting Standards Codification

Intangibles — Goodwill and Other — General Intangibles Other than Goodwill

Disclosure

350-30-50-1

For **intangible assets** acquired either individually or as part of a group of assets (in either an asset acquisition, a business combination, or an acquisition by a not-for-profit entity), all of the following information shall be disclosed in the notes to financial statements in the period of acquisition:

a. For intangible assets subject to amortization, all of the following:

   1. The total amount assigned and the amount assigned to any major **intangible asset class**

2. The amount of any significant **residual value**, in total and by major intangible asset class

3. The weighted-average amortization period, in total and by major intangible asset class.

b. For intangible assets *not* subject to amortization, the total amount assigned and the amount assigned to any major intangible asset class.

c. The amount of research and development assets acquired in a transaction other than a business combination or an acquisition by a not-for-profit entity and written off in the period and the line item in the income statement in which the amounts written off are aggregated.

d. For intangible assets with renewal or extension terms, the weighted-average period before the next renewal or extension (both explicit and implicit), by major intangible asset class.

This information also shall be disclosed separately for each material business combination or acquisition by a not-for-profit entity or in the aggregate for individually immaterial business combinations or acquisitions by a not-for-profit entity that are material collectively if the aggregate fair values of intangible assets acquired, other than goodwill, are significant.

The information relating to intangible assets must be disclosed separately for each material business combination or in the aggregate for individually immaterial business combinations that are material collectively if the aggregate fair values of intangible assets acquired, other than goodwill, are significant.

8.5.4 Additional pro forma disclosures required for public entities

ASC 805-10-50 requires additional disclosures for public entities:

Excerpt from Accounting Standards Codification

Business Combinations — Overall

Disclosure

805-10-50-2(h)

If the acquirer is a **public entity**, all of the following:

1. The amounts of revenue and earnings of the acquiree since the acquisition date included in the consolidated income statement for the reporting period.

2. If comparative financial statements are not presented, the revenue and earnings of the combined entity for the current reporting period as though the acquisition date for all business combinations that occurred during the year had been as of the beginning of the annual reporting period (supplemental pro forma information).

3. If comparative financial statements are presented, the revenue and earnings of the combined entity as though the business combination(s) that occurred during the current year had occurred as of the beginning of the comparable prior annual reporting period (supplemental pro forma information). For example, for a calendar year-end entity, disclosures would be provided for a business combination that occurs in 20X2, as if it occurred on January 1, 20X1. Such disclosures would not be revised if 20X2 is presented for comparative purposes with the 20X3 financial statements (even if 20X2 is the earliest period presented).

4. The nature and amount of any material, nonrecurring pro forma adjustments directly attributable to the business combination(s) included in the reported pro forma revenue and earnings (supplemental pro forma information).

If disclosure of any of the information required by (h) is impracticable, the acquirer shall disclose that fact and explain why the disclosure is impracticable. In this context, the term impracticable has the same meaning as in paragraph 250-10-45-9.

ASC 805 does not provide additional guidance about how entities should calculate the required pro forma revenue and earnings disclosures. One alternative would be to add the results from the financial statements of the acquiree to the historical financial results of the acquirer after making certain adjustments, such as the following:

- ***Conforming accounting policies:*** For example, a company would adjust the pro forma financial statements for the effect of applying a policy of different depreciable lives for property, plant and equipment, or for the effect of applying the acquirer's revenue recognition policy.
- ***The effect of fair value adjustments:*** For example, a company would include amortization of intangible assets recognized as part of the business combination.
- ***Taxation:*** For example, the company would need to consider the tax effects of the transaction and related adjustments as if the acquiree had been part of the reporting entity.
- ***Financial structure:*** For example, the company would need to consider adjustments reflecting the new capital structure, including the issuance of new equity and additional financing or repayments of debt as part of the acquisition.

Adjustments that are not factually supportable or that are not directly related to the business combination would not be included. For example, it would generally not be appropriate to include cost savings and other synergy benefits resulting from the business combination in the pro forma adjustments.

8.5.4.1 Definition of a public entity for purposes of evaluating the requirement to provide pro forma disclosures

Excerpt from Accounting Standards Codification

Business Combinations — Overall

Glossary

805-10-20

Public entity

A business entity or a not-for-profit entity that meets any of the following conditions:

a. It has issued debt or equity securities or is a conduit bond obligor for **conduit debt securities** that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets).

b. It is required to file financial statements with the Securities and Exchange Commission (SEC).

c. It provides financial statements for the purpose of issuing any class of securities in a public market.

In determining whether a combined acquirer and target is required to provide the disclosures outlined in ASC 805-10-50-2(h), it is necessary to look only to the financial statements that will include the disclosures. For example, assume that (1) Acquirer, which is a wholly-owned subsidiary of Parent but is not a public registrant in-and-of itself, acquires Target and (2) Parent is a public entity as defined in ASC 805. In the consolidated separate company financial statements of Acquirer for the period that includes the acquisition of Target, the disclosure requirements of ASC 805-10-50-2(h) are not applicable because Acquirer is not a public entity as defined in ASC 805. However, the disclosures outlined in ASC 805-10-50-2(h) would be applicable to the consolidated financial statements of Parent in the period of acquisition.

Note that the term "public entity" in ASC 805 differs from the term "public entity" as defined in other accounting literature, including ASC 718 and ASC 470. There could be situations where the Acquirer and Target (upon and after the business combination) would be considered "public entities" for those standards (because they are "controlled by … an entity … with equity securities that trade in a public market") but not be considered a public entity under ASC 805.

8.5.4.2 Effect of measurement period adjustments on the pro forma disclosures

The primary objective of the supplemental pro forma information is to provide the revenue and earnings of the combined entity as though the acquisition occurred as of the beginning of the period presented (or, when comparative financial statements are presented, as of the beginning of the comparable prior period).

As discussed in section 7.3.3.1, acquirers must recognize measurement period adjustments during the period in which the amounts are determined.

However, when pro forma financial information is presented after recording a measurement period adjustment to provisional amounts recognized in the business combination, we believe that the pro forma information should reflect the effects of the adjustment on a retrospective basis. That is, we believe the pro forma information should reflect the measurement period adjustment as of the beginning of the period presented (or, when comparative financial statements are presented, as of the beginning of the comparable prior period) consistent with the primary objective of the pro forma information.

8.5.4.3 Presentation of pro forma information for a business combination

As noted in ASC 805-10-50-2(h), when a public entity has completed a business combination, the acquiring entity must disclose certain, pro forma information in the notes to the financial statements. If comparable financial statements are presented, the pro forma information incorporates the business combination as of the beginning of the comparable prior period. As a result, any acquisition adjustments resulting from the business combination that are recognized within the first year after the business combination (e.g., inventory recognized at fair value and sold within 12 months of the business combination) will be reflected in the pro forma results for the comparable prior period only. When comparative information is presented, the requirement to present pro forma information as if the business combination occurred at the beginning of the comparable prior period is consistent with the acquisition date to be used with the SEC's Form 8-K pro forma disclosure requirements under Article 11 of Regulation S-X.[61]

ASC 805-10-50-2(h) also requires the pro forma information to be accompanied by a narrative description of the nature and amount of material, nonrecurring adjustments. For example, a public entity discloses material nonrecurring items such as the fair value adjustment to acquisition-date inventory.

8.5.4.3.1 Computation and presentation in MD&A

Item 303 of Regulation S-K (MD&A) generally requires the registrant to analyze periods covered by the financial statements using year-to-year comparisons based on the financial statements included in the filing. The SEC staff[62] has acknowledged that "there may be situations where comparisons other than those of the historical financial information may provide valuable supplemental and in certain cases, more relevant analyses, to fully discuss trends and changes." When a registrant determines that a supplemental discussion in MD&A based on pro forma information is appropriate and will enhance the discussion, the SEC Division of Corporation Finance's Financial Reporting Manual (FRM) section 9220.7 states that the pro forma financial information generally is presented in a format consistent with S-X Article 11 but acknowledges that other formats may be appropriate depending on the facts and circumstances.

---

[61] Regulation S-X Rule 11-02(a)(6) and (a)(7).

[62] Comments by Steven C. Jacobs, Associate Chief Accountant in the Division of Corporate Finance at the SEC, at the 2007 AICPA National Conference on Current SEC and PCAOB Developments.

8.5.4.3.2 *Pro forma periods to be presented for a business combination (added June 2023)*

ASC 805-10-50-2(h) requires that a public entity disclose supplemental pro forma information. If comparative financial statements are presented, the pro forma information reflects the business combination as of the beginning of the prior annual period. That is, pro forma information is required only for the year of acquisition and the prior year, even if an income statement is presented for more than two years. If comparative financial statements are not presented, the pro forma information reflects the business combination as of the beginning of the current annual reporting period.

The below examples illustrate the periods for which an entity may be required to provide supplemental pro forma information in accordance with ASC 805 when that entity provides comparable financial statements.

Illustration 8-1: Supplemental pro forma financial statement requirements – annual filing

Company A acquired Company B, which met the definition of a business, on 1 June 20X3. Company A is a calendar-year-end entity, and the acquisition of Company B is material to its financial statements.

Company A discloses comparative financial statements. In its year-end financial statements for 20X3, Company A would disclose the following financial information:

- The revenue and earnings of the acquiree from the acquisition date through the acquirer's calendar year-end 20X3
- Supplemental pro forma revenue and earnings of the combined entity for the year ended 31 December 20X2
- Supplemental pro forma revenue and earnings of the combined entity for the year ended 31 December 20X3

Illustration 8-2: Supplemental pro forma financial statement requirements – interim period filing

Assume the same facts as in Illustration 8-1, except Company A is filing its second-quarter financial statements for 20X3.

In its second-quarter financial statements for 20X3, Company A would disclose the following financial information:

- The revenue and earnings of the acquiree from the acquisition date (1 June 20X3) through 30 June 20X3
- Supplemental pro forma revenue and earnings of the combined entity for the six-month period ended 30 June 20X3 and 30 June 20X2
- Supplemental pro forma revenue and earnings of the combined entity for the three-month period ended 30 June 20X3 and 30 June 20X2

Although this is not addressed in ASC 805, Company A should consider providing supplemental pro forma information for the period ended 31 March 20X3 when it files its first-quarter financial statements in 20X4 (the year after the acquisition) since the acquired business would not otherwise be reflected in the comparative period.

8.5.5 SEC reporting requirements for business combinations

8.5.5.1 Financial statements of businesses acquired or to be acquired

Audited financial statements of significant acquired businesses and equity method investments must be reported in 1934 Act reports on Form 8-K and in certain 1933 Act filings and proxy statements. However, the number of years that audited financial statements must be presented generally depends on the significance of the acquired business. Rule 3-05 (Rule 8-04 for smaller reporting companies) of Regulation S-X describes the SEC's requirements for registrants to provide audited financial statements of acquired or to be acquired businesses. See our SEC Financial Reporting Series publication, ***2021 Pro forma financial information – A guide for applying Article 11 of Regulation S-X***, for additional information.

8.5.5.2 Pro forma financial information

Pro forma financial information giving effect to business combinations is sometimes required in SEC registration statements, proxy statements and Form 8-Ks as required by Article 11 (Article 8 for smaller reporting companies) of Regulation S-X.

Pro forma information pursuant to Article 11 (Article 8 for smaller reporting companies) is not required in Form 10-K or in the annual shareholders report. Registrants should be aware that the pro forma presentation requirements in ASC 805-10-50-2(h) may differ from the Article 11 (Article 8 for smaller reporting companies) requirements.[63]

See our publication ***2021 Pro forma financial information – A guide for applying Article 11 of Regulation S-X*** for additional information.

8.5.6 Business combinations after the balance sheet date

Excerpt from Accounting Standards Codification

Business Combinations — Overall

Disclosure

805-10-50-4

If the acquisition date of a business combination is after the reporting date but before the financial statements are issued or are available to be issued (as discussed in Section 855-10-25), the acquirer shall disclose the information required by paragraph 805-10-50-2 unless the initial accounting for the business combination is incomplete at the time the financial statements are issued or are available to be issued. In that situation, the acquirer shall describe which disclosures could not be made and the reason why they could not be made.

Business Combinations — Identifiable Assets and Liabilities, and Any Noncontrolling Interest

Disclosure

805-20-50-3

If the acquisition date of a business combination is after the reporting date but before the financial statements are issued or are available to be issued (as discussed in Section 855-10-25), the acquirer shall disclose the information required by paragraph 805-20-50-1 unless the initial accounting for the business combination is incomplete at the time the financial statements are issued or are available to be issued. In that situation, the acquirer shall describe which disclosures could not be made and the reason why they could not be made.

[63] As discussed earlier, ASU 2010-29 conformed the guidance in ASC 805, as it relates to the acquisition date to be used, with that of Regulation S-X requiring entities to disclose revenue and earnings of the combined entity as though the acquisition(s) that occurred during the current year had occurred as of the beginning of the comparable prior annual reporting period, if presented. However, the actual periods required to be presented under ASC 805 are different from those presented under Article 11.

Business Combinations — Goodwill or Gain from Bargain Purchase, Including Consideration Transferred

Disclosure

805-30-50-3

If the acquisition date of a business combination is after the reporting date but before the financial statements are issued or are available to be issued (as discussed in Section 855-10-25), the acquirer shall disclose the information required by paragraph 805-30-50-1 unless the initial accounting for the business combination is incomplete at the time the financial statements are issued or are available to be issued. In that situation, the acquirer shall describe which disclosures could not be made and the reason why they could not be made.

If a material business combination (or individually immaterial business combinations that are material collectively) is (are) completed after the balance sheet date, but before the financial statements are issued or are available to be issued, the disclosures outlined in ASC 805-10-50-1 through 50-2, ASC 805-20-50-1 and ASC 805-30-50-1 are required in those financial statements, unless the initial accounting for the business combination is incomplete at the time the financial statements are issued or are available to be issued. If a determination is made that some of the disclosures outlined in ASC 805-10-50-1 through 50-2, ASC 805-20-50-1 or ASC 805-30-50-1 cannot be made, disclosure is provided as to which information has not been provided and the reasons why the required disclosures are not made.

8.5.7 In what periods are the disclosures required?

The disclosures outlined in ASC 805 are required in the period in which a material business combination is completed. We believe that whenever financial statements are presented that include the period in which a material business combination occurs, the disclosures outlined in ASC 805 should be provided. For example, if a material business combination occurred in a period for which financial statements are being presented comparatively with financial statements of the current reporting period, the disclosures that presumably were presented previously for the comparative period should be repeated.

8.5.8 Initial accounting for a business combination is incomplete

Excerpt from Accounting Standards Codification

Business Combinations — Identifiable Assets and Liabilities, and Any Noncontrolling Interest

Disclosure

805-20-50-4A

If the initial accounting for a business combination is incomplete (see paragraphs 805-10-25-13 through 25-14) for particular assets, liabilities, noncontrolling interests, or items of consideration and the amounts recognized in the financial statements for the business combination thus have been determined only provisionally, the acquirer shall disclose the following information for each material business combination or in the aggregate for individually immaterial business combinations that are material collectively to meet the objective in paragraph 805-10-50-5:

a. The reasons why the initial accounting is incomplete

b. The assets, liabilities, equity interests, or items of consideration for which the initial accounting is incomplete

c. The nature and amount of any measurement period adjustments recognized during the reporting period in accordance with paragraph 805-10-25-17, including separately the amount of adjustment to current-period income statement line items relating to the income effects that would have been recognized in previous periods if the adjustment to provisional amounts were recognized as of the acquisition date. Alternatively, an acquirer may present those amounts separately on the face of the income statement.

As discussed in section 7.3, ASC 805 provides a measurement period in which to finalize the accounting for all aspects of the business combination. If the accounting for the business combination is incomplete when the financial statements are issued, ASC 805-20-50-4A requires that certain disclosures be made.

We believe that an acquirer should disclose the information required by ASC 805-20-50-4A on an item-by-item basis. That is, the acquirer should indicate, in its disclosure, the individual assets, liabilities, equity interests or items of consideration for which the initial accounting is incomplete. In addition, we believe that the acquirer must document the information that it has not yet obtained for each reporting period that the measurement period remains open.

Further, we believe that unless an acquirer has a high level of confidence that it has identified and appropriately measured all assets acquired and liabilities assumed, the acquirer should disclose the status of its business combination accounting and provide the required disclosures in ASC 805-20-50-4A. For example, an acquirer might not have a high level of confidence that it has identified all liabilities associated with tax uncertainties in all jurisdictions in which the acquiree operated, and as such, it should disclose the status of its review as well as the potential for adjustments to the provisional amounts initially recognized.

We understand that the SEC staff believes that when a registrant is awaiting additional information that it has arranged to obtain to finalize the accounting for the business combination, the registrant should describe the nature of the outstanding items and furnish other available information that will enable a reader to understand its potential effects on the final accounting for the business combination and on post-acquisition operating results. The SEC staff has challenged measurement period adjustments when prior disclosures failed to indicate that the acquirer was waiting on the specific information that resulted in the adjustment. As a result, the SEC staff has asked registrants to disclose that the initial measurement of provisional items is incomplete. We believe the SEC staff's view is that any accounting for the business combination that is not supplemented with disclosure about its preliminary nature will be considered final and, as such, any subsequent adjustments should be recognized in the results of operations.

The acquirer must disclose the amounts and reasons for adjustments to the provisional amounts. The acquirer also must present or disclose, by line item, the amount of the adjustment reflected in the current-period income statement that would have been recognized in previous periods if the adjustment to provisional amounts had been recognized as of the acquisition date. See section F.2 for an illustration of adjustments to provisional amounts and the related disclosures and presentation.

8.5.9 ASC 820 disclosure considerations

The disclosure requirements outlined in ASC 820-10-50-1 through 50-2 are applicable to a contingent consideration arrangement classified as a liability because it must be remeasured at fair value each reporting period.

ASC 820 requires disclosures about fair value measurements that are designed to provide users of the financial statements with additional transparency regarding (1) the extent to which fair value is used to measure assets and liabilities, (2) the inputs and assumptions used in measuring fair value, and (3) the effect of fair value measurements on earnings, consistent with the requirements of ASC 805-10-50-5.

The disclosure requirements in ASC 820-10-50-2 call for a reconciliation of the beginning and ending balances of any recurring fair value measurements that utilize significant unobservable inputs (i.e., Level 3 inputs). Therefore, any asset or liability (measured at fair value on a recurring basis) that was determined to be a Level 3 measurement at either the beginning or the end of a reporting period would need to be considered in the Level 3 reconciliation. Because the Level 3 reconciliation focuses on changes in fair value for the reporting period, public entities may need to provide multiple reconciliations in their Quarterly Report on Form 10-Q. For example, a public calendar year-end entity would provide separate reconciliations for the periods 1 January to 30 June, and 1 April to 30 June in its second quarter Form 10-Q. See our FRD, ***Fair value measurement***, for further discussion of the disclosure requirements for assets and liabilities that are measured at fair value on a recurring basis in periods subsequent to initial recognition.

8.5.10 Retention of an investment banker

SAB Topic 2.A.6 requires disclosure of the amount accounted for as debt issuance cost, if material, when a company has retained an investment banker to provide both advisory and financing services to an acquirer. See section 6.2 for further discussion of the accounting for transaction fees.

8.5.11 Disclosures related to acquired IPR&D assets

While ASC 805 does not require specific disclosures about acquired IPR&D assets, the SEC staff has requested registrants that have completed business combinations to provide information to the SEC staff and, in some cases, to provide additional disclosures about the acquired IPR&D assets. Registrants may be asked to explain how IPR&D assets were recognized or why, based upon other information disclosed, no or limited IPR&D assets were recorded.

8.5.12 Disclosure related to the measurement of previously held equity interests

On 6 January 2010, the FASB issued ASU 2010-02, which was effective for calendar-year for-profit enterprises in the first interim or annual reporting period ending on or after 15 December 2009. ASU 2010-02 addressed implementation issues associated with the guidance in ASC 810-10 relating to the accounting for decreases in the ownership of a subsidiary.

Among other things, the guidance in ASU 2010-02 amended certain disclosure requirements in ASC 805. Specifically, ASU 2010-02 required an enterprise to disclose the following for a business combination achieved in stages:

- The valuation techniques used to measure the acquisition-date fair value of the equity interest in the acquiree held by the acquirer immediately before the business combination
- Information that enables users of the acquirer's financial statements to assess the inputs used to develop the measurement

8.5.13 Practical expedients elected for contract assets and contract liabilities acquired after the adoption of ASU 2021-08 (added June 2022)

After the adoption of ASU 2021-08, an acquirer has an option to elect certain practical expedients for each business combination in which contract assets and contract liabilities are acquired. If the acquirer elects one or both of the practical expedients, the acquirer should provide additional disclosures. Refer to section 4.4.3A.9 for information about the practical expedients and section 4.4.3A.10 for the related disclosure requirements after the adoption of ASU 2021-08.

8.6 Conforming accounting policies

US GAAP does not require that a parent and its subsidiaries (an acquirer and an acquiree) follow the same accounting policies. Typically, in practice, acquirers conclude that it is appropriate to conform an acquiree's accounting policies to those of the acquirer. However, dissimilar operations, assets, or transactions may be reasons for maintaining different accounting policies between the acquired entity and the rest of the acquirer's operations after a business combination. For example, Acquirer, an oil services company, may account for inventories (primarily equipment and supplies) on a FIFO basis and Target, an oil producer, may account for inventories (primarily oil) on a LIFO basis. Therefore, if the acquirer and acquiree follow different acceptable alternatives under US GAAP, the acquirer would not be required to conform the accounting policies of the acquiree in its consolidated financial statements after a business combination. If an acquirer would like to conform its accounting policies to those of the acquired entity it would be required to assess the preferability of any change in accordance with ASC 250. See our FRD, ***Accounting changes and error corrections***, for further discussion.

9 Effective date and transition

9.1 Overview

The guidance in ASC 805 is effective for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after 15 December 2008. Therefore, the guidance in ASC 805 was effective 1 January 2009 for companies with calendar year-ends.

The provisions of ASC 805 are applied prospectively. Thus, business combinations with an acquisition date before the effective date of the guidance in ASC 805 are accounted for in accordance with Statement 141. That accounting is not modified as a result of the adoption of the guidance in ASC 805.

9.2 Transition considerations for prior business combinations

Under Statement 141 and its interpretive guidance, the allocation of the purchase price to the assets acquired and liabilities assumed is subject to change after the acquisition date for certain items, including (1) changes to the amounts assigned to asset acquired and liabilities assumed during the purchase price allocation period, (2) a reduction in a liability for certain restructuring activities established under EITF 95-3, and (3) the resolution of a contingent consideration based on earnings. While the guidance in ASC 805 changes the accounting for all of these items for business combinations with an acquisition date after its effective date, it *does not* change the accounting for these items for business combinations with an acquisition date before the effective date of the guidance in ASC 805. These items are discussed in more detail below.

9.2.1 Liabilities for certain restructuring activities

Prior to the guidance in ASC 805, the costs of certain qualifying restructuring activities associated with the acquired company are recognized as a liability assumed in the business combination. Any subsequent reductions in such liabilities were recognized as a reduction of goodwill if the ultimate costs expended were less than the liability recognized in the business combination.

Under ASC 805, any costs that an acquirer expects, but is not obligated, to incur in the future either to exit an acquired activity or to terminate or relocate the acquiree's employees are not accounted for as part of the business combination. Therefore, those costs generally would be accounted for as post-combination expenses of the combined entity when incurred. See further discussion in section 4.3.2.

After the adoption of the guidance in ASC 805, restructuring liabilities previously recognized as a liability assumed in a business combination pursuant to EITF 95-3 will continue to be accounted for under that guidance. For example, any subsequent reduction in those liabilities continues to be recognized as an adjustment to goodwill.

9.2.2 Resolution of contingent consideration

Under ASC 805, contingent consideration obligations that are an element of consideration transferred are recognized at fair value on the acquisition date. After initial recognition, contingent consideration obligations that are classified as (1) equity are not subsequently remeasured, (2) liabilities within the scope of ASC 815 are accounted for pursuant to that guidance and (3) liabilities that are not within the scope of ASC 815 are remeasured at fair value with changes in fair value recognized in income.

Contingent consideration resulting from acquisitions accounted for under previous GAAP and settled after the adoption of the guidance in ASC 805 will continue to be accounted under the previous guidance. That is, the subsequent resolution is considered an additional cost of the business acquired resulting in additional goodwill being recognized.

A Accounting for asset acquisitions

A.1 Scope

Excerpt from Accounting Standards Codification

Business Combinations — Related Issues

Overview and Background

805-50-05-3

The Acquisition of Assets Rather than a Business Subsections address a transaction in which the assets acquired and liabilities assumed do not constitute a **business** and require such a transaction to be accounted for as an asset acquisition. However, these Subsections do not provide guidance for the primary beneficiary of a variable interest entity (VIE) if the VIE does not constitute a business.

Scope and Scope Exceptions

805-50-15-3

The guidance in the Acquisition of Assets Rather than a Business Subsections applies to a transaction or event in which assets acquired and liabilities assumed do not constitute a **business**.

805-50-15-4

The guidance in the Acquisition of Assets Rather than a Business Subsections does not apply to the initial measurement and recognition by a primary beneficiary of the assets and liabilities of a variable interest entity (VIE) when the VIE does not constitute a business. Guidance for such a VIE is provided in Section 810-10-30.

ASC 805-50 provides only limited guidance on accounting for asset acquisitions. This Appendix addresses questions that often arise about the accounting for these types of transactions.

Business combinations are accounted for using a fair value model under which assets acquired and liabilities assumed are generally recognized at their fair value, with certain exceptions. In contrast, asset acquisitions are accounted for using a cost accumulation and allocation model under which the cost of the acquisition is allocated to the assets acquired and liabilities assumed.

While the facts and circumstances of an asset acquisition should always be considered in evaluating the accounting, it may be helpful for entities to consider the guidance in the context of the following framework, starting with determining that the transaction is an asset acquisition:

If an acquired asset or asset group does not meet the definition of a business,[64] as defined in ASC 805, the transaction is accounted for as an asset acquisition based on the principles described in ASC 805-50 and the following sections. However, as discussed in section A.1.1, upon initial consolidation of a VIE whose assets and liabilities do not constitute a business, the guidance in ASC 810-10-30 applies.

Therefore, companies will first need to determine whether an acquired set of assets and activities constitutes a business by applying the guidance in ASC 805-10. Section 2.2 addresses which acquisitions are business combinations that are within the scope of ASC 805.

In certain situations, it is possible for a transaction to be a reverse asset acquisition, which would occur when the legal acquirer (not a business) is determined to be the acquiree for accounting purposes. The determination of the accounting acquirer and acquiree involving the acquisition of a business is based on an evaluation of the relevant factors, including those described in ASC 805-10-55-11 through 55-15.

For example, assume that Company A, a legal acquirer, acquires Company B (a business) for stock or stock and cash. Further, Company A does not meet the definition of a business since substantially all of the fair value of its gross assets is concentrated in a single identifiable asset or group of similar identifiable assets (e.g., real estate).[65] Based on an evaluation of all relevant factors in ASC 805, Company A determines that Company B is the accounting acquirer. However, since Company A does not meet the definition of a business, the acquisition would be accounted for as a reverse asset acquisition and would follow the model for asset acquisitions as described throughout this publication.

See section 3.2.2.2 for additional information on reverse acquisitions.

A.1.1 Initial consolidation of a VIE that is not a business (updated June 2022)

Under ASC 805-50-15-4, a primary beneficiary's initial consolidation of a VIE whose assets and liabilities do not constitute a business is excluded from the scope of ASC 805-50. Accordingly, the primary beneficiary applies the guidance in ASC 810-10-30 for initial measurement and recognition of the assets acquired and liabilities assumed upon initial consolidation of the VIE.

When a primary beneficiary initially consolidates a VIE that is not a business, ASC 810-10-30-3 requires the recognition and measurement of the assets acquired and liabilities assumed at fair value in accordance with the guidance on business combinations in ASC 805-20-25 and ASC 805-20-30 (except for goodwill). A gain or loss is recognized for the difference between (1) the sum of the fair value of any consideration paid, the fair value of any noncontrolling interests and the reported amount of any previously held interests and (2) the net amount of the VIE's identifiable assets and liabilities recognized and measured in accordance with ASC 805.

If a reporting entity uses contingent consideration in a transaction in which it becomes the primary beneficiary of a VIE that does not constitute a business, it should recognize the contingent consideration arrangement at its acquisition date fair value as part of the consideration transferred, in accordance with the guidance in ASC 805-30-25-5 through 7.

For interpretive guidance on the initial measurement and recognition by a primary beneficiary of a VIE that does not constitute a business, see section 13.4 of our FRD, ***Consolidation***.

---

[64] See section 2.1.3 for guidance on the definition of a business.

[65] ASC 805-10-55-5A.

A.1.1.1 Subsequent accounting for IPR&D and contingent consideration (updated June 2022)

While ASC 810 provides initial recognition and measurement guidance for when a primary beneficiary consolidates a VIE that is not a business, it does not provide guidance on the subsequent accounting for IPR&D intangible assets and contingent consideration arrangements. The lack of guidance has led to diversity in practice.

For example, for IPR&D initially recognized and measured at fair value pursuant to the guidance in ASC 810, an entity may follow the subsequent accounting guidance for intangible assets acquired in a business combination in ASC 350. Alternatively, an entity may conclude that, because the VIE is not a business, it should subsequently account for these IPR&D intangible assets under ASC 730. That is, IPR&D intangible assets with no alternative future use are recognized as an expense at the acquisition date.

Because ASC 810 does not provide subsequent accounting guidance for contingent consideration, we believe that subsequent accounting should be applied on a systematic and rational basis. One acceptable approach may be to continue to remeasure the contingent consideration at fair value at each reporting period consistent with ASC 805. Other approaches may be acceptable, but we believe that the systematic and rational approach considers accretion of the liability as well as changes in estimates of the cash flows. For example, we believe that a subsequent accounting model similar to that prescribed by ASC 410 for asset retirement obligations likely would be an acceptable method to account for contingent consideration initially measured at fair value.

A.1.2 Summary of key differences between accounting for a business combination and an asset acquisition

The following table summarizes the key differences between the accounting for a business combination versus an asset acquisition:

Item	Business combination	Asset acquisition
Transaction costs	▸ Expensed as incurred.	▸ Capitalized as a component of the cost of the assets acquired.
IPR&D assets	▸ Capitalized as an indefinite-lived intangible asset, regardless of whether the IPR&D asset has an alternative future use.	▸ Expensed if the IPR&D has no alternative future use. ▸ Capitalized as an indefinite-lived intangible asset if the IPR&D has an alternative future use.
Measurement period	▸ Acquirer has up to one year to obtain information about facts and circumstances that existed as of the acquisition date and adjust provisional amounts recognized.	▸ No measurement period.
Measurement basis of net assets acquired	▸ Measured at fair value with certain exceptions.	▸ Measured following a cost accumulation and allocation model under which the cost of the acquisition is allocated on a relative fair value basis to the net assets acquired.
Consideration transferred is more than the fair value of the net assets acquired (goodwill)	▸ Only arises in a business combination.	▸ Not recognized in an asset acquisition. Any excess consideration transferred over the fair value of the net assets acquired is allocated on a relative fair value basis to the identifiable net assets (excluding non-qualifying assets). ▸ Refer to section A.4.1 for further discussion on non-qualifying assets.

Item	Business combination	Asset acquisition
Consideration transferred is less than the fair value of the net assets acquired (bargain purchases)	▸ Recognized as a gain in earnings on the acquisition date.	▸ Generally, no gain is recognized in earnings. The excess fair value of the acquired net assets over the consideration transferred is allocated on a relative fair value basis to the identifiable net assets acquired (excluding non-qualifying assets).
Assembled workforce	▸ Not recognized as a separate intangible asset but rather subsumed into goodwill.	▸ Recognized separately as an intangible asset. ▸ For intangible assets that are acquired individually or within a group of assets, the asset recognition criteria in CON 5 may be met even though the contractual-legal criterion or separability criterion in ASC 805 has not been met.
Pre-acquisition contingent assets and liabilities	▸ Pre-acquisition contingent assets and liabilities are recognized at the acquisition date at fair value if the acquisition-date fair value of the asset or liability can be determined during the measurement period. Otherwise, the contingent asset or liability is accounted for in accordance with ASC 450.	▸ Pre-acquisition contingent assets and liabilities are accounted for in accordance with ASC 450.
Deferred taxes	▸ Generally recorded on most temporary book/tax differences of assets acquired and liabilities assumed in accordance with ASC 740.	▸ Because goodwill is not recognized in an asset acquisition, the measurement of deferred income tax assets acquired and liabilities assumed in an asset acquisition will usually require an iterative approach that affects the measurement of other individual assets and assumed liabilities in the net asset group. The measurement of deferred taxes on temporary differences in an asset acquisition is determined using the simultaneous equations method described in ASC 740. ▸ Refer to section A.3.1.6 for further discussion on deferred income tax accounting.
Leases classification (under both ASC 840 and ASC 842)	▸ ASC 840 — Retain the previous classification for the leases of an acquired entity unless the provisions of the lease are modified as indicated in paragraph 840-10-35-5. ▸ ASC 842 — Reassessment of lease classification is not required unless there is a lease modification and the modification is not accounted for as a separate contract in accordance with ASC 842-10-25-8.	▸ ASC 840 — Reassessment of the assumed lease is required. ▸ ASC 842 — Analogize to the business combinations guidance or reassess the classification of the assumed lease in accordance with the criteria in ASC 842-10-25.
Contingent consideration (that does not otherwise meet the definition of a derivative)	▸ Recognized at its acquisition-date fair value as part of the consideration transferred.	▸ Generally recognized when the contingency is resolved (i.e., when the contingent consideration is paid or becomes payable) or when probable and reasonably estimable under ASC 450.

A.2 Measure the cost of the asset acquisition (updated June 2022)

Excerpt from Accounting Standards Codification

Business Combinations — Related Issues

Recognition

805-50-25-1

Assets commonly are acquired in exchange transactions that trigger the initial recognition of the assets acquired and any liabilities assumed. If the consideration given in exchange for the assets (or net assets) acquired is in the form of assets surrendered (such as cash), the assets surrendered shall be derecognized at the date of acquisition. If the consideration given is in the form of liabilities incurred or **equity interests** issued, the liabilities incurred and equity interests issued shall be initially recognized at the date of acquisition. However, if the assets surrendered are nonfinancial assets or **in substance nonfinancial assets** within the scope of Subtopic 610-20 on gains and losses from the derecognition of nonfinancial assets, the assets surrendered shall be derecognized in accordance with the guidance in Subtopic 610-20 and the assets acquired shall be treated as noncash consideration in accordance with Subtopic 610-20.

Initial Measurement

805-50-30-1

Paragraph 805-50-25-1 discusses exchange transactions that trigger the initial recognition of assets acquired and liabilities assumed. Assets are recognized based on their cost to the acquiring entity, which generally includes the transaction costs of the asset acquisition, and no gain or loss is recognized unless the **fair value** of noncash assets given as consideration differs from the assets' carrying amounts on the acquiring entity's books. For transactions involving nonmonetary consideration within the scope of Topic 845, an acquirer must first determine if any of the conditions in paragraph 845-10-30-3 apply. If the consideration given is nonfinancial assets or **in substance nonfinancial assets** within the scope of Subtopic 610-20 on gains and losses from the derecognition of nonfinancial assets, the assets acquired shall be treated as noncash consideration and any gain or loss shall be recognized in accordance with Subtopic 610-20.

805-50-30-2

Asset acquisitions in which the consideration given is cash are measured by the amount of cash paid, which generally includes the transaction costs of the asset acquisition. However, if the consideration given is not in the form of cash (that is, in the form of noncash assets, liabilities incurred, or **equity interests** issued) and no other generally accepted accounting principles (GAAP) apply (for example, Topic 845 on nonmonetary transactions or Subtopic 610-20), measurement is based on either the cost which shall be measured based on the fair value of the consideration given or the fair value of the assets (or net assets) acquired, whichever is more clearly evident and, thus, more reliably measurable. For transactions involving nonmonetary consideration within the scope of Topic 845, an acquirer must first determine if any of the conditions in paragraph 845-10-30-3 apply. If the consideration given is nonfinancial assets or in substance nonfinancial assets within the scope of Subtopic 610-20, the assets acquired shall be treated as noncash consideration and any gain or loss shall be recognized in accordance with Subtopic 610-20.

After determining that the transaction is an asset acquisition, the acquiring entity should recognize assets acquired and liabilities assumed on the acquisition date. Assets acquired are measured based on the cost of the acquisition, which is the consideration the acquirer transfers to the seller and generally includes direct transaction costs related to the acquisition.

The form of consideration transferred may be cash, noncash assets, liabilities incurred or equity interests issued by the acquirer. Assets transferred as consideration are derecognized on the acquisition date, and liabilities incurred and equity interests issued are recognized on that date. The cost of the acquisition does not include any amounts attributable to transactions that are separate and apart from the asset acquisition.

A.2.1 Noncash consideration

Most asset acquisitions involve exchanges of cash or other monetary assets. Some transactions, however, include nonmonetary assets. ASC 805-50-30-2 provides general principles for measuring the cost of an asset acquisition that involves noncash consideration. For transactions involving nonmonetary or nonfinancial assets, an acquirer should consider the substance of an exchange transaction and the nature of assets transferred to determine the applicable guidance to follow (e.g., ASC 845, ASC 610-20).

If the consideration given is cash, the cost of an asset acquisition is measured as the amount of cash paid, which generally includes direct transaction costs. If the consideration is in the form of noncash assets, liabilities incurred or equity interests issued, the cost of the noncash asset (or net assets) received is generally based on the fair value of the consideration given, unless the fair value of the noncash asset (or net assets) acquired is more reliably measurable. No gain or loss is recognized unless the cost of the noncash asset recognized differs from the carrying amount of the noncash asset surrendered.

A.2.1.1 Nonmonetary exchanges

When the consideration transferred in an asset acquisition is nonmonetary, the transaction might be in the scope of ASC 845. In general, nonmonetary transactions are measured based on the fair value of the assets exchanged. However, there are exceptions to this principle if (1) the fair value is not reasonably determinable, (2) the transaction is an exchange to facilitate sales to customers or (3) the transaction lacks commercial substance. In these cases, nonmonetary transactions are measured based on the carrying amount of the asset surrendered (after reduction for impairment, if applicable), and no gain or loss is recognized.

A.2.1.2 Transfer of nonfinancial assets

If the consideration given consists of nonfinancial assets or in-substance nonfinancial assets, the acquiring entity should consider whether the transaction is in the scope of ASC 610-20. If it is, the assets acquired must be treated as noncash consideration received, and any gain or loss must be recognized in accordance with ASC 610-20. Refer to section 2 of our FRD, ***Gains and losses from the derecognition of nonfinancial assets (ASC 610-20),*** for guidance on this assessment.

A.2.1.3 Equity interests issued in exchange for goods or services (updated June 2022)

ASC 805-50-25-1 provides that equity interests issued in exchange for an asset (or a group of assets) that are accounted for under ASC 805-50 are initially recognized and measured at the date of acquisition (i.e., the closing date). However, we are aware of a view that may consider the issuance of shares as consideration in an asset acquisition to be a share-based payment to nonemployees in exchange for goods to be used or consumed in the entity's operations. In this instance, an entity would apply ASC 718 in measuring, classifying and recognizing the equity interests issued, which may result in an earlier measurement date than the acquisition date (i.e., the grant date) for the shares transferred as well as differences in classification and recognition of shares. Refer to our FRD, ***Share-based payment***, for additional details. We believe that it may be acceptable to apply, on a consistent basis, either ASC 805-50 or ASC 718 to account for the issuance of shares in an asset acquisition as an accounting policy election.[66]

A.2.2 Direct transaction costs

Direct transaction costs incurred by the acquirer in the acquisition of an asset or a group of assets generally are a component of the consideration transferred and, as such, are capitalized as a component of the cost of the assets acquired and liabilities assumed. These capitalized costs are limited to direct costs that relate to the asset acquisition and that otherwise wouldn't be incurred. Examples include a finder's fee, fees paid to outside consultants for legal services, engineering investigations and appraisals. Internal costs, such as salaries and other period costs, related to the asset acquisition are generally charged to expense as incurred.[67] This concept is illustrated below.

Illustration A-1: Including transaction costs in consideration transferred

Acquirer purchases Target in an asset acquisition, and Target's only asset is a building used for commercial purposes. As part of the acquisition, Acquirer has the following costs related to the acquisition:

- Third-party fee to facilitate the transaction (finder's fee): $5 million
- Fee to an outside consultant to appraise the building: $3 million
- Third-party legal services: $5 million
- The portion of salaries of Acquirer's accounting, finance and legal personnel to close the transaction based on time spent: $2 million
- Other general and administrative expenses: $5 million

Acquirer capitalizes $13 million of transaction costs (finder's fee of $5 million + third-party legal services of $5 million + appraisal fee of $3 million) which are directly related to the acquisition and otherwise wouldn't have been incurred. Acquirer expenses $7 million of costs as incurred (portion of internal salaries of $2 million + other general and administrative expenses of $5 million) because these costs are not directly attributable to the acquisition of the building.

[66] This view is consistent with Board comments made at the 3 March 2021 FASB Board meeting.

[67] Because no guidance is provided in ASC 805-50 on the nature of transaction costs to capitalize (i.e., indirect costs or direct costs), these concepts are leveraged from previously existing guidance in paragraph 24 of Statement 141, which, similar to the measurement guidance in ASC 805-50, provided for a cost accumulation and allocation model.

Costs incurred by an acquirer to issue debt or equity securities to finance an asset acquisition are not considered costs of the asset acquisition and are accounted for as debt or equity issuance costs, respectively, in accordance with other applicable accounting guidance. Generally, debt issuance costs are amortized and recognized as additional interest expense over the term of the debt using the effective interest method pursuant to ASC 835-30-35-2 through 35-3 and reported on the balance sheet as a direct deduction from the liability recognized, while equity issuance costs are deducted from the proceeds of the issuance (i.e., a reduction of equity). Refer to our FRDs, ***Issuer's accounting for debt and equity financings (before the adoption of ASU 2020-06, Accounting for Convertible Instruments and Contracts in an Entity's Own Equity)*** and ***Issuer's accounting for debt and equity financings (after the adoption of ASU 2020-06, Accounting for Convertible Instruments and Contracts in an Entity's Own Equity)***, for further guidance on debt and equity issuance costs.

See section 6.2 for further discussion of the accounting for transaction costs in a business combination.

A.2.3 Contingent consideration

When a buyer and seller cannot reach consensus on the consideration to be given in exchange for the assets acquired and liabilities assumed, the purchase agreement may contain a provision (often referred to as an "earn-out" provision) under which typically the acquirer agrees to pay additional consideration to the seller in the future if certain events occur or conditions are met (often referred to as contingent consideration). These obligations may take the form of cash, other assets or additional equity interests.

ASC 805-50 requires that consideration given in an asset acquisition include liabilities incurred and equity interests issued, but it doesn't provide guidance on accounting for contingent consideration. Acquirers generally account for contingent consideration in accordance with other applicable US GAAP. All facts and circumstances of a particular transaction should be evaluated when determining the appropriate accounting for a contingent consideration arrangement.

While contingent consideration may be negotiated as part of an asset acquisition, the arrangement needs to be evaluated to determine whether the payments are considered part of or separate from the exchange transaction (see section A.2.6 for further guidance on making this determination). Contingent consideration that is not part of the exchange for the acquired assets is accounted for separately from the asset acquisition. If the acquirer determines that the contingent consideration arrangement represents consideration for the assets acquired, the guidance discussed below should be considered. The discussion below addresses the accounting for contingent consideration arrangements that are freestanding instruments.[68]

Depending on whether a contingent consideration arrangement involves equity shares or cash (or a combination of both), the acquirer may need to evaluate the arrangement in accordance with ASC 480 and/or ASC 815 to determine the appropriate accounting. As illustrated in this section, many contingent consideration arrangements in asset acquisitions are not subject to ASC 480 and/or ASC 815. However, entities should carefully evaluate the terms of the arrangement when reaching this conclusion.

[68] ASC 805-50 doesn't provide guidance on the unit of account of a contingent consideration arrangement in an asset acquisition. Absent specific guidance, an acquirer may evaluate the arrangement as a separate freestanding instrument similar to how contingent consideration is evaluated in a business combination. Alternatively, an acquirer may look to the definition of "freestanding contract" in ASC 815 to determine whether such an arrangement is freestanding or embedded in the underlying purchase agreement. Furthermore, when a contingent consideration arrangement contains multiple settlements based on different contingencies, an acquirer will need to determine whether the arrangement represents one unit of account or multiple units of account.

The discussion below addresses consideration of the relevant guidance for common forms of contingent consideration in an asset acquisition:

- Contingent consideration payable in cash and not settled in or indexed to equity shares
- Contingent consideration settled in or indexed to equity shares

When the contingent consideration arrangement is not accounted for pursuant to other guidance (e.g., ASC 815 or ASC 480), we generally believe that a contingent consideration obligation should be recognized when the contingency is resolved and the consideration is paid or becomes payable.[69] However, given the lack of explicit guidance in ASC 805-50, we are aware of other acceptable approaches in practice, such as recognizing the obligation when the contingency is probable and reasonably estimable under ASC 450. Entities should apply a consistent accounting policy regardless of which approach is applied.

Upon recognition, the amount would be included in the measurement of the cost of the acquired asset or group of assets, depending on the nature of the asset or asset group acquired.

A.2.3.1 Contingent consideration paid in cash and not settled in or indexed to equity shares

If a contingent consideration arrangement requires payment of cash upon settlement and the settlement amount is not settled in or indexed to equity shares, the acquirer should first determine whether the contingent consideration is a derivative that should be recognized at fair value at the time of acquisition under ASC 815.

ASC 815 defines a derivative as a financial instrument or other contract with all of the following characteristics:

- The contract has both (1) one or more underlyings and (2) one or more notional amounts or payment provisions or both.
- The contract requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.
- The contract has net settlement provisions through (1) implicit or explicit terms, (2) a market mechanism outside the contract or (3) delivery of an asset that, because the delivered asset is readily convertible to cash, puts the recipient in a position not substantially different from net settlement (a gross settlement that is economically equivalent to a net settlement).

While contingent consideration may meet all of the characteristics of a derivative, ASC 815 may not apply to the arrangement because of certain scope exceptions. Two common scope exceptions for contingent consideration are provided in ASC 815-10-15-59(b) and ASC 815-10-15-59(d).

ASC 815-10-15-59(b) provides a scope exception for non-exchange traded contracts with an underlying that is the price or value of a nonfinancial asset of one of the parties to the contract, provided that the asset is not readily convertible to cash. This scope exception applies only if the nonfinancial asset is unique and the nonfinancial asset is owned by the party that would not benefit under the arrangement from an increase in the fair value of the nonfinancial asset.

---

[69] Because no guidance is provided in ASC 805-50 on accounting for contingent consideration that does not require recognition under other guidance (e.g., ASC 815, ASC 480) in an asset acquisition, our view is informed by previously existing guidance in paragraph 27 of Statement 141, which, similar to the recognition and measurement guidance in ASC 805-50, provided for a cost accumulation and allocation model.

ASC 815-10-15-59(d) provides a scope exception for non-exchange traded contracts in which settlement is based on a specified volume of sales or service revenues of one of the parties to the contract.

If the contingent consideration is required to be accounted for as a derivative, the fair value of contingent consideration recognized is included in the consideration transferred and becomes part of the basis in the asset (or assets) acquired. For example, if an entity acquires an asset for $10 million in cash and a contingent consideration arrangement that is accounted for as a derivative with a fair value of $2 million at the acquisition date, upon an asset acquisition, the asset would be initially measured at $12 million.

Refer to section 2 of our FRD, ***Derivatives and hedging***, for additional guidance. The following illustration highlights the accounting evaluation of a contingent consideration arrangement that does not involve equity shares but requires settlement in cash:

Illustration A-2: Evaluation of initial accounting for contingent consideration in an asset acquisition

Entity A, a pharmaceutical company, acquires Entity B, a biotechnology company that is developing a new technology (Product X) in a specific therapeutic area. Product X is expected to be a significant source of revenue if it receives Food and Drug Administration (FDA) approval. Before the acquisition date, Entity B did not have any other products or any source of revenue. Further, Entity A expects to continue developmental work and commercialize Product X under its own brand. Total consideration consists of $10 million paid in cash at the date of acquisition, and $25 million that will be paid in cash upon the occurrence of specific events as follows:

- Milestone payment No. 1 — $5 million upon FDA approval of Product X
- Milestone payment No. 2 — $10 million when worldwide sales of Product X exceed $50 million
- Milestone payment No. 3 — $10 million when worldwide sales of Product X exceed $100 million

Entity A concludes that substantially all of the fair value of Entity B's gross assets is concentrated in a single identifiable asset, Product X. Therefore, Entity A concludes that Entity B does not meet the definition of a business, and the transaction is accounted for as an asset acquisition.

Analysis

Entity A determines that the three milestone payments are considered separate, freestanding financial instruments that should be assessed for accounting individually. Entity A also determines that each milestone payment arrangement meets the definition of a derivative under ASC 815-10-15-83 because (1) it has an underlying (the occurrence or nonoccurrence of a milestone event) and a payment provision that determines the amount of settlement (e.g., $5 million or $10 million); (2) the contract requires an initial net investment that is smaller, by more than a nominal amount, than would be required for other types of contracts that would be exchanged in responding to changes in the underlying (i.e., the occurrence or nonoccurrence of contingencies); and (3) it requires settlement through a one-way transfer of cash.

While the milestone payment arrangements meet the definition of a derivative, they may qualify for certain scope exceptions in ASC 815, and therefore, do not have to be accounted for as derivatives that are subject to fair value measurement under ASC 815. Entity A evaluated each milestone payment under the applicable scope exceptions in ASC 815 as follows:

Milestone payment No. 1:

ASC 815-10-15-59(b) provides a scope exception for non-exchange traded contracts with an underlying that is the price or value of a nonfinancial asset of one of the parties to the contract, provided that the asset is not readily convertible to cash. This scope exception applies only if the nonfinancial asset is unique and the nonfinancial asset is owned by the party that would not benefit under the arrangement from an increase in the fair value of the nonfinancial asset.

In this example, Product X is IPR&D (a nonfinancial asset) that Entity A expects to continue to develop and ultimately commercialize. Entity A concludes that Product X is unique because it is a new technology. Additionally, Entity A determines that Product X is not readily convertible to cash.

The value of Product X is most affected by the probability of commercial success and forecasted sales. Upon achievement of FDA approval, the fair value of Product X is expected to increase since the product would then be commercially sold. However, because Entity A is required to make milestone payment No. 1 upon the achievement of FDA approval, Entity A (as the payor of the milestone payment) does not benefit from the contingent consideration arrangement. Rather, Entity B is the party that benefits under the contingent consideration arrangement (since it receives the milestone payment) from the increase in the fair value of Product X.

Therefore, Entity A concludes that milestone payment No. 1 qualifies for the scope exception in ASC 815-10-15-59(b).

Milestone payments Nos. 2 and 3:

ASC 815-10-15-59(d) provides a scope exception of non-exchange traded contracts with an underlying that is based on the specified volumes of sales or service revenues of one of the parties to the contract.

In this case, these contingent payments are based on the future sales of Product X. Accordingly, Entity A determines that milestone payments Nos. 2 and 3 qualify for the scope exception in ASC 815-10-15-59(d).

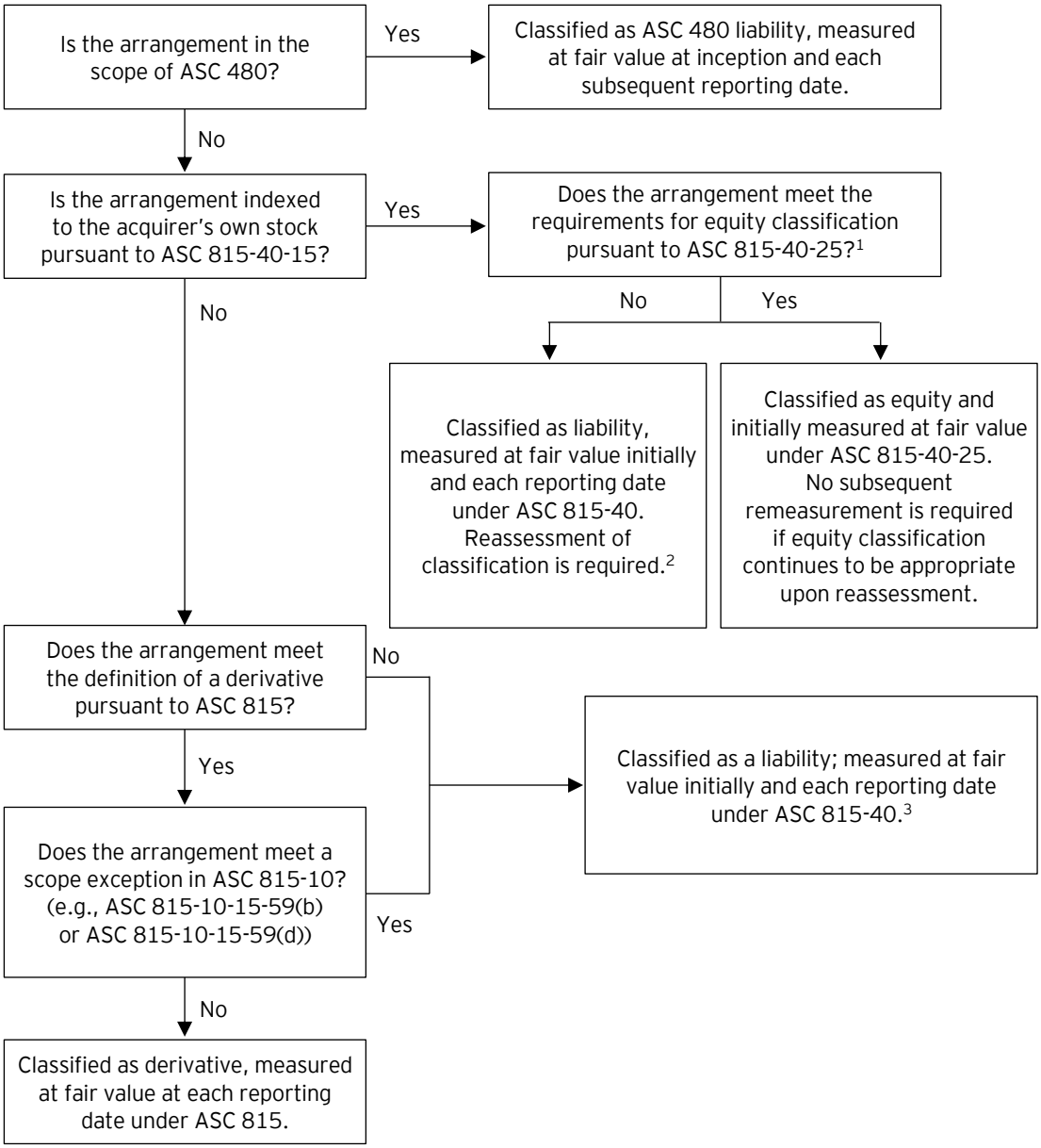
Conclusion

The milestone arrangements are not accounted for as derivatives in accordance with ASC 815, and there is no other applicable GAAP requiring the recognition of these arrangements at fair value on the acquisition date. Accordingly, Entity A recognizes the contingent consideration obligation when the contingency is resolved and the consideration is paid or becomes payable based on its accounting policy.

A.2.3.2 Contingent consideration arrangements settled in or indexed to equity shares (updated June 2022)

If a contingent consideration arrangement settles through the issuance of, or is indexed to, the equity shares of the acquirer, the acquirer will generally be required to measure the contingent consideration arrangement at its acquisition date fair value pursuant to the guidance in ASC 480 and ASC 815. Entities will also need to carefully consider the guidance in ASC 480 and ASC 815 to determine its classification and subsequent measurement. This determination can be complex and often will require the exercise of professional judgment based on the particular facts and circumstances.

The flowchart below provides a roadmap for entities to follow as they determine the appropriate classification of such contingent consideration arrangements that are freestanding instruments.



[1] ASU 2020-06 simplifies the settlement assessment that entities are required to perform to determine whether a contract qualifies for equity classification.

[2] Determine whether the arrangement meets the definition of a derivative and does not meet a scope exception in ASC 815-10. If so, it is subject to the derivative disclosure requirements.

[3] ASU 2020-06 requires an entity that has freestanding equity contracts that do not meet the definition of a derivative (and are not indexed to an entity's own equity under ASC 815-40-15) to be subsequently measured at fair value through earnings. Before the adoption of ASU 2020-06, there was no subsequent measurement guidance for freestanding equity contracts that are not derivatives and are not indexed to an entity's own stock.

A.2.3.2.1 Application of ASC 480 to classification of contingent consideration

When a contingent consideration arrangement will result in the delivery of, or its settlement amount is based on, the equity shares of the acquirer, companies should first consider whether the arrangement is in the scope of ASC 480.

Financial instruments in the scope of ASC 480 are required to be classified as liabilities. A financial instrument is in the scope of ASC 480 if it embodies an obligation for the issuer to:

- Mandatorily redeem a financial instrument
- Repurchase shares by transferring assets, regardless of whether the instrument is settled on a net-cash or gross physical basis
- Issue a variable number of shares and, at inception, its monetary value is solely or predominately one of the following:
  - Fixed (e.g., an obligation to deliver shares with a fair value at settlement equal to $1,000)
  - Derived from an underlying other than the fair value of the issuer's shares (e.g., an obligation to deliver shares with a fair value at settlement equal to the value of one ounce of gold)
  - Moves inversely to the fair value of the issuer's shares (e.g., net-share settled written put options)

In practice, contingent consideration arrangements that are settled in stock often involve instruments most similar to those discussed in the third bullet point above (e.g., an arrangement that requires the acquirer to settle any obligation by delivering shares and the value of that obligation is predominantly based on whether certain contingencies or target thresholds are met). In those cases, the acquirer would need to determine whether the arrangement is in the scope of ASC 480. We believe that determination will depend on whether the arrangement's monetary value, at inception, is based predominately on the occurrence of a contingency (e.g., revenue target) as opposed to share price.

If the monetary value is based predominately on the occurrence of contingencies, the arrangement would be classified as a liability under ASC 480. If the arrangement is not a liability under ASC 480, companies would need to apply the guidance in ASC 815 (as discussed further below). Further, we believe the determination of whether the arrangement's monetary value, at inception, is based predominately on the occurrence of a contingency (e.g., revenue target) as opposed to share price will depend on the particular facts and circumstances. Generally, we believe the more substantive the contingency (i.e., the more difficult it is to reach), the more likely the arrangement is based predominately on the occurrence of a contingency (resulting in liability classification).

If liability classification is required under ASC 480, the acquirer should follow the applicable guidance for initial and subsequent measurement of the contingent consideration. Refer to our FRDs, ***Issuer's accounting for debt and equity financings (before the adoption of ASU 2020-06, Accounting for Convertible Instruments and Contracts in an Entity's Own Equity)*** and ***Issuer's accounting for debt and equity financings (after the adoption of ASU 2020-06, Accounting for Convertible Instruments and Contracts in an Entity's Own Equity)***, for further guidance.

A.2.3.2.2 Application of ASC 815 to classification of contingent consideration

If the contingent consideration arrangement is not subject to ASC 480, the guidance in ASC 815 should be considered to determine the classification and measurement. Specifically, ASC 815-40 provides for equity classification if an arrangement or instrument (1) is indexed to the issuer's stock (ASC 815-40-15) and (2) meets the requirements of the equity classification guidance (ASC 815-40-25).

ASC 815-40-15 outlines a two-step evaluation to determine whether an instrument is indexed to the issuer's own stock. The first step is to evaluate any contingent provisions that trigger the settlement of a contract or arrangement (i.e., exercise contingencies). As long as an exercise contingency is not based on an observable market or index unrelated to the issuer, the instrument would not be precluded from being considered indexed to the issuer's own stock. The second step requires an analysis of provisions that could change the instrument's settlement amount. In general, the instrument must settle in an amount based on an exchange of a fixed amount of cash (or principal amount of debt) for a fixed number of shares. ASC 815-40-15 allows for certain exceptions to the fixed-for-fixed notion. The application of these exceptions to arrangements that are not literally fixed-for-fixed can be complex and requires careful consideration of the particular provisions.

Accordingly, if a qualifying contingency (e.g., revenues; earnings before interest, taxes, depreciation and amortization; net income of the target) determines whether a fixed number of shares will be delivered (i.e., the possible outcomes are binary, either no shares are delivered or a single number of shares is delivered), the contingent consideration arrangement would be considered indexed to the issuer's own stock. However, if a qualifying contingency has the characteristics of modifying the number of shares to be delivered rather than simply acting as an on/off switch (i.e., there is more than one possible outcome for a settlement, such as zero, 50, 100 or 200 shares, depending on the resolution of the contingency), that contingency affects the settlement amount. In that scenario, the settlement of the arrangement is not considered fixed-for-fixed because the number of shares that can be issued is not fixed. This arrangement would not be considered indexed to the entity's own stock, and therefore, would be classified as a liability pursuant to ASC 815-40-15-8A.

If a contingent consideration arrangement is deemed to be indexed to the issuer's (i.e., acquirer's) own stock under ASC 815-40-15, the arrangement should then be analyzed under ASC 815-40-25 to determine whether equity classification is appropriate. That determination depends heavily on how the instrument settles and whether an acceptable form of settlement is entirely within the control of the issuing entity. The basic principle underlying the equity classification guidance is that instruments that require net cash settlement (or such settlement is a contractual alternative not within the control of the issuer or is presumed under the guidance) are assets or liabilities, and those that require settlement in shares (either net-share or physical settlement) are equity instruments. Instruments that provide the issuer with a choice of net cash settlement or settlement in shares are assumed to settle in shares, while those that provide the counterparty with that choice are assumed to net cash settle.

ASC 815-40-25 includes other conditions that must be met for equity classification. Those conditions focus on whether the issuer will have the ability, in all cases, to effect settlement in shares. Otherwise, net cash settlement is presumed, and equity classification is not permitted.

Contingent consideration arrangements that are indexed to the issuer's own stock and qualify for equity classification would be classified as equity and measured at fair value at the acquisition date. The contingent consideration arrangement should be assessed at the end of each reporting period to determine whether equity classification continues to be appropriate. For those arrangements that do not qualify for equity classification, the acquirer would recognize and measure a liability at fair value at the acquisition date pursuant to ASC 815-40. Refer to our FRDs, ***Issuer's accounting for debt and equity financings (before the adoption of ASU 2020-06, Accounting for Convertible Instruments and Contracts in an Entity's Own Equity)*** and ***Issuer's accounting for debt and equity financings (after the adoption of ASU 2020-06, Accounting for Convertible Instruments and Contracts in an Entity's Own Equity)***, for further guidance.

The following illustration highlights the accounting evaluation of a contingent consideration arrangement that may involve the transfer of equity shares of the acquirer:

Illustration A-3: Revenue contingency settled in a fixed number of shares

Company A acquires AssetCo for 300 shares of Company A's equity securities and determines the transaction should be accounted for as an asset acquisition. The agreement includes a provision under which Company A will deliver 100 additional shares to the former owner of AssetCo if AssetCo's assets generate revenue greater than X for the 12 months following the acquisition date. If revenue is less than X, no additional shares will be delivered. For purposes of this illustration, the contingent consideration arrangement is analyzed as if it were a separate freestanding instrument from the underlying purchase agreement.

Analysis

Is the arrangement in the scope of ASC 480?

While there is diversity in practice, the most commonly held view is that the arrangement is not considered to be settled for a variable number of shares.[1] Rather, there is only one settlement outcome — that is, a settlement in 100 shares. Under this view, the contingency is considered merely an "on-off switch" that does not affect the monetary amount on settlement. In addition, the monetary value on settlement isn't a fixed dollar amount known at inception and doesn't vary inversely with the fair value of the issuer's equity shares. Therefore, the arrangement is outside the scope of ASC 480, regardless of the probability of the trigger being achieved. As a result, the acquirer should look to other guidance to determine the appropriate classification.

If the arrangement is not a liability under ASC 480, is the arrangement indexed to the entity's own stock?

Yes. The contingency trigger is based on revenue, which is an observable index calculated solely by reference to the entity's operations. In addition, the number of shares to be delivered are fixed. The arrangement would be considered indexed to the entity's own stock under ASC 815-40-15, which means equity classification is not precluded.

Does the arrangement meet the equity classification requirements in ASC 815-40-25?

This arrangement may qualify for equity classification if all of the criteria in ASC 815-40-25 are met.

If all of the conditions in ASC 815-40-25 are met, the arrangement would be classified in equity and initially recognized at fair value pursuant to ASC 815-40-25. The amount recognized would be included as part of consideration transferred. Company A is required to reassess the classification at each reporting date. If equity classification continues to be appropriate upon reassessment, subsequent remeasurement will not be required.

[1] Alternatively, the arrangement may be considered to be settled for a variable number of shares (either zero or 100 shares) and the determinants of the monetary value of such an arrangement are (1) the likelihood of reaching the revenue threshold (zero or 100 shares), and (2) price per share at the time such shares are contingently deliverable (value of the 100 shares, if that settlement is triggered). If the monetary value is predominantly based on the likelihood of reaching the revenue threshold, the arrangement would be classified as a liability, as such value varies in relation to something other than the fair value of the issuer's equity shares (480-10-25-14(b)). If, however, the value is not predominantly based on the likelihood of reaching the revenue threshold (e.g., the likelihood of reaching the revenue threshold is relatively high), ASC 480 does not address the classification of this arrangement, and Company A would continue to other guidance to determine the appropriate classification.

See section A.6.1 for the subsequent accounting for cost recognized as a result of a contingent consideration arrangement.

A.2.4 Acquisition of a controlling interest of less than 100% in an entity that is not a business

A company may acquire a controlling equity interest that represents less than 100% of an entity that does not meet the definition of a business. When this occurs, a noncontrolling interest in the acquired entity is created. Assuming the entity holding the asset (or a group of assets) being acquired is not a VIE, we generally believe that the acquirer should include the fair value of the noncontrolling interest as part of the cost of the asset acquisition and recognize the noncontrolling interest based on its proportionate share of the fair value of the net assets acquired on the acquisition date.

Illustration A-4 provides an example that may be helpful when determining how to account for such a transaction.

Illustration A-4: Acquisition of a controlling interest of less than 100% in another entity that is not a business

Acquirer enters into an agreement to purchase 80% of the outstanding shares of Target for cash consideration of $320. Target owns a single asset and doesn't meet the definition of a business. The remaining 20% of Target is held by Company A, an unrelated third party. The fair value of the asset is $400, which equals the fair value of Target.

Analysis

Acquirer has obtained control of Target and therefore applies the guidance in ASC 810-10, which results in Acquirer consolidating Target and recognizing a noncontrolling interest for the portion of Target that was not acquired. Acquirer would recognize 100% of the fair value of the asset ($400) in the consolidated financial statements. Acquirer would record the following journal entry:

Asset	$ 400	
Noncontrolling interests		$ 80[1]
Cash		320

[1] Acquirer would recognize the noncontrolling interest at its proportionate share of the fair value of the asset acquired ($400 x 20%).

A.2.5 Previously held interests

A company may obtain control of an asset or group of assets from an entity in which the company holds a noncontrolling equity interest immediately before consummation of the acquisition. ASC 805-50 does not provide guidance on how to account for previously held equity interests. We believe that, because the guidance prescribes a cost accumulation approach, the acquiring company should include both the carrying value of the preexisting ownership interest and the cost of the additional ownership interest acquired in the total cost of the asset acquisition. We are aware of an alternate view in practice that would result in the remeasurement of the previously held interest at its fair value as of the date of the transaction.

A.2.6 Transactions that are separate from an asset acquisition

An acquirer may enter into other arrangements with the seller at or near the same time as the asset acquisition. Such arrangements may be contained in a separate agreement or they may be included as a provision in the asset purchase agreement itself. We believe that the consideration transferred in an asset acquisition, like the consideration transferred in a business combination, should only include amounts that the parties agreed would be transferred in exchange for the assets acquired and liabilities assumed. Exchanged values of any portion of the assets acquired, liabilities assumed or consideration given that are not part of the exchange for the acquired assets are accounted for separately from the asset acquisition and may increase or decrease the measurement of the cost that is allocated to the assets acquired and liabilities assumed.

To determine whether an arrangement is part of or separate from the asset acquisition, we believe the acquirer should apply the same principle in ASC 805 that it applies in business combinations. That is, a transaction is likely a separate transaction that should be accounted for apart from the asset acquisition if it is entered into by or on behalf of the acquirer or is primarily for the benefit of the acquirer. Because this determination requires judgment, an acquirer should consider the following factors provided in ASC 805-10-55-18:

- The reasons for the transaction
- Who initiated the transaction
- The timing of the transaction

These factors should be considered holistically; no one factor is determinative. Refer to section 3.4.1.2 for further discussion on how an acquirer should determine which elements of a transaction to account for as part of an asset acquisition.

After the acquirer determines which assets acquired or liabilities assumed are part of the exchange for the acquiree's assets, it must determine how to allocate the consideration transferred between the various components (i.e., the asset acquisition and the separate transaction(s)). Because there is no guidance on this point, we believe that using a relative fair value approach to allocate the consideration transferred between the two (or more) components would be reasonable and acceptable. Other alternatives may also be acceptable.

Some of the more common types of arrangements that are entered into at or near the same time as an asset acquisition and are generally recognized as separate transactions are discussed below.

A.2.6.1 Settlement of preexisting relationships

The buyer and seller may have previously entered into a relationship before contemplating an asset acquisition. As part of or contemporaneously with acquisition negotiations, the parties may agree to effectively settle the preexisting relationship. When this occurs, a question arises about how to account for the settlement.

While there is no guidance on the settlement of a preexisting relationship in an asset acquisition, we believe that a settlement gain or loss should be recognized consistent with the ASC 805 principles relating to the settlement of preexisting relationships in a business combination. In addition, the amount recognized as a gain or loss will depend on whether the relationship is contractual or noncontractual in nature. If the preexisting relationship was documented in a contract, it is considered a contractual relationship. Otherwise, the relationship is considered noncontractual.

ASC 805-10-55-21 provides that the settlement of a noncontractual relationship is measured at fair value. In contrast, the settlement of a contractual relationship is measured at the lesser of the following items:

- The amount by which the contract is favorable or unfavorable from the perspective of the buyer relative to market terms for the same or similar items
- The amount of any stated settlement provisions in the contract available to the counterparty to whom the contract is unfavorable

Illustration A-5: Settlement of a contractual relationship in an asset acquisition

Acquirer purchases raw materials from Acquiree under a five-year supply contract at fixed rates. Because the fixed rates are lower than the rates at which Acquirer could purchase similar raw materials from another supplier, Acquirer considers the contract an executory contract that is unfavorable to the Acquiree and determines that the fair value of the off-market component of the contract is $5 million. The supply agreement permits either party to cancel the contract for a payment of $3 million. Acquirer purchases the manufacturing equipment that produces the raw materials from Acquiree for $100 million.

Analysis

The gain Acquirer recognizes upon settlement of the executory contract is determined based on the lesser of (1) the $5 million amount by which the supply contract is unfavorable to Acquiree or (2) the $3 million stated settlement provision amount available to Acquiree (i.e., the counterparty to whom the contract is unfavorable). Accordingly, Acquirer recognizes a $3 million gain upon termination of the supply contract, and the consideration transferred in the asset acquisition is $103 million, which represents the cost of the acquired equipment.

If a preexisting contract is otherwise cancelable without penalty, the stated settlement provision amount of that contract is zero and no settlement gain or loss would be recognized. If the settlement of a preexisting relationship involves a lease, refer to sections 4.2.4 and 4.3.9 in our FRD, ***Lease accounting: Accounting Standards Codification 840,*** Leases, or section 4.8.2 in our FRD, ***Lease accounting: Accounting Standards Codification 842,*** Leases, for additional guidance.

A.2.6.2 R&D assets

Payments to the former owners of an asset or asset group for future services are generally considered a separate transaction and not accounted for as part of the asset acquisition. When an acquiring entity will make future payments to the former owners of the acquired assets, the entity must carefully evaluate whether these payments are for future services to be performed by the seller or whether they represent contingent consideration for the asset(s) acquired. This evaluation requires significant judgment.

As an example, assume that an acquirer obtains a license to a drug compound from the seller and simultaneously engages the former owners to perform research and development (R&D) services in exchange for payments in the future. If the acquirer determines that payments for services performed by the seller in connection with the R&D activities are not part of the asset acquired, these payments should be expensed as R&D costs in accordance with ASC 730.

A.3 Allocate the cost of the asset acquisition

Excerpt from Accounting Standards Codification

Business Combinations — Related Issues

Initial Measurement

805-50-30-3

Acquiring assets in groups requires not only ascertaining the cost of the asset (or net asset) group but also allocating that cost to the individual assets (or individual assets and liabilities) that make up the group. The cost of such a group is determined using the concepts described in the preceding two paragraphs. The cost of a group of assets acquired in an asset acquisition shall be allocated to the individual assets acquired or liabilities assumed based on their relative fair values and shall not give rise to goodwill. The allocated cost of an asset that the entity does not intend to use or intends to use in a way that is not its highest and best use, such as a brand name, shall be determined based on its relative fair value. See paragraph 805-50-55-1 for an illustration of the relative fair value method to assets acquired outside a business combination.

A.3.1 Cost assignment in asset acquisitions

After the cost of an asset acquisition is determined, the acquiring entity is required to allocate the cost to the individual assets acquired or liabilities assumed, based on their relative fair values as discussed in ASC 805-50-30-3. Fair value is measured in accordance with ASC 820. No goodwill should be recognized in an asset acquisition.

Similarly, when the fair value of the identifiable net assets acquired (or assets acquired and liabilities assumed) in an asset acquisition is greater than the cost, a bargain purchase gain is not recognized. This differs from the approach for business combinations, under which the acquired assets and assumed liabilities, including any previously existing ownership interests and noncontrolling interests, are generally measured at fair value. That is, the business combination model is a "new basis" approach, while the asset acquisition model is a "cost accumulation" approach.

Some of the more important measurement and recognition differences between accounting for asset acquisitions and accounting for business combinations are discussed below.

A.3.1.1 Intangible assets

When an acquisition of a group of assets includes intangible assets, those intangible assets are recognized at their relative fair values in accordance with ASC 350-30-25. Goodwill is not recognized in an asset acquisition and, as such, any consideration transferred that exceeds the fair value of the net assets acquired is allocated to the identifiable assets based on relative fair values as discussed in section A.4.1. Section 4.2.5 discusses the determination of the fair value of certain intangible assets acquired in a business combination.

A.3.1.1.1 Assembled workforce

An assembled workforce is a collection of employees that allows the acquirer to continue to operate the acquired asset(s). That is, the acquirer does not need to go through the process of finding, hiring and training employees because they are already in place and performing. An assembled workforce is not recognized as a separate acquired asset in a business combination under the contractual-legal and separable criteria in ASC 805 for business combinations. Because that guidance does not apply to asset acquisitions, intangible assets such as an assembled workforce may meet the asset recognition criteria in CON 5 and, therefore, may be separately recognized in an asset acquisition, as described in ASC 350-30-25-4. However, the existence of an assembled workforce may suggest that the acquired set is a business (i.e., if an entity determines that the employees perform or are capable of performing a substantive process) and should be accounted for as a business combination. As a result, careful consideration is required before a conclusion is reached that the acquired set is not a business.

Further, we believe that if unique skills (e.g., technological expertise, skilled craftsmanship) are embedded in an assembled workforce acquired in an asset acquisition, the value attributed to the assembled workforce intangible asset should include the value of the skills of that workforce.

A.3.1.1.2 IPR&D

An entity that acquires IPR&D assets in an asset acquisition follows the guidance in ASC 730, which requires that both tangible and intangible identifiable research and development assets with no alternative future use be allocated a portion of the consideration transferred and charged to expense at the acquisition date. Conversely, tangible and intangible identifiable IPR&D assets with an alternative future use be allocated a portion of the consideration transferred and capitalized.

This accounting differs significantly from the accounting for IPR&D acquired in a business combination, which must be recognized at fair value and initially characterized as an indefinite-lived intangible asset, regardless of whether the IPR&D has an alternative future use.[70] See section 4.2.6 for a discussion of IPR&D acquired in a business combination.

A.3.1.1.3 Defensive intangible assets

Defensive intangible assets (also referred to as "locked-up assets") are those that an acquirer purchases in a business combination or an asset acquisition that it does not intend to actively use, develop or exploit but intends to retain to prevent competitors from obtaining them. While these assets are not being actively used, they are likely contributing to an increase in the value of other assets owned by the acquirer.

As described in ASC 805-50-30-3, assets that an entity does not intend to use are measured at relative fair value, and therefore are allocated a portion of the consideration transferred. ASC 350-30 provides guidance on the subsequent accounting for defensive intangible assets and requires an entity to assign a useful life in accordance with ASC 350-30-35-1 through 35-5. Refer to section 4.2.1.1 for further discussions of the subsequent accounting.

A.3.1.1.4 Reacquired rights

As part of an asset acquisition, an acquirer may reacquire a right that it previously had granted to the acquiree to use one or more of the acquirer's recognized or unrecognized assets. Examples of such rights include a right to use the acquirer's trade name under a franchise agreement or a right to use the acquirer's technology under a technology licensing agreement.

To account for a reacquired right, a determination must be made that the overall transaction is, in fact, an asset acquisition (that is, a reacquired right) and not simply a cancellation or rescission of the contract under which the reacquired right was granted to the presumed acquiree. If the transaction is substantially determined to be a cancellation or rescission of a contract and not an asset acquisition, the accounting is based on the principles discussed in ASC 606. See section 3.2, *Contract enforceability and termination clauses*, of our FRD, ***Revenue from contracts with customers (ASC 606)***, for guidance on how to account for a contract with a customer that includes a termination provision.

ASC 805-50 doesn't provide guidance on accounting for reacquired rights in an asset acquisition. If a reacquired right satisfies the recognition criteria in CON 5, including the definition of an asset, and the acquirer expects to receive a probable future economic benefit, we believe the reacquired right may be recognized as an intangible asset. Because there is no specific measurement guidance in ASC 805-50 for reacquired rights in an asset acquisition, analogizing to the measurement guidance in ASC 805-20-30-20 for reacquired rights in a business combination may be appropriate. Accordingly, an acquirer would measure a reacquired right (recognized as an intangible asset) based solely on the remaining contractual term of the related contract. Refer to section 4.2.5.3.7 for further details on the accounting for reacquired rights in a business combination.

---

[70] During its deliberations on Statement 141(R), the FASB considered extending the recognition provisions to include research and development assets acquired outside of a business combination, but ultimately decided not to do so. The FASB did not want to spend additional time deliberating the related issues because this would have unduly delayed the issuance of Statement 141(R). The EITF ultimately addressed the issue but did not come to a consensus.

A.3.1.2 Indemnification assets

A seller may provide an indemnification to an acquirer for uncertainties about the settlement amounts of acquired assets or liabilities assumed by the acquirer (e.g., uncertain tax positions, environmental liabilities or other legal matters). Indemnification arrangements often require the acquiree to reimburse the acquirer for some or all of the costs incurred by the acquirer.

Indemnification arrangements are acquired assets that are recognized in business combinations. The guidance in ASC 805 provides that an indemnification asset is recognized on the same basis as is the indemnified item. That is, the acquirer recognizes an indemnification asset at the same time that it recognizes the indemnified item, measured on the same basis as the indemnified item, subject to the need for a valuation allowance for uncollectible amounts. In the absence of specific guidance, we believe that it is appropriate for an acquirer to apply this guidance by analogy to account for indemnification assets in an asset acquisition.

Refer to section 4.2.7 for further discussion on the accounting for indemnification assets in a business combination.

A.3.1.3 Leases

A lease agreement conveys the right to use an identified asset (i.e., property, plant or equipment) for a period of time in exchange for consideration. Under a lease, the party obtaining the right to use the leased property is referred to as a lessee, and the party conveying the right to use the property is referred to as a lessor. In an asset acquisition, the acquirer may assume the role of the lessor (e.g., it purchases a tenant-occupied commercial property) or the role of a lessee (e.g., it acquires an entity that is not a business that has leased office space).

Accounting guidance for lease arrangements for both lessees and lessors under US GAAP is primarily contained in ASC 842 (or ASC 840 before an entity adopts ASU 2016-02, *Leases (Topic 842))* and applies to all entities. Refer to section 1.1 in our FRD, ***Lease accounting: Accounting Standards Codification 840,*** **Leases**, or section 1.2 in our FRD, ***Lease accounting: Accounting Standards Codification 842,*** **Leases**, for additional guidance on evaluating whether an arrangement is or contains a lease.

A.3.1.3.1 Accounting for leases in asset acquisitions

In an asset acquisition, a lessor should follow the guidance in ASC 350-30-25 to recognize lease-related intangibles, if any, and the related leased assets by allocating the cost of acquisition based on their relative fair values. An entity that becomes a lessor as a result of an asset acquisition must reassess the assumed lease and classify the lease as an operating or a sales-type or direct finance lease in accordance with ASC 842-10-25-3 (refer to section 3.2 of our FRD, ***Lease accounting: Accounting Standards Codification 842,*** **Leases**). That is, an entity that acquires a lessor interest in a lease in an asset acquisition does not automatically retain the prior lease classification as is generally the case in a business combination.

ASC 805-50 does not address classification of leases acquired in an asset acquisition. We are aware of some diversity in practice in this area. We believe either of the following approaches are acceptable: (1) an entity could analogize to the business combinations guidance (i.e., the classification of a lease should not be reassessed unless the transaction results in a lease modification under ASC 842) or (2) an acquirer that becomes a lessor or lessee as a result of an asset acquisition could reassess the classification of the assumed lease in accordance with the criteria in ASC 842-10-25.[71] (Refer to section 3 of our FRD, ***Lease accounting: Accounting Standards Codification 842,*** **Leases**, for further discussion.)

[71] An acquirer that becomes a lessor or lessee as a result of an asset acquisition must reassess the classification of the assumed lease in accordance with ASC 840.

If an entity acquires an asset and leases it back to the seller, the entity will apply the sale and leaseback guidance discussed in section 7 of our FRD, ***Lease accounting: Accounting Standards Codification 842, Leases***, to determine whether the transaction is a purchase or a financing of the asset.

A.3.1.4 Exchange of share-based payments in an asset acquisition

In an asset acquisition, the acquirer may exchange its share-based payment awards for awards held by grantees of the target entity. ASC 805-50 does not provide measurement guidance related to the replacement of an acquiree's share-based payment awards. Absent such guidance, we believe an acquirer may analogize to the business combinations guidance, which provides an exception for the measurement of share-based payment awards. That is, a liability or equity instrument issued to replace the acquiree's share-based payment awards is measured on the acquisition date based upon the fair value-based measurement provisions of ASC 718.

Under the business combinations guidance, if the acquirer is obligated to replace the acquiree's share-based payment awards, either all or a portion of the fair value-based measure of the acquirer's replacement awards would be included in measuring the consideration transferred in the asset acquisition as of the date of acquisition. The acquirer is obligated to replace the acquiree awards if the acquiree or its grantees have the ability to enforce replacement.

If there is no replacement obligation and the acquiree's share-based payment awards would have expired or been terminated on the acquisition date under those awards' original terms, any voluntary replacement of those awards would be considered a new award, and the entire fair value-based measure of the new award would be recognized as compensation cost by the acquirer.

On the other hand, if the acquirer voluntarily replaces the acquiree's share-based payment awards that would not otherwise expire or terminate on the acquisition date under those awards' original terms, in most cases we believe the accounting results would be similar to situations in which a replacement obligation exists.

See section 6.3 for further guidance on the exchange of share-based payment awards in a business combination.

A.3.1.5 Acquired contingencies

Contingent assets and liabilities acquired in an asset acquisition are accounted for in accordance with the guidance in ASC 450. As such, an acquired loss contingency is recognized if it is both probable that a loss will occur, and the loss can be reasonably estimated. Gain contingencies are not recognized in an asset acquisition. That is, gain contingencies only occur once the contingency is resolved.

A.3.1.6 Deferred income taxes

Because goodwill is not recognized in an asset acquisition, the measurement of deferred income tax assets acquired and liabilities assumed in an asset acquisition will often require an iterative approach that in many cases affects the measurement of acquired assets. The measurement of deferred taxes on temporary differences in an asset acquisition is determined using the simultaneous equations method described in ASC 740. See section 13 in our FRD, ***Income taxes***, for further discussion of the requirements of ASC 740 for asset acquisitions.

A.4 Evaluate the difference between cost and fair value

Upon allocating the cost of the asset acquisition to the individual assets acquired and liabilities assumed based on their relative fair values under ASC 805-50-30-3, an acquiring entity may determine that the total cost of the acquisition exceeds the fair value of the identifiable net assets acquired. Conversely, the acquiring entity may determine that the total cost of the acquisition may be less than the fair value of the identifiable net assets acquired. The accounting depends on this determination (i.e., the acquisition cost exceeds or is less than the fair value of the assets acquired and liabilities assumed).

A.4.1 Cost of the acquisition exceeds the fair value of acquired assets

When the acquisition cost exceeds the fair value of the set of assets acquired and liabilities assumed in an asset acquisition, this may indicate that synergies exist among the assets. However, the guidance in ASC 350 prohibits the recognition of goodwill in an asset acquisition. If more than an insignificant amount of potential goodwill exists in a transaction, this may indicate that a process included in the set is substantive, and thus, the set may be a business.

An acquirer that believes the cost of an asset acquisition exceeds the fair value of the identifiable net assets should first confirm that it has appropriately determined the fair value of the net assets acquired. The acquirers should also carefully evaluate whether the premium paid (i.e., the excess cost) relates to prior commitments, contingencies or disputes with the seller that are being settled and should result in a reduction of a recognized liability or a charge to expense.

In addition, an acquirer should confirm that all identifiable assets, including intangible assets, have been appropriately identified and recognized under the asset recognition criteria in CON 5, regardless of whether they meet the recognition criteria applied in business combinations. The guidance in ASC 350 states that acquired intangible assets that do not otherwise meet the contractual-legal or separability criteria required in ASC 805 but still meet the asset recognition criteria, as defined in CON 5, should be recognized. These intangible assets may include the following:

- An assembled workforce
- Employees with unique skills, knowledge or relationships
- Unique manufacturing process
- Customer service capability
- Nonunion status or strong labor relations
- Presence in geographic markets or locations
- A customer base

Once each acquired asset, including those listed above, has been identified and appropriately measured, the excess cost over fair value is allocated to these assets based on the ASC 350 relative fair value requirement. However, because this means that identified assets would be recognized at amounts that are greater than their fair values, we believe companies should not allocate any excess cost over fair value to "non-qualifying" assets (as detailed below). This is because, loss recognition generally would result when those assets are remeasured or settled after the acquisition date.

ASC 805-50 doesn't provide guidance on circumstances in which there is an excess of cost over the fair value of net assets acquired. We believe it is appropriate to leverage the legacy guidance in paragraph 44 of Statement 141, which, similar to the measurement guidance in ASC 805-50, provided for a cost accumulation and allocation model. That guidance said that non-qualifying assets include:

- Financial assets (other than investments accounted for by the equity method), as defined in ASC 860, which include:
  - Cash
  - Evidence of an ownership interest in an entity
  - A contract that conveys to a second entity a contractual right (1) to receive cash or another financial instrument from the first entity or (2) to exchange other financial instruments on potentially favorable terms with the first entity
- Assets to be disposed of by sale
- Deferred tax assets
- Prepaid assets related to pension or other postretirement benefit plans
- Other current assets (ASC 210 provides guidance on identifying current assets).

After excluding non-qualifying assets from the relative fair value allocation, the allocation of excess cost to qualifying assets might result in an immediate impairment charge, which is precluded by the guidance in ASC 350. However, we do not believe an immediate impairment would result because acquired long-lived assets, except for indefinite-lived intangible assets, are subject to impairment testing pursuant to the guidance in ASC 360. That is, the acquired long-lived assets are included in asset groups in which recoverability is determined based on undiscounted cash flows. Thus, even if the acquired long-lived assets are the only assets in the asset group, the use of undiscounted cash flows makes it unlikely that the asset group would fail the recoverability test, especially if synergies exist among the newly acquired assets or with preexisting assets.

Indefinite-lived intangible assets are subject to a fair value impairment test under the guidance in ASC 350. As a result, if indefinite-lived intangible assets are recognized at amounts that exceed fair value, an immediate impairment will result. Therefore, companies cannot assign an amount greater than fair value to indefinite-lived intangible assets, unless these intangible assets are combined with previously owned indefinite-lived intangible assets as a single unit of account for impairment testing under the guidance in ASC 350-30-35.

Illustration A-6: The cost of an acquisition exceeds the fair value of acquired assets

Acquirer purchases acquired assets and assumed liabilities for $500,000. The acquisition of these assets and assumed liabilities does not meet the definition of a business under ASC 805. Acquirer incurred $50,000 in direct costs to effect the transaction. The fair value of the assets acquired and liabilities assumed at the acquisition date are illustrated in the table below.

Analysis

ASC 805-50 does not address how to allocate the cost of an asset acquisition that exceeds the fair value of an acquired set that includes both assets acquired and liabilities assumed. Given the lack of guidance, we believe a reasonable approach is to treat the assumed liabilities similar to non-qualifying assets (as discussed above). In this situation, Acquirer allocates the excess cost over the fair value of the acquired assets as follows:

	Fair value	Relative percentage	x	Cost of the acquisition*	=	Allocated cost
Building	$ 276,000	60.0%		$ 510,000		$ 306,000
Land	138,000	30.0%		510,000		153,000
Finite-lived intangible asset	46,000	10.0%		510,000		51,000
Collateralized debt	(40,000)					(40,000)
Prepaid rent	80,000					80,000
	$ 500,000					$ 550,000

* Excludes the cost of "non-qualifying" assets (e.g., prepaid rent of $80,000) and assumed liabilities (e.g., debt of $40,000).

While the cost of the acquisition ($550,000) is greater than the fair value of the net assets acquired ($500,000), the excess is not recorded as goodwill. Instead, the excess cost of $50,000 (acquisition cost of $550,000 – fair value of net assets of $500,000) is allocated across the qualifying assets on a relative fair value basis.

A.4.2 Cost of the acquisition is less than the fair value of acquired assets

While ASC 805 doesn't address the accounting for an acquisition when the cost is less than the fair value of the identifiable net assets acquired, this situation may indicate that a transaction is a bargain purchase. However, as opposed to accounting in a business combination, a bargain purchase gain is not recorded in an asset acquisition.

An acquirer that believes the cost of an acquisition is less than the fair value of the identifiable net assets should first confirm that it has appropriately determined the fair value of the net assets acquired. The acquirer should also evaluate whether it has identified and recognized all liabilities assumed from the seller at fair value, including commitments or contingent liabilities. Additionally, the acquirer needs to evaluate whether there are elements of the arrangement that should be accounted for separately from the asset acquisition, which could also eliminate or reduce the difference between the cost and the fair value of the net assets acquired.

If the fair value of the identifiable net assets still exceeds the cost of the acquisition, the allocation of cost on a relative fair value basis to all qualifying assets results in the recognition of initial asset bases at less than the assets' fair value. This could result in gain recognition when certain assets are realized shortly after the acquisition date.

Accordingly, we believe that the excess of fair value over cost should be allocated on a relative fair value basis to all qualifying assets, including IPR&D and identifiable intangible assets. That is, the acquirer will identify and recognize non-qualifying assets and the assumed liabilities at fair value (unless other GAAP prescribes another measurement basis, e.g., ASC 450), with the remaining acquired assets recognized at

amounts determined by allocating the remaining cost of the acquisition to those assets based on their relative fair value to the total fair value of all qualifying assets (which, as described above, will result in recognizing qualifying assets at less than fair value).

Illustration A-7: The cost of an acquisition is less than the fair value of acquired assets

Company A acquires Machine A, Machine B and associated inventory from Company B in exchange for $50,000. The fair values of Machine A, Machine B and associated inventory were determined to be $35,000, $15,000 and $8,000, respectively. After thorough due diligence, Company A has determined that no commitments or contingent liabilities were assumed. Company A incurred $4,000 in direct costs to effect the transaction.

Analysis

Because the measurement principle for asset acquisitions continues to be based on cost, Company A does not recognize a gain for the bargain purchase. Therefore, Company A would recognize the acquisition of Machine A, Machine B and associated inventory at $54,000 (the cash paid, plus the transactions costs). The estimated fair value of the qualifying assets would be reduced on a relative fair value basis. The transaction would be recorded as follows:

Machine A	$ 32,200[1]	
Machine B	13,800[2]	
Inventory	8,000[3]	
Cash		$ 54,000[4]

[1] Machine A is measured at relative fair value less allocated excess (($35,000/$50,000) × ($54,000 – $8,000) = $32,200).

[2] Machine B is measured at relative fair value less allocated excess (($15,000/$50,000) × ($54,000 – $8,000) = $13,800).

[3] The value of the inventory is not adjusted because it is a non-qualifying asset.

[4] Cash paid as consideration of $50,000, plus transaction costs of $4,000.

A.4.2.1 Contingent consideration arrangements with IPR&D

When an asset acquisition is, in substance, the acquisition of IPR&D, the fair value of the acquired assets may exceed the cost of the acquisition. IPR&D acquisitions typically call for an initial payment and ongoing milestone and/or royalty payments, all of which are contingent on future successful R&D outcomes and/or product sales. They may include one or more IPR&D projects. If a group of assets is acquired, the acquirer may be required to allocate the cost of acquisition to assets acquired on a relative fair value basis as discussed above.

The initial payment related to the IPR&D is expensed on the day of acquisition in accordance with ASC 730 because the project typically has no future alternative use. The ongoing milestone and/or royalty payments are accounted for under other applicable guidance (e.g., ASC 815). If an instrument meets the definition of a derivative and does not meet one of the scope exceptions in ASC 815, the guidance in ASC 815 requires that the derivative be recognized at fair value. In this case, the fair value amount becomes part of the acquisition cost.

If the applicable US GAAP guidance does not require recognition of the contingent payment arrangement at the acquisition date, we believe the subsequent payments would be recognized when the contingencies are resolved and the consideration is paid or becomes payable. However, given the lack of explicit guidance in ASC 805-50, we are aware of other acceptable approaches in practice, such as recognizing the obligation when the contingency is probable and reasonably estimable under ASC 450.

Depending on the status of the IPR&D project at the time a contingent payment is recognized (e.g., in development or complete and commercially available), the acquirer may determine that the payment should be expensed or capitalized as an intangible asset. This determination should be based on the facts and circumstances for each IPR&D project.

Illustration A-8: The fair value of acquired assets exceeds the cost, which includes contingent consideration and IPR&D

An acquirer enters into an agreement to license worldwide exclusive development and commercialization rights to an early stage drug candidate that does not meet the definition of a business. The acquirer pays $20 million at closing and agrees to pay up to an additional $30 million, with $10 million increments due upon the achievement of each of three separate revenue-based milestones paid subsequent to FDA approval. The asset acquired has been determined to be solely IPR&D with a fair value of $35 million. Several months after the transaction closes, the FDA approves the drug candidate for commercial sales.

Analysis

As of the acquisition date, the acquirer recognizes and immediately charges $20 million to R&D expense. The acquirer also determines that the arrangement is comprised of the three contingent payments (i.e., the revenue-based milestone payments) meets the definition of a derivative under ASC 815; however, the arrangement qualifies for the scope exception in ASC 815-10-15-59(d) because the underlying is based on the acquirer's revenues from sales when the project is commercialized. As a result, the arrangement is not accounted for as a derivative pursuant to ASC 815. There is also no other applicable US GAAP requiring the recognition of the arrangement at fair value on the acquisition date.

Accordingly, when a milestone is achieved and $10 million is paid or payable, the acquirer would account for the milestone payment depending on the nature of the milestone and whether the IPR&D was still in development or completed at the time the milestone was achieved. In this case, because all three payments are contingent on achievement of revenue milestones once the R&D project is complete (i.e., after FDA approval) and the drug candidate is marketable, the cost of these payments would be capitalized.

A.5 Present and disclose the asset acquisition

ASC 805-50 does not provide guidance on how acquiring entities should present and disclose asset acquisition transactions. In some cases, other US GAAP topics provide specific presentation and/or disclosure requirements, depending on the nature of the assets acquired or the liabilities assumed. For example:

- Intangible assets acquired either individually or as part of a group of assets in an asset acquisition are disclosed in accordance with ASC 350-30-50-1.
- Nonmonetary assets transferred are disclosed during the period in which a company enters into a nonmonetary transaction in accordance with ASC 845-10-50-1. The nature of the transaction, the basis of accounting for the assets transferred, and any gains or losses recognized on the transfer should be disclosed.

- Contingent consideration arrangements should be disclosed in accordance with other applicable US GAAP (e.g., ASC 815, ASC 450). Entities also should disclose how they intend to account for the contingent consideration (e.g., when the related contingency is resolved and the consideration is paid or becomes payable).

In addition, Rule 5-02.13(a) of Regulation S-X provides presentation and disclosure requirements for tangible assets, including the requirement that registrants must disclose the basis used to determine the amounts of depreciable assets. As a result, registrants with a significant acquisition of tangible assets should disclose the basis used to determine the value of the acquired asset(s) in the period of acquisition.

Absent other specific guidance, we believe it would be appropriate to make these disclosures for all significant assets acquired and liabilities assumed in an asset acquisition.

A.5.1 Statement of cash flows

ASC 805-50 does not provide guidance on how acquiring entities should classify cash payments made to acquire an asset or group of assets. Accordingly, entities apply the guidance in ASC 230 to classify cash flows pertaining to the assets acquired as either operating, investing or financing activities, based on the nature of the cash flows (i.e., the assets being acquired).

Because ASC 230 is principles based, cash flow classification often requires significant judgment, particularly when a transaction might result in reporting cash flows in more than one major classification category. Reasonable conclusions about classifying cash flows might differ depending on how one assesses the substance of a particular transaction. We encourage entities to provide appropriate disclosures about their policies and judgments and to consistently apply their policies. Refer to our FRD, ***Statement of cash flows***, for additional information.

A.6 Subsequent accounting

Excerpt from Accounting Standards Codification

Business Combinations — Related Issues

Subsequent Measurement

805-50-35-1

After the acquisition, the acquiring entity accounts for the asset or liability in accordance with the appropriate generally accepted accounting principles (GAAP). The basis for measuring the asset acquired or liability assumed has no effect on the subsequent accounting for the asset or liability.

After an asset acquisition, the assets acquired and liabilities assumed should be accounted for in accordance with applicable US GAAP guidance. That is, the initial measurement basis of the assets acquired or liabilities assumed does not affect the subsequent accounting.

A.6.1 Assets recognized based on the settlement of a contingent consideration arrangement

If contingent consideration arrangement meets the definition of a derivative in ASC 815 and does not qualify for a scope exception, the acquirer initially records and recognizes the obligation at fair value at the date of acquisition. The contingent consideration would be subject to derivative accounting (i.e., it would be measured at fair value each reporting period) under ASC 815. In addition, contingent considerations may be subject to fair value measurement under other applicable guidance (e.g., ASC 480, ASC 815-40). As a result, any changes made in the carrying value of the obligation after the acquisition date would not adjust the cost basis of the acquired asset or group of assets. Such amounts would be accounted for in accordance with ASC 815 or other applicable guidance.

For contingent consideration that does not meet the definition of a derivative in ASC 815, and is not otherwise recognized on the acquisition date under other applicable US GAAP, we believe that any payment made after the acquisition date should increase the cost basis of the acquired asset, or group of assets, and should be accounted for in a manner (capitalized or expensed) that is consistent with the nature of the asset. Additionally, if an entity acquires a group of assets, the additional cost should be allocated to the group of assets based on their relative fair values at the acquisition date, consistent with the requirement in ASC 805-50-30-3. For those payments that are capitalized, entities should consider the economics of the underlying asset, or group of assets, to determine the expense recognition pattern associated with any related depreciation and amortization.

Illustration A-9: Subsequent accounting for assets recognized based on the settlement of a contingent consideration arrangement

On 1 January 20X1, Company A acquires Machine X from Company B for $100,000 and a contingent consideration arrangement to pay an additional $40,000 if the company A's sales from products manufactured by the machine exceed a certain threshold over the next year. Machine X has a remaining useful life of five years at the time of acquisition and is being depreciated on a straight-line basis. Assume that Company A concludes that the contingent consideration arrangement is not subject to the derivative accounting requirements in ASC 815 and that no other applicable GAAP would require Company A to recognize the contingent consideration at the acquisition date. As a result, Company A will recognize the additional payment when the contingency is resolved and the consideration is paid or becomes payable based on its accounting policy.

On 1 January 20X2, one year after the acquisition, the $40,000 contingent payment to Company B is now payable. As a result, Company A recognizes a liability for the entire amount.

Analysis

Because the measurement principle for asset acquisitions is based on cost, Company A would recognize an increase to the asset of $40,000 on 1 January 20X2 (when the contingent payment is resolved and payable). Company A would account for the additional cost basis consistent with the accounting for the asset recognized on 1 January 20X1. That is, the asset would be presumed to have a remaining useful life of four years on 1 January 20X2. Therefore, Company A would recognize the following depreciation expense:

	Year 1	Year 2	Year 3	Year 4	Year 5
Asset recognized on 1 January 20X1[1]	$ 20,000	$ 20,000	$ 20,000	$ 20,000	$ 20,000
Incremental amount of asset recognized on 1 January 20X2[2]	–	10,000	10,000	10,000	10,000
Annual depreciation expense	**$ 20,000**	**$ 30,000**	**$ 30,000**	**$ 30,000**	**$ 30,000**

[1] $20,000 is derived as follows: [$100,000 / 5 years (the remaining useful life of the asset on 1 January 20X1)]

[2] $10,000 is derived as follows: [$40,000 / 4 years (the remaining useful life of the asset on 1 January 20X2)]

A.7 Other considerations

Excerpt from Accounting Standards Codification

Business Combinations — Related Issues

Scope and Scope Exceptions

805-50-15-11

The guidance in the Pushdown Accounting Subsections does not apply to transactions in paragraph 805-10-15-4.

Recognition

805-50-25-2

When accounting for a transfer of assets or exchange of shares between entities under common control, the entity that receives the net assets or the **equity interests** shall initially recognize the assets and liabilities transferred at the date of transfer. See the Transactions Between Entities Under Common Control Subsection of Section 805-50-45 for guidance on the presentation of financial statements for the period of transfer and comparative financial statements for prior years.

Initial Measurement

805-50-30-5

When accounting for a transfer of assets or exchange of shares between entities under common control, the entity that receives the net assets or the **equity interests** shall initially measure the recognized assets and liabilities transferred at their carrying amounts in the accounts of the transferring entity at the date of transfer. If the carrying amounts of the assets and liabilities transferred differ from the historical cost of the parent of the entities under common control, for example, because **pushdown accounting** had not been applied, then the financial statements of the receiving entity shall reflect the transferred assets and liabilities at the historical cost of the parent of the entities under common control.

805-50-30-6

In some instances, the entity that receives the net assets or equity interests (the receiving entity) and the entity that transferred the net assets or equity interests (the transferring entity) may account for similar assets and liabilities using different accounting methods. In such circumstances, the carrying amounts of the assets and liabilities transferred may be adjusted to the basis of accounting used by the receiving entity if the change would be preferable. Any such change in accounting method shall be applied retrospectively, and financial statements presented for prior periods shall be adjusted unless it is impracticable to do so. Section 250-10-45 provides guidance if retrospective application is impracticable.

SEC materials

805-50-S99-4

The following is the text of the SEC Observer Comment: Measurement of Certain Transfers Between Entities Under Common Control in the Separate Financial Statements of Each Entity.

The SEC staff's views on carrying over historical cost to record, in the separate financial statements of each entity, transfers between companies under common control or between a parent and its subsidiary are focused on transfers of net assets (as in a business combination) or long-lived assets. Those views would not normally apply to recurring transactions for which valuation is not in question (such as routine transfers of inventory) in the separate financial statements of each entity that is a party to the transaction.

A.7.1 Application of a measurement period

The business combinations guidance in ASC 805-10 allows the acquiring entity to report provisional amounts and adjust them for a period of time up to one year after the acquisition date (referred to as the "measurement period") while it obtains information about the facts and circumstances that existed as of the acquisition date. Refer to section 1.7.3 for guidance on the accounting for measurement period adjustments in a business combination.

There is no measurement period for an asset acquisition, and companies should not analogize to the measurement period guidance in ASC 805-10 when they are accounting for an asset acquisition.

A.7.2 Common control transactions

ASC 805-50 addresses the accounting for common control transactions from the perspective of the entity that receives the net assets or equity interests (receiving entity) and generally requires the receiving entity to recognize the assets and liabilities transferred at their carrying amounts in the financial statements of the entity that transfers the net assets (transferring entity or transferor) on the date of transfer. When the transferring entity is required to report standalone financial statements, we believe the same concepts (e.g., carrying amount) generally apply.

Unlike common control transactions that involve the transfer of a business, the transfer of net assets that are not a business between entities under common control generally does not constitute a change in the reporting entity. As such, the transfer of net assets that are not a business is accounted for prospectively in the period in which the transfer occurs, and prior periods are not restated.

Gains on transfers of assets (i.e., by the transferor) and asset write-ups (i.e., by the transferee) generally are not permitted between entities under common control. However, there are certain exceptions, such as the transfer of financial assets and certain inventory transfers.

Refer to Appendix C for a comprehensive discussion of accounting for common control transactions.

A.7.2.1 Transfer of financial assets

ASC 860-10-55-78 indicates that transfers of financial assets from one subsidiary to another subsidiary of a common parent would be accounted for as a sale, and therefore recognized and measured at fair value in each subsidiary's standalone financial statements if all the conditions in ASC 860-10-40-5 have been met and the transferee is not consolidated by the transferor. Any gains or losses and asset revaluations recognized in separate financial statements are eliminated in consolidation or combination by the parent. This guidance only applies to transfers of financial assets between subsidiaries of a common parent.

ASC 606 and ASC 610-20 changed the scope of ASC 860 for transfers of equity method investments. That is, before the adoption of ASC 606, transfers of equity method investments deemed to be in-substance real estate were accounted for in accordance with ASC 360-20. To determine whether a transfer of an equity method investment is in substance a sale of real estate, an entity was required to "look through" to the underlying assets and liabilities of the investee.

After the adoption of ASC 606, entities that previously applied the look-through guidance to determine whether equity method investments are in-substance real estate will no longer be able to do so, since these equity method investments are now in the scope of ASC 860. Accordingly, the guidance in ASC 860-10-55-78 related to transfers of financial assets between subsidiaries of a common parent would apply to transfers of equity method investments that were previously in the scope of ASC 360-20. See our FRD, ***Transfers and servicing of financial assets***, for further details.

A.7.2.2 Transfer of inventory

Gain recognition by the transferor (and step-up in value by the transferee) on routine transfers of inventory in the ordinary course of business is generally acceptable in the presentation of standalone financial statements. The following items should be considered when evaluating whether a transaction is in the ordinary course of business:

- The form and substance of the transaction
- Whether the parties to the transaction lack economic substance (e.g., if an entity would not be able to make payment for goods purchased from a related party without funds borrowed from the related party, the related party should generally not recognize a sale)
- Whether other accounting literature requires a different treatment

Any gain recognized on the transfer of inventory is eliminated in consolidation unless the inventory transfer is from a non-regulated subsidiary to a regulated subsidiary, as discussed in ASC 980-810-45.

A.7.3 Pushdown accounting

Business combination transactions result in a new basis of accounting, at fair value, being established in the acquirer's consolidated financial statements for the assets acquired and liabilities assumed. When the acquired entity remains a separate reporting entity after the acquisition, guidance in ASC 805 provides the acquired entity with the option to reflect the new accounting basis at fair value in its separate financial statements (generally referred to as "pushdown accounting"). The guidance explicitly states that pushdown accounting does *not* apply to the acquisition of an asset or a group of assets, including an acquisition of equity interests in the acquired entity, that does not constitute a business.

A.8 SEC reporting considerations

When an SEC registrant acquires an asset or a group of assets, it needs to determine whether the acquired set is a business under the SEC's definition of a business in Rule 11-01(d) of Regulation S-X and, therefore, whether it is subject to the SEC's reporting requirements related to acquired businesses.

Because the definition of a business under Rule 11-01(d) of Regulation S-X differs from the US GAAP definition in many respects, it is possible for an acquisition to be considered a business for SEC reporting purposes but not for accounting purposes. The definition of a business for SEC reporting purposes focuses primarily on whether the nature of the revenue-producing activity will remain generally the same after the acquisition; however, an acquisition of a separate entity, subsidiary or division is presumed to be a business. It would be unusual for an acquisition to meet the definition of a business for accounting purposes but not for SEC reporting purposes. Refer to our SEC Financial Reporting Series publication, ***2021 Pro forma financial information – A guide for applying Article 11 of Regulation S-X***, for guidance on the SEC's definition of a business.

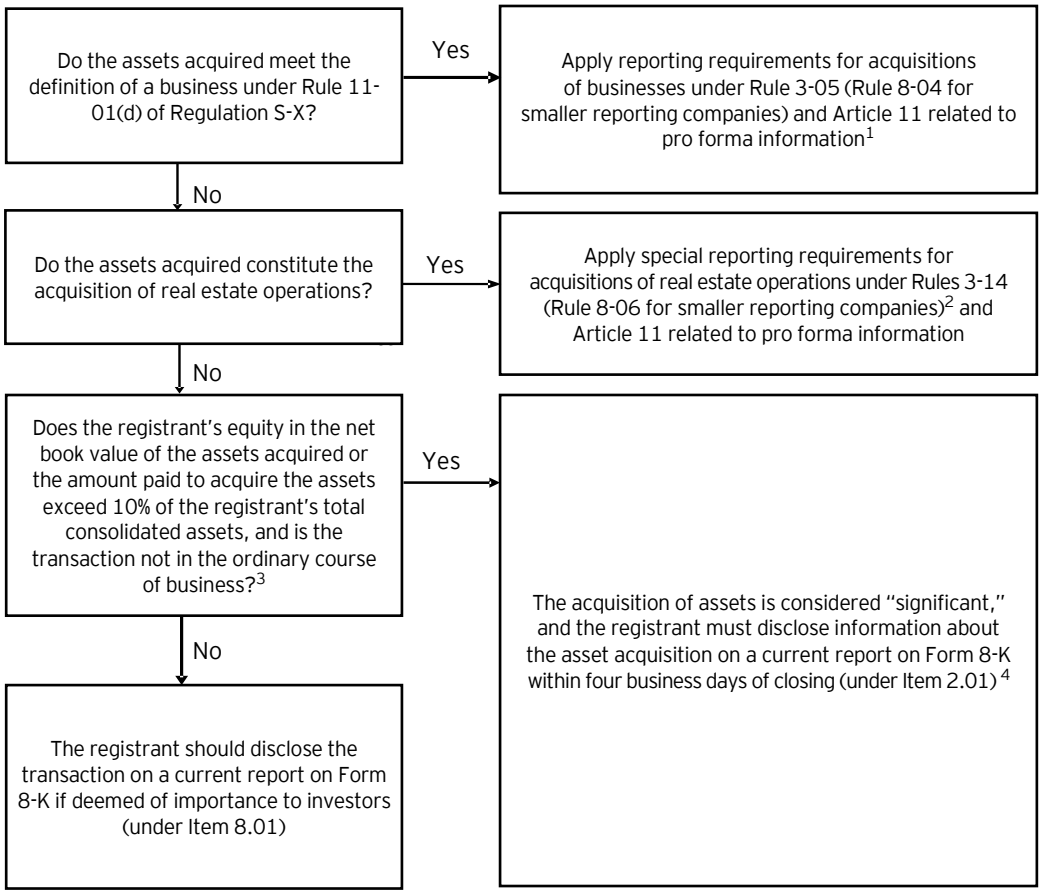
Rule 3-05 (Rule 8-04 for smaller reporting companies) of Regulation S-X describes the SEC's requirements for registrants to provide audited financial statements of acquired or to-be-acquired businesses. Special considerations apply to acquisitions of businesses determined to be real estate operations under Rule 3-14 of Regulation S-X. The registrant is not required to furnish separate pre-acquisition financial statements of the acquired set or pro forma financial information if it concludes that the acquisition does not meet the SEC's definition of a business under Rule 11-01(d) of Regulation S-X. The registrant may still be required to report certain information related to an acquisition of assets in a registration statement or current report on Item 2.01 of Form 8-K, depending on the nature of the assets acquired and how significant they are relative to the registrant's total consolidated assets. An asset acquisition is deemed significant if the registrant's equity in the net book value of such assets or the amount paid for the assets upon such acquisition exceeded 10% of the total assets of the registrant on a consolidated basis.

In May 2020, the SEC amended its requirements for registrants to provide information about significant business acquisitions and disposals. The amendments change the significance tests used to determine whether registrants need to file audited financial statements of the acquired business and related pro forma financial information, the periods those financial statements must cover, and the form and content of the pro forma financial information.

The rules were effective 1 January 2021. See our SEC Financial Reporting Series publication, ***2021 Pro forma financial information – A guide for applying Article 11 of Regulation S-X***, for more information.

The following decision tree may be helpful in determining the SEC reporting requirements for a registrant that acquires an asset or group of assets that do not meet the SEC's definition of a business:

Illustration A-10: Determining the SEC reporting requirements when a domestic SEC registrant acquires an asset or group of assets



[1] Different reporting requirements under the SEC rules may have to be applied for acquisitions of investment funds and securitization vehicles.

[2] See our Technical Line, ***How to apply the amended S-X Rule 3-14 to real estate acquisitions***. In addition, certain thresholds under Rule 3-14 have recently changed due to changes to Rule 3-05; see our To the Point, ***SEC streamlines disclosure requirements for acquisitions and disposals of businesses***, for more details.

[3] Instruction 4 of Item 2.01, *Completion of Acquisition or Disposition of Assets*, on Form 8-K defines what constitutes a "significant amount of assets" that does not involve a business.

[4] See Item 2.01, *Completion of Acquisition or Disposition of Assets*, on Form 8-K for a description of the information to be disclosed.

A.9 Internal control over asset acquisitions

Internal controls over the accounting for an asset acquisition should be designed and implemented to address risks of material misstatement to the financial statements. Entities should assess the risks of material misstatement for each asset acquisition transaction to effectively design responsive internal controls. These risks may be similar, but not identical, to those in a business combination. Management needs to consider the complexity of the transaction and the significance and nature of the assets acquired in order to evaluate whether the individuals implementing and performing the controls have the right skills to effectively prevent or detect a material misstatement in the financial statements.

Refer to Appendix E for guidance on internal control over business combinations, which can be applied similarly to asset acquisitions.

B Pushdown accounting

B.1 Overview

For transactions accounted for under ASC 805, a new basis of accounting at fair value is established in the acquirer's consolidated financial statements for the assets acquired and liabilities assumed. When the acquired entity remains a separate reporting entity subsequent to the acquisition, US GAAP historically provided limited guidance as to whether the acquirer's new accounting basis at fair value should be reflected in the separate financial statements of the acquired entity (generally referred to as "pushdown accounting").

In November 2014, the FASB issued ASU 2014-17, which gives all acquired entities that are businesses or nonprofit activities the option to apply pushdown accounting in their separate financial statements when an acquirer obtains control of them. The SEC staff responded to the issuance of the ASU by rescinding its guidance on pushdown accounting. As a result, the US GAAP guidance now applies to both SEC registrants and non-registrants.

The US GAAP guidance was developed by the EITF, which acknowledged during deliberations that making pushdown accounting optional may reduce comparability among entities' financial statements. The EITF nevertheless decided to make the guidance optional to allow entities to make a choice based on their facts and circumstances, including the needs of the users of their financial statements. In doing so, the EITF noted that comparisons have long been difficult because SEC registrants in certain circumstances had the option to apply pushdown accounting.

Further, although recapitalizations as well as the creation of a Newco to facilitate a merger may result in a change in control of an entity, they may not result in a new basis of accounting at the entity level.

B.1.1 Differences between ASU 2014-17 and the rescinded SEC staff guidance

ASU 2014-17 significantly changes practice for SEC registrants. The rescinded SEC staff guidance required SEC registrants to apply pushdown accounting when they became "substantially wholly owned." The SEC staff viewed an acquired entity to be "substantially wholly owned" when an acquirer acquired 95% or more of the outstanding voting securities of the entity in a single or a series of transactions. The SEC staff considered ownership interests between 80% and 95% to be substantial and therefore encouraged (but did not require) the application of pushdown accounting at those levels. The SEC staff prohibited pushdown accounting at ownership levels of less than 80%. The threshold of an acquirer obtaining control under the new US GAAP guidance is lower than the threshold of "substantially wholly owned" under the rescinded SEC staff guidance. The EITF concluded that a threshold of obtaining control is the most appropriate trigger for applying pushdown accounting because it is consistent with the thresholds of obtaining control in ASC 810 and ASC 805. We believe that this lower threshold generally will increase the number of instances in which an acquiree is eligible to apply pushdown accounting.

The rescinded SEC staff guidance also applied to situations in which an acquired entity became "substantially wholly owned" as a result of a single or a series of transactions by a group of investors who act together effectively as one investor (referred to as a "collaborative group"). If the investors both "mutually promoted" the acquisition and collaborated on the subsequent control of the investee, then aggregation of those investors' outstanding voting securities was required for purposes of determining whether pushdown accounting was required (at the 95% or above ownership level) or permitted (between 80% and 95%). The EITF believed that the threshold of obtaining control under the new US GAAP guidance eliminated the need for a collaborative group concept.

Finally, the rescinded SEC staff guidance also required an acquired entity to reflect debt incurred by the acquirer to finance the acquisition of substantially all of the common stock of the acquiree in the acquiree's separate financial statements if (1) the acquiree were to assume the debt of the acquirer either presently or in a planned transaction in the future, (2) the proceeds of a debt or equity offering of the acquiree will be used to retire all or part of the acquirer's debt or (3) the acquiree guarantees or pledges its assets as collateral for the acquirer's debt. Under the new US GAAP guidance, any debt incurred by the acquirer to finance the acquisition of the acquiree will be recognized in the acquiree's separate financial statements only if it represents an obligation of the acquiree. Therefore, there will be fewer circumstances in which acquisition-related debt of the acquirer will be reflected in the financial statements of the acquiree.

A summary of the changes discussed above is shown in the following table:

	ASU 2014-17	Prior SEC staff guidance
Scope	All acquirees	SEC registrants only
Pushdown accounting threshold		
Prohibited	When an acquirer does not obtain control of acquiree	Less than 80% acquired
Allowed	When an acquirer obtains control of acquiree	80%-95% acquired
Required	Never	When becomes substantially wholly owned (≥95%)
Collaborative group evaluation	No	Yes
Acquirer debt to finance acquisition	Recognized by acquiree only if it represents an obligation of acquiree	Recognized by acquiree if (1) the acquiree were to assume the debt either presently or in a planned transaction in the future, (2) the proceeds of a debt or equity offering of the acquiree will be used to retire all or part of the acquirer's debt or (3) the acquiree guarantees or pledges its assets as collateral for the acquirer's debt

We believe these changes will reduce some of the complexity that previously existed in practice.

B.2 Scope

Excerpt from Accounting Standards Codification

Business Combinations — Related Issues

Overview and Background

805-50-05-9

The guidance in the Pushdown Accounting Subsections addresses whether and at what threshold an **acquiree** that is a business or **nonprofit activity** can apply **pushdown accounting** in its separate financial statements.

Scope and Scope Exceptions

805-50-15-10

The guidance in the Pushdown Accounting Subsections applies to the separate financial statements of an **acquiree** and its subsidiaries.

805-50-15-11

The guidance in the Pushdown Accounting Subsections does not apply to transactions in paragraph 805-10-15-4.

Business Combinations — Overall

Scope and Scope Exceptions

805-10-15-4

The guidance in the Business Combinations Topic does not apply to any of the following:

a. The formation of a joint venture

b. The acquisition of an asset or a group of assets that does not constitute a **business** or a **nonprofit activity**

c. A combination between entities, businesses, or nonprofit activities under common **control** (see paragraph 805-50-15-6 for examples)

d. An acquisition by a not-for-profit entity for which the acquisition date is before December 15, 2009 or a **merger of not-for-profit entities** (NFPs)

e. A transaction or other event in which an NFP obtains **control of a not-for-profit entity** but does not consolidate that entity, as described in paragraph 958-810-25-4. The Business Combinations Topic also does not apply if an NFP that obtained control in a transaction or other event in which consolidation was permitted but not required decides in a subsequent annual reporting period to begin consolidating a controlled entity that it initially chose not to consolidate.

f. Financial assets and financial liabilities of a consolidated variable interest entity that is a **collateralized financing entity** within the scope of the guidance on collateralized financing entities in Subtopic 810-10.

The above guidance addresses whether and at what threshold an acquiree that is a business[72] or nonprofit activity can elect to apply pushdown accounting in its separate financial statements. However, the guidance does not apply to the following transactions:

- The formation of a joint venture (see section 2.2.1)
- The acquisition of an asset or a group of assets that does not constitute a business or nonprofit activity (see Appendix A)
- A combination between entities, businesses or nonprofit activities under common control (see Appendix C)
- An acquisition by a not-for-profit entity for which the acquisition date is before 15 December 2009 or a merger of not-for-profit entities
- A transaction or other event in which a not-for-profit entity obtains control of another not-for-profit entity but does not consolidate that entity as described in paragraph 958-810-25-4

[72] See section 2.1.3 for guidance on the definition of a business.

- Financial assets and financial liabilities of a consolidated variable interest entity that is a collateralized financing entity within the scope of the guidance on collateralized financing entities in ASC 810-10
  - Finally, the guidance does not apply to transactions in which there is a loss of control of an acquiree but no party obtains control of the acquiree.

B.3 Recognition

Excerpt from Accounting Standards Codification

Business Combinations — Related Issues

Recognition

805-50-25-4

An **acquiree** shall have the option to apply **pushdown accounting** in its separate financial statements when an **acquirer**—an entity or individual—obtains **control** of the acquiree. An acquirer might obtain control of an acquiree in a variety of ways, including any of the following:

a. By transferring cash or other assets

b. By incurring liabilities

c. By issuing equity interests

d. By providing more than one type of consideration

e. Without transferring consideration, including by contract alone as discussed in paragraph 805-10-25-11.

805-50-25-5

The guidance in the General Subsections of Subtopic 810-10 on consolidation, related to determining the existence of a controlling financial interest shall be used to identify the acquirer. If a business combination has occurred but applying that guidance does not clearly indicate which of the combining entities is the acquirer, the factors in paragraphs 805-10-55-11 through 55-15 shall be considered in identifying the acquirer. However, if the acquiree is a **variable interest entity** (VIE), the primary beneficiary of the acquiree always is the acquirer. The determination of which party, if any, is the primary beneficiary of a VIE shall be made in accordance with the guidance in the Variable Interest Entities Subsections of Subtopic 810-10, not by applying the guidance in the General Subsections of that Subtopic relating to a controlling financial interest or the guidance in paragraphs 805-10-55-11 through 55-15.

805-50-25-6

The option to apply **pushdown accounting** may be elected each time there is a change-in-control event in which an **acquirer** obtains **control** of the **acquiree**. An acquiree shall make an election to apply pushdown accounting before the **financial statements are issued** (for a **Securities and Exchange Commission (SEC) filer** and a conduit bond obligor for **conduit debt securities** that are traded in a public market) or the **financial statements are available to be issued** (for all other entities) for the reporting period in which the change-in-control event occurred. If the acquiree elects the option to apply pushdown accounting, it must apply the accounting as of the **acquisition date**.

805-50-25-7

If the **acquiree** does not elect to apply **pushdown accounting** upon a change-in-control event, it can elect to apply pushdown accounting to its most recent change-in-control event in a subsequent reporting period as a **change in accounting principle** in accordance with Topic 250 on accounting changes and error corrections. Pushdown accounting shall be applied as of the acquisition date of the change-in-control event.

805-50-25-8

Any subsidiary of an **acquiree** also is eligible to make an election to apply **pushdown accounting** to its separate financial statements in accordance with the guidance in paragraphs 805-50-25-4 through 25-7 irrespective of whether the acquiree elects to apply pushdown accounting.

805-50-25-9

The decision to apply pushdown accounting to a specific change-in-control event if elected by an acquiree is irrevocable.

An acquiree has an option to apply pushdown accounting in its separate financial statements when an acquirer (an entity or individual) obtains control of the acquiree, regardless of the manner in which control is obtained (e.g., acquisition of a majority of voting rights or a change in the primary beneficiary of a variable interest entity). Paragraph ASC 805-50-25-4 provides examples of ways in which an acquirer might obtain control of an acquiree. However, the guidance does not apply to transactions that result in a loss of control of the acquiree but no party obtains control of the acquiree.

The EITF concluded that a threshold of obtaining control is the most appropriate trigger for applying pushdown accounting because it is consistent with the thresholds of obtaining control in ASC 810 and ASC 805. The EITF believed using this threshold for the application of pushdown accounting would reduce the complexity that some believe existed under the prior SEC staff guidance.

The determination of whether control has been obtained begins with an assessment of whether control is based on the variable interest or voting interest model in the consolidation guidance. Accordingly, the first step is assessing whether the acquired entity is a variable interest entity based on the guidance in ASC 810-10. If the acquired entity is a VIE, the primary beneficiary of the acquiree is always the acquirer.

If the acquiree is not a VIE, then the evaluation will be based on the voting interest model. ASC 810-10-15-8 states, "For legal entities other than limited partnerships, the usual condition for a controlling financial interest is ownership of a majority voting interest, and, therefore, as a general rule ownership by one reporting entity, directly or indirectly, of more than 50% of the outstanding voting shares of another entity is a condition pointing toward consolidation. The power to control may also exist with a lesser percentage of ownership, for example, by contract, lease, agreement with other stockholders, or by court decree." In addition, ASC 810-10-15-8A states, "Given the purpose and design of limited partnerships, kick-out rights through voting interests are analogous to voting rights held by shareholders of a corporation. For limited partnerships, the usual condition for a controlling financial interest, as a general rule, is ownership by one limited partner, directly or indirectly, of more than 50% of the limited partnership's kick-out rights through voting interests. The power to control also may exist with a lesser percentage of ownership, for example, by contract, lease, agreement with partners, or by court decree." Therefore, as a general rule, the party that holds directly or indirectly more than 50% of the voting shares (or kick-out rights) of the acquiree will be the acquirer. If a business combination has occurred but applying the consolidation guidance does not clearly indicate which of the combining entities is the acquirer, the factors in paragraphs ASC 805-10-55-11 through 55-15 are considered in identifying the acquirer. See section 3.2.2 for a discussion of these factors.

An acquired entity can elect to apply pushdown accounting upon each event in which an acquirer obtains control of it. For example, an acquiree may elect to apply pushdown accounting upon an event in which an acquirer obtains control of it, but elect not to apply pushdown accounting upon the next event. In other words, the decision by an acquiree to apply pushdown accounting is not an accounting policy choice that would be required to be applied to future transactions. The EITF concluded that every event is distinct and, therefore, an acquiree should make its pushdown accounting election on the basis of the facts and circumstances and the needs of its users at the time of the event.

If the acquiree elects not to apply pushdown accounting at the time an acquirer obtains control of it, the acquiree later can elect to apply pushdown accounting retrospectively to the most recent event in which an acquirer obtained control of the acquiree. For example, assume that Company B acquired 100% of Company A on 1 January 20X5. Further assume that Company X acquired 100% of Company A from Company B on 30 June 20X6. If Company A elects to apply pushdown accounting in the first quarter of 20X7, it would be required to apply pushdown accounting to the most recent event in which an acquirer obtained control of it, which would be the 30 June 20X6 acquisition as opposed to the 1 January 20X5 acquisition. Such an election would be treated as a change in accounting principle in accordance with ASC 250. See our FRD, ***Accounting changes and error corrections***, for further guidance. In reaching this decision, the EITF concluded that if the acquiree's circumstances change (e.g., if there is a significant change in the investor mix that would make pushdown accounting more relevant to current investors), the acquiree should not be prohibited from applying pushdown accounting to the most recent event in which an acquirer obtained control of the acquiree. However, once an entity elects to apply pushdown accounting, its decision is irrevocable.

The following illustration provides an example of an acquiree electing to apply pushdown accounting in a subsequent reporting period.

Illustration B-1: Acquirer obtains control of an acquiree and the acquiree elects to apply pushdown accounting in a subsequent reporting period

On 1 January 20X5, Company A acquires 90% of the outstanding voting shares of Company B and accounts for the business combination under ASC 805. Company B elects not to apply pushdown accounting at the time Company A obtains control of it. Company B, which has a calendar year end, issues its 20X5 financial statements in February 20X6. Therefore, the 20X5 financial statements reflect the net assets of Company B at their historical carrying amounts.

In October 20X6, there is a significant change in Company B's investor mix such that pushdown accounting is more relevant to the new investors. Therefore, Company B elects to apply pushdown accounting to the most recent event in which an acquirer obtained control of it (i.e., the 1 January 20X5 acquisition by Company A) in its 20X6 financial statements.

Analysis

Company B's decision to subsequently apply pushdown accounting is accounted for retrospectively as a change in accounting principle pursuant to ASC 250. Accordingly, Company B will restate the 20X5 financial information included in its 20X6 financial statements to retrospectively apply pushdown accounting from the acquisition date (1 January 20X5). Therefore, the 20X6 financial statements (which include the 20X5 comparative period) reflect the net assets of Company B at the basis of accounting established by Company A.

The guidance also allows any subsidiary of an acquired entity to apply pushdown accounting to its separate financial statements, regardless of whether the acquired entity elects to apply pushdown accounting. The EITF considered that each entity may have a different set of users whose perspectives may differ from one another. Therefore, the EITF believed that each entity within the group of entities acquired by the acquirer should be allowed to separately evaluate whether pushdown accounting applies to their separate financial statements.

B.4 Measurement

Excerpt from Accounting Standards Codification

Business Combinations — Related Issues

Initial Measurement

805-50-30-10

If an **acquiree** elects the option in this Subtopic to apply **pushdown accounting**, the acquiree shall reflect in its separate financial statements the new basis of accounting established by the **acquirer** for the individual assets and liabilities of the acquiree by applying the guidance in other Subtopics of Topic 805. If the acquirer did not establish a new basis of accounting for the individual assets and liabilities of the acquiree because it was not required to apply Topic 805 (for example, if the acquirer was an individual or an investment company—see Topic 946 on investment companies), the acquiree shall reflect in its separate financial statements the new basis of accounting that would have been established by the acquirer had the acquirer applied the guidance in other Subtopics of Topic 805.

805-50-30-11

An acquiree shall recognize goodwill that arises because of the application of pushdown accounting in its separate financial statements. However, bargain purchase gains recognized by the acquirer, if any, shall not be recognized in the acquiree's income statement. The acquiree shall recognize the bargain purchase gains recognized by the acquirer as an adjustment to additional paid-in capital (or net assets of a not-for-profit acquiree).

805-50-30-12

An **acquiree** shall recognize in its separate financial statements any acquisition-related liability incurred by the **acquirer** only if the liability represents an obligation of the acquiree in accordance with other applicable Topics.

Subsequent Measurement

805-50-35-2

An **acquiree** shall follow the subsequent measurement guidance in other Subtopics of Topic 805 and other applicable Topics to subsequently measure and account for its assets, liabilities, and equity instruments, as applicable.

An acquiree that elects to apply pushdown accounting will reflect the new basis of accounting established by the acquirer through its application of ASC 805 to the individual assets and liabilities of the acquiree. If an acquiree is acquired by an acquirer that does not apply ASC 805 (e.g., an investment company that accounts for the acquiree at fair value), and it elects to apply pushdown accounting, the acquiree will reflect in its financial statements the new basis that would have been hypothetically established if the acquirer had applied ASC 805.

The following illustration shows the determination of the accounting basis to be pushed down to an acquiree's separate financial statements.

Illustration B-2: Determination of the accounting basis to be pushed down when an acquiree elects to apply pushdown accounting

On 1 January 20X5, Company A acquires 90% of the outstanding voting shares of Company B for cash consideration of $400. Company A accounts for the business combination under ASC 805. The fair value of the noncontrolling interest of Company B is $40[73] and the fair value of the identifiable net assets acquired is $300. Accordingly, Company A records goodwill of $140 ($400 + $40 − $300). Company B elects to apply pushdown accounting.

Analysis

Company B records in its separate financial statements the new basis of accounting recorded by Company A on the acquisition date (1 January 20X5). Therefore, the amount of net assets (including goodwill) to be "pushed down" in Company B's separate financial statements is $440 ($300 + $140).

B.4.1 Bargain gain

If applying ASC 805 (whether by the acquirer or hypothetically by the acquiree) results in a bargain gain, the guidance precludes the acquiree from recognizing the gain in its income statement. Instead, the acquiree will recognize any such gain as an adjustment to additional paid-in capital (or net assets of a not-for-profit acquiree). As illustrated in the following example, the adjustment to additional paid-in capital (or net assets of a not-for-profit acquiree) may not coincide with the bargain gain recorded by the acquirer.

Illustration B-3: Acquiree elects to apply pushdown accounting when acquirer recognizes a bargain gain

On 1 January 20X5, Company A acquires 100% of the outstanding voting shares of Company B for cash consideration of $600. Company A accounts for the business combination under ASC 805. The carrying amount and fair value of Company B's identifiable net assets as of 1 January 20X5 is as follows:

	Company B (carrying amount)	Company B (fair value)
Assets	$ 500	$ 800
Liabilities	100	100
Net assets	$ 400	$ 700
Equity:		
Common stock	$ 150	
Additional paid-in capital	50	
Retained earnings	200	
Total equity	$ 400	

As a result, Company A records a bargain gain of $100 ($600 cash consideration - $700 Company B's fair value). Company B elects to apply pushdown accounting.

[73] The valuation of the noncontrolling interest excludes a control premium.

Analysis

Company B would reflect in its separate financial statements the new basis of accounting recorded by Company A on the acquisition date (1 January 20X5) as follows:

	Company B (before pushdown)	Pushdown accounting adjustments	Company B (after pushdown)
Assets	$ 500	$ 300	$ 800
Liabilities	100	–	100
Net assets	$ 400	$ 300	$ 700
Equity:			
Common stock	$ 150	$ –	$ 150
Additional paid-in capital	50	300	550[1]
Retained earnings	200	–	–[1]
Total equity	$ 400	$ 300	$ 700

The adjustment to additional paid-in capital of $300 as a result of the application of pushdown accounting does not coincide with the bargain gain recorded by Company A of $100. This is the case because the adjustment to additional paid-in capital is simply the difference between the carrying amount and the fair value of Company B's net identifiable assets.

[1]Retained earnings is reduced to zero (debit of $200), with an offsetting entry to APIC (credit of $200).

B.4.2 Acquisition-related liabilities incurred by acquirer

ASC 805-50-30-12 indicates that any acquisition-related liability incurred by the acquirer is recognized in the acquiree's separate financial statements only if it represents an obligation of the acquiree, and it must be recognized in accordance with other applicable GAAP (e.g., joint and several debt arrangement under ASC 405-40). For example, if an acquirer incurred debt or issued mandatorily redeemable preferred stock to finance the acquisition of an acquiree, that debt or mandatorily redeemable preferred stock would not be recognized in the financial statements of the acquiree unless the acquiree were to assume the debt or the mandatorily redeemable preferred stock such that it became an obligation of the acquiree.

B.4.3 Treatment of a contingent consideration asset or liability

Often the consideration transferred in a business combination may include a contingent consideration arrangement. ASC 805 states that an acquirer recognizes the acquisition-date fair value of the contingent consideration as part of the consideration transferred in exchange for the acquiree. That arrangement may represent an asset or liability.

Questions may arise about whether the contingent consideration asset or liability should be pushed down to the acquiree. Consistent with the guidance for acquisition-related liabilities incurred by an acquirer in paragraph ASC 805-50-30-12, we believe that unless the acquiree (or a subsidiary of the acquiree) has an obligation to pay or has the right to receive the contingent consideration, then the contingent consideration liability or asset would not be pushed down to the acquiree. In most situations, the contingent consideration liability or asset will not be an obligation or right of the acquiree.

B.4.4 Treatment of a parent's fair value option election in acquiree's financial statements

Excerpt from Accounting Standards Codification

Financial Instruments — Overall

Recognition

825-10-25-4

An entity may choose to elect the fair value option for an eligible item only on the date that one of the following occurs:

a. The entity first recognizes the eligible item.

b. The entity enters into an eligible **firm commitment**.

c. Financial assets that have been reported at fair value with unrealized gains and losses included in earnings because of specialized accounting principles cease to qualify for that specialized accounting (for example, a transfer of assets from a subsidiary subject to Subtopic 946-10 to another entity within the consolidated reporting entity not subject to that Subtopic).

d. The accounting treatment for an investment in another entity changes because the investment becomes subject to the equity method of accounting.

   1. Subparagraph superseded by Accounting Standards Update No. 2016-01.

   2. Subparagraph superseded by Accounting Standards Update No. 2016-01.

e. An event that requires an eligible item to be measured at fair value at the time of the event but does not require fair value measurement at each reporting date after that, excluding the recognition of impairment under lower-of-cost-or-market accounting or other-than-temporary impairment or accounting for equity securities in accordance with Topic 321.

Pending Content:

Transition Date: (P) December 16, 2019; (N) December 16, 2022 | **Transition Guidance:** 326-10-65-1

e. An event that requires an eligible item to be measured at fair value at the time of the event but does not require fair value measurement at each reporting date after that, excluding the recognition of impairment under lower-of-cost-or-market accounting or accounting for securities in accordance with either Topic 321 on investments—equity securities or Topic 326 on measurement of credit losses.

825-10-25-5

Some of the events that require remeasurement of eligible items at fair value, initial recognition of eligible items, or both, and thereby create an election date for the fair value option as discussed in paragraph 825-10-25-4(e) are:

a. Business combinations, as defined in Subtopic 805-10

b. Consolidation or deconsolidation of a subsidiary or VIE

c. Significant modifications of debt, as defined in Subtopic 470-50.

The fair value option may be elected by an acquirer for eligible instruments of an acquiree upon initial consolidation. However, the standalone financial statements of the acquiree reflect that entity's prior fair value elections. If the acquiree elects to apply pushdown accounting, it also has the opportunity, at the same date, to elect the fair value option for any of its eligible financial instruments.

B.4.5 Acquisition-related costs

As discussed in section 6.2, acquisition-related costs do not form part of the basis of accounting recorded by the acquirer. As such, consistent with the guidance in ASC 805, these costs are expensed by the acquirer when incurred.

B.4.6 Measurement period (added June 2022)

The measurement period is the time after the acquisition during which the acquirer obtains information necessary to identify and measure all aspects of the business combination in accordance with ASC 805. If a target elects pushdown accounting, we believe that the acquirer's measurement period would also apply to the target. Since the target is electing to pushdown the acquirer's basis, we believe that the target should reflect the changes the acquirer makes to provisional amounts during the measurement period and any of the acquirer's related measurement period disclosures. For example, we believe the target should disclose if the amounts the acquirer recognized are provisional and the information the acquirer has arranged to obtain but has not yet received. See section 7.3 for additional information about the measurement period, including information about measurement period adjustments.

B.4.7 Subsequent accounting

ASC 805-50-35-2 requires an acquiree to subsequently measure its assets and liabilities in accordance with ASC 805-10-35-1 or other applicable GAAP. For example, ASC 805 provides subsequent accounting guidance for reacquired rights, assets and liabilities arising from preacquisition contingencies, indemnification assets, contingent consideration and contingent consideration arrangements of an acquiree assumed by the acquirer. Assets and liabilities not covered by ASC 805 would be subsequently accounted for pursuant to other applicable GAAP. For example, intangible assets and goodwill would be subsequently accounted for pursuant to ASC 350. See section 4.7 for further information on the subsequent accounting for assets and liabilities acquired in a business combination.

B.4.7.1 Pushdown of goodwill and testing for impairment

If an acquired entity elects to apply pushdown accounting, then any goodwill recorded by the acquirer from the acquisition of the acquiree is pushed down into the acquiree's separate financial statements. Notwithstanding the fact that the acquiree's separate financial statements will reflect the full amount of goodwill, the acquirer must follow the guidance in ASC 350 and assign the goodwill to its reporting units for purposes of testing the goodwill for impairment in its consolidated financial statements. Because goodwill is assigned to the reporting units that are expected to benefit from the synergies of the combination, it is possible that the acquirer may assign a portion of the goodwill to reporting units other than those of the acquired entity. This means that the amount of goodwill that is reflected in the acquiree's separate financial statements may differ from the amount of goodwill that is assigned to the acquiree for purposes of the acquirer's goodwill impairment test. This is illustrated in the following example.

Illustration B-4: Amount of goodwill "pushed down" to the acquiree differs from the amount of goodwill "assigned" to the acquiree

On 1 January 20X5, Company A acquires 100% of the outstanding voting shares of Company B and records goodwill of $140. On that date, Company B elects to apply pushdown accounting, and the amount of goodwill that is reflected in Company B's separate financial statements is $140. For purposes of testing the goodwill for impairment in its consolidated financial statements, Company A must assign the goodwill of $140 to those reporting units that are expected to benefit from the synergies of the combination. Pursuant to ASC 350, Company A assigns goodwill of $100 to Company B, a new reporting unit, and $40 to other reporting units. Thus, while Company B will reflect goodwill of $140 in its separate financial statements, it will be assigned goodwill of only $100 in Company A's consolidated financial statements.

When an acquiree tests its goodwill for impairment, it must follow the guidance in ASC 350 and test the amount of goodwill that is reflected in its separate financial statements for impairment. That is, the acquiree goodwill is tested for impairment at the subsidiary level using the acquiree's reporting units. If the acquiree is required to recognize a goodwill impairment loss in its separate financial statements, that impairment is not recognized in the acquirer's consolidated financial statements (i.e., the impairment is not "pushed up" to the higher level of consolidation). Continuing with Illustration B-4 above, Company B is required to test goodwill of $140 for impairment (i.e., the amount of goodwill that is reflected in Company B's separate financial statements). See our FRD, ***Intangibles — goodwill and other***, for a further discussion on assigning goodwill to reporting units.

B.5 Disclosure

Excerpt from Accounting Standards Codification

Business Combinations — Related Issues

Disclosure

805-50-50-5

If an **acquiree** elects the option to apply **pushdown accounting** in its separate financial statements, it shall disclose information in the period in which the pushdown accounting was applied (or in the current reporting period if the acquiree recognizes adjustments that relate to pushdown accounting) that enables users of financial statements to evaluate the effect of pushdown accounting. To meet this disclosure objective, the acquiree shall consider the disclosure requirements in other subtopics of Topic 805.

805-50-50-6

Information to evaluate the effect of **pushdown accounting** may include the following:

a. The name and a description of the **acquirer** and a description of how the acquirer obtained **control** of the acquiree.

b. The **acquisition date**.

c. The acquisition-date fair value of the total consideration transferred by the acquirer.

d. The amounts recognized by the acquiree as of the acquisition date for each major class of assets and liabilities as a result of applying pushdown accounting. If the initial accounting for pushdown accounting is incomplete for any amounts recognized by the acquiree, the reasons why the initial accounting is incomplete.

e. A qualitative description of the factors that make up the goodwill recognized, such as expected synergies from combining operations of the acquiree and the acquirer, or intangible assets that do not qualify for separate recognition, or other factors. In a bargain purchase (see paragraphs 805-30-25-2 through 25-4), the amount of the bargain purchase recognized in additional paid-in capital (or net assets of a not-for-profit acquiree) and a description of the reasons why the transaction resulted in a gain.

f. Information to evaluate the financial effects of adjustments recognized in the current reporting period that relate to pushdown accounting that occurred in the current or previous reporting periods (including those adjustments made as a result of the initial accounting for pushdown accounting being incomplete [see paragraphs 805-10-25-13 through 25-14]).

The information in this paragraph is not an exhaustive list of disclosure requirements. The acquiree shall disclose whatever additional information is necessary to meet the disclosure objective set out in paragraph 805-50-50-5.

Acquirees that elect to apply pushdown accounting are required to provide disclosures that enable users of their financial statement to evaluate the effect of pushdown accounting. ASC 805-50-50-6 provides a list of example disclosures for companies to consider, including how the acquirer obtained control of the acquiree, the acquisition date fair value of the total consideration transferred by the acquirer, and a qualitative

description of the factors that make up goodwill. This list is not meant to be exhaustive. In addition, acquirees should consider the disclosure requirements in the other subtopics of ASC 805. When an acquiree considers the disclosure requirements in the other subtopics of ASC 805, it may determine that certain disclosures are not applicable such as the disclosures relating to pro forma information or noncontrolling interests.

If the initial accounting is incomplete for any amounts recognized by the acquiree, the acquiree should disclose the reasons why. If adjustments are made to provisional amounts recognized by the acquirer that are also recognized by the acquiree (e.g., final valuation of an intangible asset), the acquiree is required to consider similar disclosures that enable users of the financial statements to evaluate the effect of these adjustments.

In addition, an acquiree is not required to disclose that it did not elect to apply pushdown accounting when an acquirer obtained control of it.

B.6 Transition

The guidance in ASU 2014-17 was effective immediately upon issuance (18 November 2014). An acquiree can apply pushdown accounting to any future event or to its most recent event in which an acquirer obtains or obtained control of the acquired entity, including prior to the effective date of the ASU. If the financial statements for the period encompassing the most recent event in which an acquirer obtained control of the acquired entity have already been issued or made available to be issued, the application of the pushdown guidance is accounted for retrospectively as a change in accounting principle in accordance with ASC 250. See Illustration B-1 in section B.3 for an example of the application of the guidance in ASC 250.

An acquired entity may not revoke the application of pushdown accounting that was applied by an acquiree prior to the effective date of ASU 2014-17.

B.7 Financial reporting considerations

B.7.1 Financial statement presentation and disclosure

The application of pushdown accounting will result in a change to an acquired entity's separate financial statement presentation. Because the application of pushdown accounting results in a new basis of accounting to be reflected in an acquired entity's separate financial statements, it's as if the old reporting entity has been terminated and a new one has been created. Therefore, it would not be appropriate to combine the periods prior to and subsequent to the date that pushdown accounting is applied, generally referred to as the "predecessor" and "successor" periods.

To emphasize this change in reporting entity, the successor and predecessor periods would be separated by a black line in the acquiree's standalone financial statements. For example, if an entity was acquired on 30 September and the acquiree elected to apply pushdown accounting as of that date, then the acquiree's 31 December statements of income, comprehensive income, cash flows and changes in shareholders' equity would include a nine-month predecessor period and a three-month successor period, separated by a black line. The columns associated with each of these periods generally would be labeled "Predecessor Entity" and "Successor Entity" or something similar. In addition, the notes to the financial statements would reflect the relevant information for the predecessor and successor periods.

The financial statements also would clearly describe the basis of presentation as a consequence of applying pushdown accounting.

B.7.1.1 Expenses related to the business combination (updated June 2023)

When financial statements reflecting the application of pushdown accounting are presented, companies should carefully evaluate the specific facts and circumstances to assess whether expenses related to the business combination should be presented in either the predecessor period, the successor period or "on the line" (i.e., no expense is recognized in the predecessor or the successor period).

If a target incurs expenses that are contingent on the consummation of the business combination, the target may present them as expenses incurred in the predecessor period. That's because the predecessor financial statements cover the period up to immediately before the closing date of the transaction, when there is no longer a risk that the business combination will not occur.

Alternatively, when a target incurs expenses contingent on the consummation of a business combination, it may present those costs "on the line." At the 2014 AICPA National Conference on Current SEC and PCAOB Developments, the SEC staff[74] indicated that it is aware that in certain circumstances the expenses are not presented in either period. The SEC staff indicated that it has not objected to this presentation when the expenses are clearly contingent upon the consummation of the business combination (e.g., a "success fee" due to an adviser or investment banker) but expects robust disclosure of the nature and amount of such expenses as well as the basis for their classification.

Determining whether expenses are fully contingent upon the business combination will require the use of professional judgment and should be based on the facts and circumstances.

If an acquirer incurs costs that are contingent on the execution of a business combination, the acquirer should recognize those costs in its financial statements in the period of the acquisition. Refer to section 6.2 for additional information on an acquirer's accounting for acquisition-related costs.

B.7.2 Effect on new registration statements when pushdown accounting is applied in an interim period

Registration statements (e.g., Form S-3) and proxy statements (excluding Form S-8)[75] require reissuance of recast financial statements when there has been a change in an accounting principle that requires retrospective application if the registration statement also includes (or incorporates by reference) financial statements that reflect the period in which the accounting change occurred (i.e., post-event financial statements).

As discussed in section B.3, if an acquiree elects not to apply pushdown accounting at the time an acquirer obtains control of it, the acquiree later can elect to apply pushdown accounting retrospectively to the most recent event in which an acquirer obtained control of the acquiree. Such an election will be treated as a change in accounting principle in accordance with ASC 250. If an acquiree subsequently elects to apply pushdown accounting in an interim period after it has filed its Form 10-K, which did not reflect pushdown accounting at the time it was filed, and the acquiree subsequently files a new registration statement on Form S-3, the acquiree would be required to revise its annual financial statements included or incorporated by reference in the registration statement. This is illustrated in the following example.

---

[74] Comments by Carlton E. Tartar, Associate Chief Accountant, Office of the Chief Accountant, at the 2014 Conference on Current SEC and PCAOB Developments, 8 December 2014.

[75] Form S-8 does not contain express language requiring the retrospective revision of financial statements to reflect specified events. Rather, Form S-8 requires a registrant to consider whether there are "material changes in the registrant's affairs" that would require the financial statements incorporated by reference to be revised.

Illustration B-5: Effect on a new registration statement when the acquiree elects to apply pushdown accounting at a later date

On 1 January 20X5, Company A acquired 85% of the outstanding shares of Company B. Company B elected not to apply pushdown accounting in its separate financial statements included in its 20X5 and 20X6 Forms 10-K and in its first and second quarter Forms 10-Q for 20X7. During the third quarter of 20X7, Company B elects to apply pushdown accounting, which is reflected as a retrospective change in accounting principle in its third quarter Form 10-Q filed on 5 November 20X7. Company B expects to file a 1933 Act registration statement on Form S-3 with the SEC on 20 November 20X7.

Analysis

Company B's decision to subsequently apply pushdown accounting during the third quarter of 20X7 is accounted for retrospectively as a change in accounting principle pursuant to ASC 250. As a result, the Form S-3 that Company B expects to file on 20 November 20X7 must include, or incorporate by reference, Company B's revised financial statements as of 31 December 20X6 and 20X5 and for each of the three years in the period ended 31 December 20X6. The revised financial statements may be (1) included in an Item 8.01 Form 8-K that is incorporated by reference into the registration statement or (2) included in the actual registration statement.

C Accounting for common control transactions

C.1 Introduction

Common control transactions include a transfer of net assets or an exchange of equity interests between entities under common control. An example includes a parent that exchanges its ownership interests or the net assets of a wholly owned subsidiary for additional shares of another subsidiary.

Common control transactions have characteristics that are similar to a business combination but do not meet the requirements to be accounted for as a business combination. As such, the accounting and reporting for a combination between entities or businesses under common control are included in a separate subtopic (ASC 805-50, *Business Combinations — Related Issues*) within ASC 805.

ASC 805 defines a business combination as a transaction or other event in which an acquirer obtains control of one or more businesses. One of the overall principles of ASC 805 is that obtaining control is a recognition event that results in a 100% new basis (i.e., the full goodwill method) in the acquired entity. While combinations among entities or businesses under common control may result in a change in control from the perspective of a standalone reporting entity, common control transactions do not result in a change in control at the ultimate parent or the controlling shareholder level. Therefore, unlike accounting for business combinations, common control transactions are not accounted for at fair value. Rather, common control transactions are generally accounted for at the carrying amount of the net assets or equity interests transferred.

Because transactions among entities under common control do not result in a change in control at the ultimate parent level, the ultimate parent's consolidated financial statements will not be affected by a common control transaction. Any differences between the proceeds received or transferred and the carrying amounts of the net assets are considered equity transactions that would be eliminated in consolidation, and no gain or loss would be recognized in the consolidated financial statements of the ultimate parent. The accounting and reporting for common control transactions in standalone subsidiary financial statements is the focus of this appendix.

When common control transactions include transactions with noncontrolling interest holders, changes in noncontrolling interests are accounted for as equity transactions.

ASC 805-50 only addresses the accounting for common control transactions from the perspective of the entity that *receives* the net assets or equity interests (receiving entity). However, when the entity that *transfers* the net assets (transferring entity or transferor) is required to report standalone financial statements, we believe the same concepts (e.g., carrying amount) generally apply.

C.2 Defining common control

US GAAP does not define the term "common control." The Emerging Issues Task Force in EITF Issue No. 02-5, *Definition of "Common Control" in Relation to FASB Statement No. 141* (EITF 02-5), discussed, but did not reach a consensus, on the issue of how to determine whether separate entities are under common control. EITF 02-5 summarizes the criteria for determining whether common control exists based on a 1997 speech by the SEC staff.[76] Although EITF 02-5 was not codified, the guidance from this speech has been applied in practice by SEC registrants and the SEC observer to the EITF noted that SEC registrants would be expected to continue to apply that guidance. Specifically, EITF 02-5 indicates that common control exists only in the following situations:

- An individual or entity holds more than 50% of the voting ownership interest of each entity.
- Immediate family members hold more than 50% of the voting ownership interest of each entity (with no evidence that those family members will vote their shares in any way other than in concert). Immediate family members include a married couple and their children, but not the married couple's grandchildren. Entities might be owned in varying combinations among living siblings and their children. Those situations would require careful consideration of the substance of the ownership and voting relationships.
- A group of shareholders holds more than 50% of the voting ownership interest of each entity, and contemporaneous written evidence of an agreement to vote a majority of the entities' shares in concert exists.

With respect to immediate family member relationships in the second bullet above, we understand that this set of relationships should be construed literally and should not be expanded. For example, shares held by in-laws should not be considered by analogy as held under common control. Due to the lack of other authoritative guidance, the SEC's guidance is widely applied by public and nonpublic companies. Judgment is required to determine whether common control exists in situations other than those described above.

Illustration C-1: Identifying entities under common control

A brother and a sister each own a 35% interest in Company A. Their parents own a 100% interest in Company B. If Company A and Company B merged into a single entity (an SEC registrant), would the two companies be considered under common control by the parents and their children as a group and, therefore, account for the merger at the carrying amounts of the net assets transferred?

Analysis

The SEC staff indicated that, absent evidence to the contrary, it would not object to the assertion that the immediate family members vote their shares in concert as a group. Therefore, the merger of Company A and Company B into a new entity is a transaction of entities under common control, which would be accounted for at the carrying amounts of the net assets transferred.

ASC 805-50 also provides examples of the types of transactions that qualify as common control transactions.

[76] Comments by Donna L. Coallier, Professional Accounting Fellow at the SEC, 1997 Speeches by Commission Staff, 9 December 1997.

Excerpt from Accounting Standards Codification

Business Combinations — Related Issues

Scope and Scope Exceptions

805-50-15-6

The guidance in the Transactions between Entities under Common Control Subsections applies to combinations between entities or **businesses** under common control. The following are examples of those types of transactions:

a. An entity charters a newly formed entity and then transfers some or all of its net assets to that newly chartered entity.

b. A parent transfers the net assets of a wholly owned subsidiary into the parent and liquidates the subsidiary. That transaction is a change in legal organization but not a change in the reporting entity.

c. A parent transfers its controlling interest in several partially owned subsidiaries to a new wholly owned subsidiary. That also is a change in legal organization but not in the reporting entity.

d. A parent exchanges its ownership interests or the net assets of a wholly owned subsidiary for additional shares issued by the parent's less-than-wholly-owned subsidiary, thereby increasing the parent's percentage of ownership in the less-than-wholly-owned subsidiary but leaving all of the existing **noncontrolling interest** outstanding.

e. A parent's less-than-wholly-owned subsidiary issues its shares in exchange for shares of another subsidiary previously owned by the same parent, and the noncontrolling shareholders are not party to the exchange. That is not a **business combination** from the perspective of the parent.

f. A limited liability company is formed by combining entities under common control.

g. Two or more **not-for-profit entities** (NFPs) that are effectively controlled by the same board members transfer their net assets to a new entity, dissolve the former entities, and appoint the same board members to the newly combined entity.

805-50-15-6B

Mergers and acquisitions between or among two or more NFPs, all of which benefit a particular group of citizens, shall not be considered common control transactions solely because those entities benefit a particular group. The mission, operations, and historical sources of support of two or more NFPs may be closely linked to benefiting a particular group of citizens. However, that group neither owns nor controls the NFPs.

The list of examples above is not all-inclusive. Although the examples above are primarily parent-subsidiary transactions, common control transactions also include transfers or exchanges between subsidiaries directly or indirectly controlled by the same parent or controlling shareholder.

Transfers among entities with a high degree of common ownership are not necessarily common control transactions. When two or more entities have shareholders in common but no one shareholder (after taking into account immediate family member relationships and the existence of contemporaneous written agreements) controls the entities, the entities have common ownership but not common control. Transactions involving common ownership are discussed in section C.6.

C.2.1 Determining whether common control exists

In ASC 805, "control" has the same meaning as a "controlling financial interest" as described in ASC 810-10. ASC 810-10-15-8 states, "For legal entities other than limited partnerships, the usual condition for a controlling financial interest is ownership of a majority voting interest, and, therefore, as a general rule ownership by one reporting entity, directly or indirectly, of more than 50% of the outstanding voting shares of another entity is a condition pointing toward consolidation. The power to control may also exist with a lesser percentage of ownership, for example, by contract, lease, agreement with other stockholders, or by court decree." In addition, ASC 810-10-15-8A states, "Given the purpose and design of limited partnerships, kick-out rights through voting interests are analogous to voting rights held by shareholders of a corporation. For limited partnerships, the usual condition for a controlling financial interest, as a general rule, is ownership by one limited partner, directly or indirectly, of more than 50% of the limited partnership's kick-out rights through voting interests. The power to control also may exist with a lesser percentage of ownership, for example, by contract, lease, agreement with partners, or by court decree." As such, the determination of whether entities are under common control is not limited to the consideration of voting interests.

Determining whether a reporting entity has a controlling financial interest in a VIE requires an assessment of the characteristics of the reporting entity's variable interests and other involvements (including involvement of related parties and de facto agents) in a VIE. A reporting entity is deemed to have a controlling financial interest in a VIE if it has both (a) the power to direct the activities of the VIE that most significantly affect the VIE's economic performance and (b) the obligation to absorb losses of the VIE or receive benefits from the VIE that could potentially be significant to the VIE. See our FRD, ***Consolidation***, for additional guidance.

All forms of control are considered in determining if entities are under common control. Entities that are consolidated by the same parent are considered to be under common control. For example, if Company A owns a 60% voting interest in Subsidiary X and is the primary beneficiary of Company Y (a VIE), all three entities (Company A, Subsidiary X and Company Y) are considered to be under common control even if Company A does not have a controlling voting interest in Company Y.

See our FRD, ***Consolidation***, for more information.

C.3 Nature of common control transactions

Common control transactions generally are accounted for by the receiving entity based on the nature of what is transferred or exchanged — a business or an asset.

The transfer of a business[77] among entities under common control is accounted for at carrying amount with retrospective adjustment of prior period financial statements similar to the manner in which a pooling-of-interest was accounted for under APB 16, *Business Combinations*. Considerations for applying the pooling-of-interests method are discussed further in section C.4.2.1. The retrospective adjustment of prior period financial statements is based on the concept that there has been a change in the reporting entity as defined below. That is, the financial statements are that of a different reporting entity and are retrospectively adjusted to present the new reporting entity.

ASC 250 defines a change in the reporting entity as a change that results in financial statements that, in effect, are those of a different reporting entity. ASC 250 generally limits a change in the reporting entity to the following:

- Presenting consolidated or combined financial statements in place of financial statements of individual entities

[77] See section 2.1.3 for guidance on the definition of a business.

- Changing specific subsidiaries that make up the group of entities for which consolidated financial statements are presented
- Changing the entities included in combined financial statements

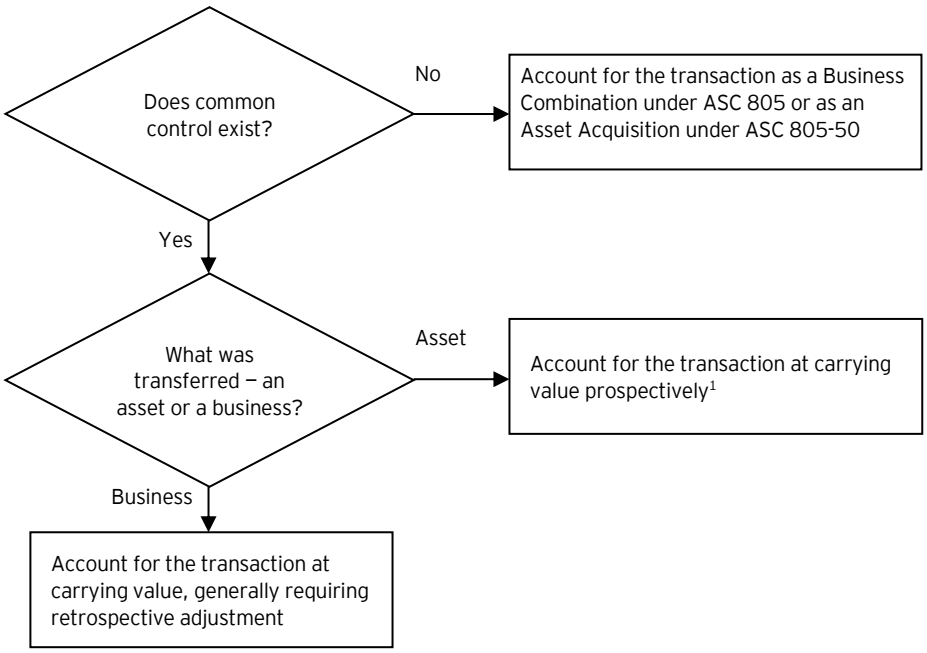
Accounting for the transfer of net assets or an exchange of equity interests among entities under common control requires the use of judgment in determining whether or not the net assets transferred or shares exchanged constitutes a business. Generally, we believe that the transfer of a business, will represent a change in reporting entity for the receiving entity, and in limited circumstances the transferring entity, requiring retrospective adjustment of the consolidated financial statements.

The transfer of net assets that are not a business generally does not constitute a change in the reporting entity. As such, the transfer of net assets that are not a business is accounted for prospectively in the period in which the transfer occurs, and prior periods are not restated.

Gains on transfers of assets (i.e., by the transferor) and asset write-ups (i.e., by the transferee) generally are not permitted between entities under common control. However, there are certain exceptions such as the transfer of financial assets and certain inventory transfers.

The following decision tree helps illustrate how to account for transactions among entities under common control.

Illustration C-2: Determining how a receiving entity accounts for common control transactions



[1] Gains on transfers of assets (i.e., by the transferor) and asset write-ups (i.e., by the transferee) generally are not permitted between entities under common control. However, there are certain exceptions such as the transfer of financial assets and certain inventory transfers.

C.3.1 Transfer of financial assets

ASC 860-10-55-78 indicates that transfers of financial assets from one subsidiary to another subsidiary of a common parent would be accounted for as a sale, and therefore recognized and measured at fair value, in each subsidiary's standalone financial statements if all the conditions in ASC 860-10-40-5 have been met and the transferee is not consolidated by the transferor. Any gains or losses and asset revaluations recognized in separate financial statements are eliminated in consolidation or combination by the parent. This guidance only applies to transfers of financial assets between subsidiaries of a common parent.

ASC 606 and ASC 610-20 changed the scope of ASC 860 for transfers of equity method investments. That is, before the adoption of ASC 606, transfers of equity method investments deemed to be in-substance real estate were accounted for in accordance with ASC 360-20. To determine whether a transfer of an equity method investment is in substance a sale of real estate, an entity was required to "look through" to the underlying assets and liabilities of the investee.

After the adoption of ASC 606, entities that previously applied the look-through guidance to determine whether equity method investments are in-substance real estate will no longer be able to do so, since these equity method investments are now in the scope of ASC 860. Accordingly, the guidance in ASC 860-10-55-78 related to transfers of financial assets between subsidiaries of a common parent would apply to transfers of equity method investments that were previously in the scope of ASC 360-20. See our FRD, ***Transfers and servicing of financial assets***, for further details.

C.3.2 Transfer of inventory

Gain recognition by the transferor (and step-up in value by the transferee) on routine transfers of inventory in the ordinary course of business is generally acceptable in the presentation of standalone financial statements. The following items should be considered when evaluating the ordinary course of business:

- The form and substance of the transaction
- Whether the parties to the transaction lack economic substance (e.g., if an entity would not be able to make payment for goods purchased from a related party without funds borrowed from the related party, the related party should generally not recognize a sale)
- Specific accounting literature directs otherwise

Any gain recognized on the transfer of inventory is eliminated in consolidation unless the inventory transfer is from a non-regulated subsidiary to a regulated subsidiary, as discussed in ASC 980-810-45.

C.3.3 Common control lease arrangements (after adoption of ASU 2023-01) (added June 2023)

Entities under common control may enter into arrangements with one another. After adoption of ASU 2023-01,[78] private companies and certain not-for-profit entities may elect to use the written terms and conditions of a common control arrangement, rather than the legally enforceable terms, to determine whether a lease exists and to classify and account for the lease. The practical expedient can be elected on an arrangement-by-arrangement basis. However, if no written terms and conditions exist (or the practical expedient is not elected), an entity is required to determine the legally enforceable terms and conditions of the common control arrangement and use them to evaluate whether a lease exists and to classify and account for the lease.

[78] ASU 2023-01 is effective for all entities for fiscal years beginning after 15 December 2023, including interim periods within those fiscal years. Early adoption is permitted for financial statements that have not been made available for issuance in any interim or annual period as of the beginning of the related fiscal year.

In addition, ASU 2023-01 amended ASC 842 to require all lessees, including public business entities, to amortize leasehold improvements associated with common control leases over their useful life to the common control group. At the end of the lease, a lessee is required to account for the leasehold improvements as a transfer of assets between entities under common control through an adjustment to equity (or net assets for not-for-profit entities).

C.4 Accounting and reporting by the receiving entity

The guidance in ASC 805-50 addresses the determination of the basis at which the *receiving entity* in a common control transaction will record the net assets or business transferred.

Excerpt from Accounting Standards Codification

Business Combinations — Related Issues

Initial Measurement

805-50-30-5

When accounting for a transfer of assets or exchange of shares between entities under common control, the entity that receives the net assets or the **equity interests** shall initially measure the recognized assets and liabilities transferred at their carrying amounts in the accounts of the transferring entity at the date of transfer. If the carrying amounts of the assets and liabilities transferred differ from the historical cost of the parent of the entities under common control, for example, because **pushdown accounting** had not been applied, then the financial statements of the receiving entity shall reflect the transferred assets and liabilities at the historical cost of the parent of the entities under common control.

805-50-30-6

In some instances, the entity that receives the net assets or equity interests (the receiving entity) and the entity that transferred the net assets or equity interests (the transferring entity) may account for similar assets and liabilities using different accounting methods. In such circumstances, the carrying amounts of the assets and liabilities transferred may be adjusted to the basis of accounting used by the receiving entity if the change would be preferable. Any such change in accounting method shall be applied retrospectively, and financial statements presented for prior periods shall be adjusted unless it is impracticable to do so. Section 250-10-45 provides guidance if retrospective application is impracticable.

In a transfer between entities under common control, the receiving entity recognizes the assets and liabilities transferred at their carrying amounts in the financial statements of the transferring entity on the date of the transfer (unless the carrying amounts differ from the historical cost of the parent of the entities under common control as discussed below). The use of these carrying amounts is required even if the fair value of the transferred amounts is reliably determinable.

If the receiving entity transfers cash in the exchange, any cash transferred in excess of the carrying amount of the assets and liabilities transferred is treated as an equity transaction (i.e., a dividend). If the receiving entity issues equity interests in the exchange, the equity interests issued are recorded at an amount equal to the carrying amount of the net assets transferred, even if the fair value of the equity interests issued is reliably determinable.

In certain situations, such as when pushdown accounting was not applied in the transferring entity's financial statements, the carrying amounts of the net assets of a subsidiary (the transferring entity) may differ from the historical cost of the subsidiary in the ultimate parent or controlling shareholders' consolidated financial statements. In such a scenario, the carrying amount of the transferred net assets is recorded by the receiving entity at the ultimate parent's historical cost.

Illustration C-3: Differences in carrying amount between parent and subsidiary

Assume Parent has an 80% ownership in Subsidiary A and a 100% ownership in Subsidiary B. Parent transfers its 100% ownership interest in Subsidiary B to Subsidiary A. Further assume that the carrying amount of the net assets of Subsidiary B is $750 while Parent's basis in Subsidiary B is reflected at $1,000 in its consolidated financial statements.

Analysis

After the common control transaction, the standalone consolidated financial statements of Subsidiary A reflects the historical cost of Subsidiary B's net assets as it is reflected in the consolidated financial statements of Parent, or $1,000.

In other situations, the receiving entity and the transferring entity may account for similar assets and liabilities using different accounting methods (e.g., FIFO versus LIFO accounting for inventory). In such situations, following the guidance in ASC 805-50-30-6, the carrying amounts of the assets and liabilities transferred may be adjusted to the basis of accounting used by the receiving entity if that change would be preferable. The change is made by retrospective adjustment of the combined financial statements.

C.4.1 VIE and primary beneficiary are under common control

The Variable Interest Entities Subsections of ASC 810-10 incorporate the general principles governing common control transactions in ASC 805-50 and other guidance contained in US GAAP.

Excerpt from Accounting Standards Codification

Consolidation — Overall

Initial Measurement

810-10-30-1

If the **primary beneficiary** of a **variable interest entity** (VIE) and the VIE are under common control, the primary beneficiary shall initially measure the assets, liabilities, and **noncontrolling interests** of the VIE at amounts at which they are carried in the accounts of the reporting entity that controls the VIE (or would be carried if the reporting entity issued financial statements prepared in conformity with generally accepted accounting principles [GAAP]).

This paragraph requires that there be no remeasurement of a VIE's assets and liabilities if the primary beneficiary and VIE are under common control.

Illustration C-4: VIE and primary beneficiary are under common control

Company X and Company Y are under the common control of Company ABC. Company X and Company Y enter into an agreement in which Company X guarantees the debt of Company Y. The guarantee represents a variable interest in Company Y. After performing an analysis under the Variable Interest Entities Subsections of ASC 810-10, Company Y is determined to be a VIE for which Company X is the primary beneficiary.

Analysis

Company X would record the net assets of Company Y at the amounts at which they are carried in Company ABC's financial statements.

C.4.2 Financial statement presentation by the receiving entity

Excerpt from Accounting Standards Codification

Business Combinations — Related Issues

Other Presentation Matters

805-50-45-2

The financial statements of the receiving entity shall report results of operations for the period in which the transfer occurs as though the transfer of net assets or exchange of **equity interests** had occurred at the beginning of the period. Results of operations for that period will thus comprise those of the previously separate entities combined from the beginning of the period to the date the transfer is completed and those of the combined operations from that date to the end of the period. By eliminating the effects of intra-entity transactions in determining the results of operations for the period before the combination, those results will be on substantially the same basis as the results of operations for the period after the date of combination. The effects of intra-entity transactions on current assets, current liabilities, revenue, and cost of sales for periods presented and on retained earnings at the beginning of the periods presented shall be eliminated to the extent possible.

805-50-45-3

The nature of and effects on earnings per share (EPS) of nonrecurring intra-entity transactions involving long-term assets and liabilities need not be eliminated. However, paragraph 805-50-50-2 requires disclosure.

805-50-45-4

Similarly, the receiving entity shall present the statement of financial position and other financial information as of the beginning of the period as though the assets and liabilities had been transferred at that date.

805-50-45-5

Financial statements and financial information presented for prior years also shall be retrospectively adjusted to furnish comparative information. All adjusted financial statements and financial summaries shall indicate clearly that financial data of previously separate entities are combined. However, the comparative information in prior years shall only be adjusted for periods during which the entities were under common control.

As described previously, generally a common control transaction involving the transfer of a business represents a change in reporting entity requiring retrospective adjustment of the combined financial statements. Conversely, a common control transaction involving the transfer of net assets that does not constitute a business or a noncontrolling interest (e.g., equity method investment) is not accounted for as a change in reporting entity and is therefore, accounted for prospectively. The Subsections of ASC 805-50 provide guidance on financial statement presentation when there has been a change in reporting entity and is similar to the pooling-of-interests method under APB 16.

C.4.2.1 Considerations for applying pooling-of-interests

Excerpt from Accounting Standards Codification

Business Combinations — Related Issues

Overview and Background

805-50-05-5

Some transfers of net assets or exchanges of shares between entities under common control result in a change in the reporting entity. In practice, the method that many entities have used to account for those transactions is similar to the pooling-of-interests method. The Transactions Between Entities Under Common Control Subsections provide guidance on preparing financial statements and related disclosures for the entity that receives the net assets.

Statement 141, *Business Combinations*, eliminated the application of pooling-of-interest method for business combinations, except as it related to common control transactions. While the pooling-of-interests method was not codified, ASC 805-50 refers to the application of the pooling-of-interests method for common control transactions that result in a change in reporting entity (i.e., the transfer of a business). The guidance below on the pooling-of-interests method is based on the guidance previously found in APB 16 and should be considered for common control transactions that result in a change in reporting entity requiring retrospective adjustment to the financial statements. The guidance is not applicable for a transfer of net assets or an exchange of equity interests that does not result in a change in reporting entity, which is accounted for prospectively at their carrying amounts.

The pooling-of-interests method accounts for the combination between two businesses under common control as the uniting of the ownership interests of the two entities. Procedures applied under the pooling-of-interests method are summarized in the following steps:

a. The assets and liabilities of the net assets or business transferred are carried forward at the carrying amounts of the ultimate parent or controlling shareholder. No adjustments are made to reflect fair values or recognize any new assets or liabilities for the periods presented that would otherwise be done under the acquisition method.

b. The equity accounts of the combining entities are combined.

   - The par value of the common stock issued by the receiving (issuing) entity to effect the combination is credited to the common stock account of the receiving entity. Adjustments may be required to reflect the par value of the receiving entity.

   - The retained earnings of the transferring entity are added to the retained earnings of the receiving entity.

   - Any difference between the consideration paid or transferred and the net assets "acquired" is reflected as an equity transaction (i.e., dividend or capital transaction).

c. Revenues and expenses of the combining entities (after eliminating intercompany transactions) are combined from the beginning of the period in which the combination occurs to the date the combination is completed. Income of the combined entity is reported subsequent to the combination date. The income statement reflects the results of the combining entities for the full year (provided the entities were under common control the full year), irrespective of when the combination took place.

d. Intercompany balances and transactions between the combining entities (and the related profits) prior to the combination are eliminated from the combined financial statements.

e. Comparatives are presented as if the entities had always been combined for periods when the combining entities were under common control.

f. No "new" goodwill is recognized as a result of the combination. The only goodwill that is recognized is any existing goodwill relating to either of the combining entities.

See section C.4.2.2 for additional considerations regarding identifying the ongoing reporting entity in common control transactions.

Illustration C-5: Pooling-of-interests — equity consideration

Assume Company A and Company B are businesses under common control. On 30 June 20X9, Company A issued 100 shares of its $1 par value common stock in exchange for all outstanding shares of common stock of Company B. Further assume Company A is considered the ongoing reporting entity.

Financial information of Company A and Company B as of 30 June 20X9 (immediately prior to the transaction) is as follows:

	Company A	Company B
Assets	$ 1,000	$ 500
Liabilities	400	100
Net assets	$ 600	$ 400
Equity:		
Common stock	$ 200	$ 150
Additional paid-in capital	100	50
Retained earnings	300	200
Total equity	$ 600	$ 400

On 30 June 20X9, Company A would need to record an entry for the $100 par value of equity shares issued. As the total amount of common stock and APIC accounts of Company B ($200) exceeds the par value of the common stock issued by Company A ($100), in consolidation Company A records the excess to APIC.

Common stock — Company B	$ 150	
APIC — Company B	50	
Common stock — Company A		$ 100
APIC — Company A		100

The adjusted financial information of Company A on 30 June 20X9 would be shown as follows:

	Company A	Adjustment	Consolidated Company A 30 June 20X9
Assets	$ 1,000	$ 500	$ 1,500
Liabilities	400	100	500
Net assets	$ 600	$ 400	$ 1,000
Equity:			
Common stock	$ 200	$ 100	$ 300
Additional paid-in capital	100	100	200
Retained earnings	300	200	500
Total equity	$ 600	$ 400	$ 1,000

Illustration C-6: Pooling-of-interests — cash consideration

Assume the same facts as illustrated at C-5 except that instead of Company A issuing 100 shares of common stock, assume Company A pays the shareholders of Company B cash of $100 in exchange for all outstanding shares of common stock of Company B. Company A would record the cash consideration and the difference between the historical cost of Company B as an equity transaction with its parent, as follows:

Historical cost of Company B	$ 400
Less: cash consideration	100
Equity transaction with its parent	$ 300

The adjusted financial information of Company A on 30 June 20X9 would be shown as follows:

	Combined financial information of companies A and B 30 June 20X9	Payment of cash	Adjustments to reflect the par value of Company A stock	Consolidated Company A 30 June 20X9
Assets	$ 1,500	$ (100)	$ -	$ 1,400
Liabilities	500	-	-	500
Net assets	$ 1,000	$ (100)	$ -	$ 900
Equity:				
Common stock	$ 350	$ -	$ (150)	$ 200
Additional paid-in capital	150	(100)	150	200*
Retained earnings	500	-	-	500*
Total equity	$ 1,000	$ (100)	$ -	$ 900

* The equity transaction with parent recorded by Company A of $ 300 is reflected by an increase in additional paid-in-capital of $100 (ending balance of $200 less beginning balance of $100), and an increase to retained earnings of $200 (ending balance of $500 less beginning balance of $300).

C.4.2.2 Determining the predecessor entity in certain common control transactions

The guidance in ASC 805-50, which addresses the procedural guidance for retrospectively adjusting the prior period financial statements, applies only to the periods in which the entities were under common control. Therefore, for periods in which the combining entities were not under common control, the financial statements presented are those of the entity that is determined to be the predecessor up to the date at which the entities became under common control.

If both entities were under common control during the entire period, it is not necessary to determine which entity is the predecessor entity because it has no effect on the retrospectively adjusted financial statements. However, careful consideration should be made when both entities were not under common control during the entire period presented in the retrospectively adjusted financial statements. At the 2006 AICPA National Conference on Current SEC and PCAOB Developments,[79] the SEC staff stated that the predecessor entity in a common control transaction generally is the entity that was first controlled by the parent. Therefore, for common control transactions, the predecessor entity is determined from the perspective of the ultimate parent or controlling shareholder. Because the parent controls the form of the transaction, different accounting should not result solely based on the legal form of the transaction.

[79] Leslie A. Overton, Associate Chief Accountant, Division of Corporate Finance, *Remarks before the 2006 AICPA National Conference on Current SEC and PCAOB Developments*, 12 December 2006.

Illustration C-7: Periods when the combining entities were not under common control

Parent owns 100% of the ownership interests of two voting interest entities — Subsidiary A, which was acquired in May 20X6, and Subsidiary B, which was acquired in July 20X7. In January 20X8, Subsidiary B issued additional shares to Parent in exchange for all of Parent's ownership interest in Subsidiary A.

Analysis

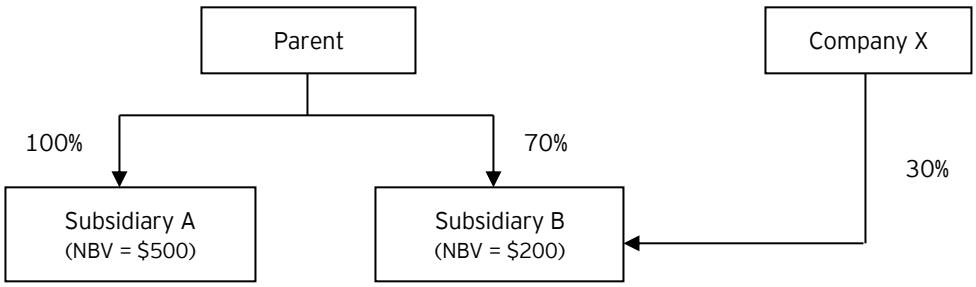
The merger of Subsidiary A and Subsidiary B is a common control transaction, and the prior periods financial statements are retrospectively adjusted to reflect the transaction as if it occurred at the beginning of the period Subsidiary A and Subsidiary B were under common control. Because the entities were not under common control for the entire period in which financial statements are required (three-year presentation), a predecessor entity must be identified. In this case, and despite the legal form of the transaction (i.e., Subsidiary B acquires Subsidiary A), the predecessor entity is Subsidiary A because it was controlled by Parent prior to Subsidiary B. As such, the financial statements for the period prior to July 20X7 (when Subsidiary A and Subsidiary B became under common control) reflect only Subsidiary A.

C.4.3 Noncontrolling interests in a common control transaction

In a common control transaction, any interests outstanding that are not held by the parties considered to be under common control are recognized in the consolidated financial statements as noncontrolling interests at their carrying amounts. The guidance in ASC 810-10 states that transactions with noncontrolling shareholders that do not involve the controlling shareholder losing control of the entity are recognized as equity transactions. As such, any changes in noncontrolling interests that result from the combination of entities under common control that does not result in a loss of control are accounted for as equity transactions. The carrying amount of the noncontrolling interest is adjusted to reflect the change in its ownership interest in the subsidiary. For further details on accounting for changes in noncontrolling interests see our FRD, ***Consolidation***.

Illustration C-8: Changes in noncontrolling interests in a common control transaction

Assume Parent owns 100% of Subsidiary A and 70% of Subsidiary B. Company X owns the 30% noncontrolling interest in Subsidiary B.

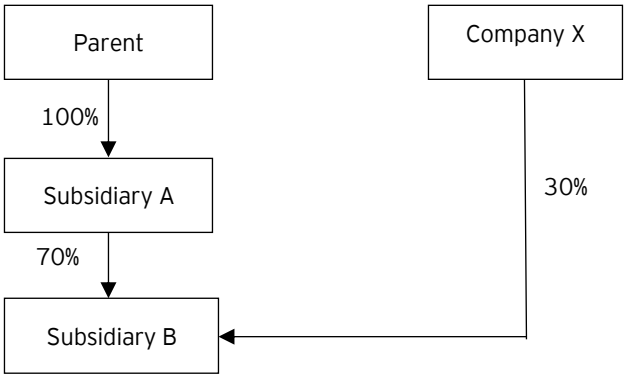


The Parent's consolidated financial statements reflect the following (assumes no fair value adjustments):

Net assets	$	700
NCI equity — Sub B ($200 NBV of Sub B * 30%)		60
Parent equity	$	640

Transaction 1:

Assume Parent transfers its 70% investment in Subsidiary B to Subsidiary A for cash equal to the carrying amount of Subsidiary B.



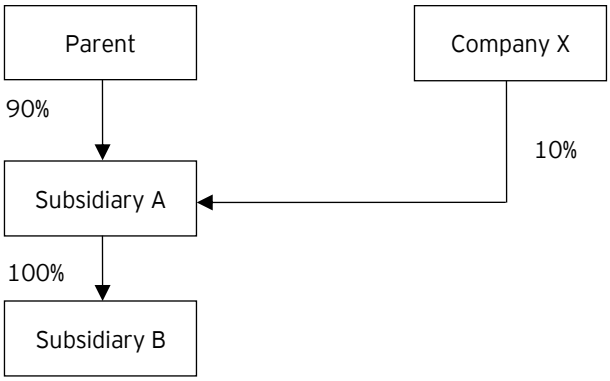
The transfer by Parent of its 70% investment in Subsidiary B to Subsidiary A is a common control transaction. The transaction would not affect Parent's consolidated financial statements. Subsidiary A would record the following journal entry in its standalone (consolidated) financial statements:

Net assets	$ 200	
Cash		$ 140
NCI equity – Sub B		60

Subsidiary A would account for the transaction similar to the pooling-of-interest method in its standalone (consolidated) financial statements and combine the results of operations of Subsidiary A and Subsidiary B as though the transfer had occurred at the beginning of the period. Comparative information in prior years would also be retrospectively adjusted for periods during which the entities were under common control.

Transaction 2:

Now assume that, as part of an integrated transaction as described above, Company X also exchanges its 30% interest in Subsidiary B for a 10% interest in Subsidiary A.



The exchange with Company X, a noncontrolling shareholder, does not result in Parent losing control. Therefore, the exchange is accounted for as an equity transaction.

The Parent would debit equity for $60 to eliminate its noncontrolling interest in Subsidiary B at its carrying amount. The Parent also would credit equity for $70 to record the noncontrolling interest in Subsidiary A at its carrying amount (calculated below). The change in noncontrolling interests is recorded to parent equity, as follows:

NCI equity – Sub B	$	60		
Parent equity		10		
NCI equity – Sub A			$	70

The $70 noncontrolling interest in Subsidiary A is calculated as follows:

10% of the $500 carrying amount of Subsidiary A's net assets	$	50
10% of the $200 carrying amount of Subsidiary B's net assets		20
Total	$	70

In summary, the Parent's consolidated financial statements reflect the following:

Net assets	$	700
NCI equity – Consolidated Sub A		70
Parent equity	$	630

Subsidiary A would record the following journal entry in its standalone (consolidated) financial statements to eliminate its noncontrolling interest in Entity B at its carrying amount:

NCI equity – Sub B	$	60		
Equity			$	60

The exchange of the noncontrolling interest is accounted for on the date the transaction occurs. We do not believe Subsidiary A would retrospectively adjust its standalone (consolidated) financial statements for Transaction 2.

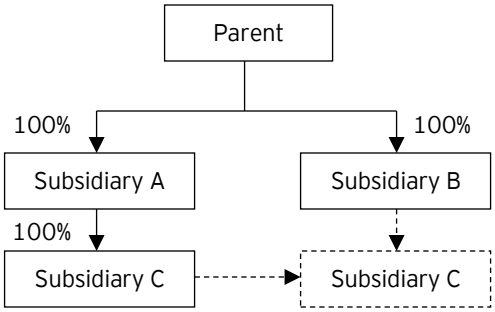
C.5 Accounting and reporting by the transferring entity

The procedural guidance on the combination of entities under common control included in ASC 805-50 addresses the accounting only from the perspective of the receiving entity. There is no specific guidance on how the transferring entity accounts for transactions between entities under common control.

As a transaction between entities under common control does not result in a change in control at the ultimate parent level, a new basis of accounting is not recognized by the receiving entity. It is for similar reasons that we generally would expect that the transferring entity would not recognize a gain or loss on the transaction. Any difference between the proceeds received by the transferring entity and the book value of the asset group (after impairment, if any) would be recognized as an equity transaction (i.e., dividend or capital transaction) and no gain or loss would be recorded.

Illustration C-9: Differences between proceeds received and carrying amount of net assets transferred

Parent has two wholly owned subsidiaries — Subsidiary A and Subsidiary B. Subsidiary A has a 100% ownership interest in Subsidiary C and prepares standalone (consolidated) financial statements. Subsidiary C meets the definition of a business, and the carrying amount of its net assets is $10 million. On 1 January 20X9, Subsidiary A transfers its 100% ownership interest in Subsidiary C to Subsidiary B for $12 million in cash. Assume there is no difference in the carrying amounts of the net assets of Subsidiary C as recorded by Subsidiary A and by Parent.



The transaction represents a transfer of a business between entities under common control. Subsidiary B (the receiving entity) would record the assets and liabilities received at the carrying amounts recorded by Subsidiary A with the excess paid over the carrying amount of $2 million recorded to equity as a deemed dividend. Subsidiary A would record the assets transferred as a disposal, with the excess proceeds of $2 million recorded as an equity transaction.

If Subsidiary A (the transferring entity) had transferred its interest in Subsidiary C to Subsidiary B for $8 million in cash, the difference between the proceeds received and the carrying amount of $2 million would be recorded as an equity transaction (i.e., a dividend) to Parent in Subsidiary A's standalone financial statements. This accounting assumes the asset group was not impaired.

C.5.1 Impairment considerations

Excerpt from Accounting Standards Codification

Property, Plant, and Equipment — Overall

Derecognition

360-10-40-4

For purposes of this Subtopic, a long-lived asset to be disposed of in an exchange measured based on the recorded amount of the nonmonetary asset relinquished or to be distributed to owners in a spinoff is disposed of when it is exchanged or distributed. If the asset (**asset group**) is tested for recoverability while it is classified as held and used, the estimates of future cash flows used in that test shall be based on the use of the asset for its remaining useful life, assuming that the disposal transaction will not occur. In such a case, an undiscounted cash flows recoverability test shall apply prior to the disposal date. In addition to any **impairment** losses required to be recognized while the asset is classified as held and used, an impairment loss, if any, shall be recognized when the asset is disposed of if the carrying amount of the asset (**disposal group**) exceeds its fair value. The provisions of this Section apply to nonmonetary exchanges that are not recorded at fair value under the provisions of Topic 845.

While the sale of net assets between entities under common control does not represent a nonreciprocal transfer with owners, given the lack of guidance for the accounting by the transferor, some have considered that guidance by analogy in determining the transferor's accounting in its standalone financial statements.

Some believe the transferring entity may account for the transfer of net assets as an asset disposal other than by sale, pursuant to ASC 360. Consistent with the guidance described in ASC 360-10-40-4, an asset (asset group) that constitutes a business that is distributed to owners in a spin-off[80] is to be measured based on the recorded amount of the nonmonetary asset relinquished or to be distributed when it is exchanged. The asset (asset group) that constitutes a business being disposed would be tested for recoverability as held and used (estimate of future cash flows based on the use of the asset for its remaining useful life, assuming that the disposal transaction will not occur). A loss on disposal would be recorded if the carrying amount of the asset (asset group) that constitutes a business exceeded its fair value. A pro rata distribution to owners of an investee accounted for under the equity method is to be considered to be equivalent to a spin-off.

Excerpt from Accounting Standards Codification

Nonmonetary Transactions — Overall

Initial Measurement

845-10-30-10

Accounting for the distribution of nonmonetary assets to owners of an entity in a spinoff or other form of reorganization or liquidation or in a plan that is in substance the rescission of a prior business combination shall be based on the recorded amount (after reduction, if appropriate, for an indicated impairment of value) (see paragraph 360-10-40-4) of the nonmonetary assets distributed. Subtopic 505-60 provides additional guidance on the distribution of nonmonetary assets that constitute a **business** to owners of an entity in transactions commonly referred to as spinoffs. A pro rata distribution to owners of an entity of shares of a **subsidiary** or other investee entity that has been or is being consolidated or that has been or is being accounted for under the equity method is to be considered to be equivalent to a spinoff. Other nonreciprocal transfers of nonmonetary assets to owners shall be accounted for at fair value if the fair value of the nonmonetary asset distributed is objectively measurable and would be clearly realizable to the distributing entity in an outright sale at or near the time of the distribution.

Based on the guidance provided in ASC 845-10-30-10, a distribution to owners in a spin-off that does not meet the definition of a business is to be measured at fair value if the fair value of the nonmonetary asset distributed is objectively measurable and would be clearly realizable to the distributing entity in an outright sale at or near the time of the distribution.

C.5.2 Financial statement presentation by the transferring entity

When accounting for a transfer of net assets under common control as a disposal of long-lived assets, a transferring entity should also consider whether that disposal should be reported as discontinued operations in accordance with the *Discontinued Operations* subtopic of ASC 205 in its standalone financial statements. Such an evaluation will require the use of judgment to determine whether the criteria for discontinued operations have been met. See our FRD, ***Discontinued operations: Accounting Standards Codification 205-20***, for further guidance.

[80] A spin-off is defined in US GAAP as "the transfer of assets that constitute a business by an entity (the spinnor) into a new legal spun off entity (the spinnee), followed by a distribution of the shares of the spinnee to its shareholders, without the surrender by the shareholders of any stock of the spinnor." ASC 505-60 provides further considerations regarding the accounting for spin-offs.

The requirement of the receiving entity to restate prior period financial statements is based on the concept that there has been a change in the reporting entity. Generally, we do not believe that the transfer of net assets or the exchange of equity interests between entities under common control results in a change in the reporting entity of the transferring entity (even if the assets transferred or shares exchanged constitute a business). As such, we do not believe that retrospective adjustment of the prior period financial statements (in the standalone financial statements of the transferring entity) to reflect the removal of the transferred net assets at their carrying amount is appropriate in most circumstances.

While not directly addressing common control transactions, the SEC staff expressed a similar view in SAB Topic 5.Z.7, in which the staff responded to the question of whether a company that disposes of a subsidiary in a spin-off may elect to characterize the spin-off as a change in the reporting entity and restate its historical financial statements as if the company never had an investment in the subsidiary. SAB Topic 5.Z.7 states:

> **Facts:** A Company disposes of a business through the distribution of a subsidiary's stock to the Company's shareholders on a pro rata basis in a transaction that is referred to as a spin-off.
>
> **Question:** May the Company elect to characterize the spin-off transaction as resulting in a change in the reporting entity and restate its historical financial statements as if the Company never had an investment in the subsidiary, in the manner specified by paragraph 34 of APB 20?
>
> **Interpretive response:** Not ordinarily. If the Company was required to file periodic reports under the Exchange Act within one year prior to the spin-off, the staff believes the Company should reflect the disposition in conformity with ASC 360. This presentation most fairly and completely depicts for investors the effects of the previous and current organization of the Company. However, in limited circumstances involving the initial registration of a company under the Exchange Act or Securities Act, the staff has not objected to financial statements that retroactively reflect the reorganization of the business as a change in the reporting entity if the spin-off transaction occurs prior to effectiveness of the registration statement. This presentation may be acceptable in an initial registration if the Company and the subsidiary are in dissimilar businesses, have been managed and financed historically as if they were autonomous, have no more than incidental common facilities and costs, will be operated and financed autonomously after the spin-off, and will not have material financial commitments, guarantees, or contingent liabilities to each other after the spin-off. This exception to the prohibition against retroactive omission of the subsidiary is intended for companies that have not distributed widely financial statements that include the spun-off subsidiary. Also, dissimilarity contemplates substantially greater differences in the nature of the businesses than those that would ordinarily distinguish reportable segments as defined by ASC 280.

While this topic does not directly address a change in reporting entity in a common control transaction, we believe the criteria presented are analogous to those that should be carefully considered when evaluating whether, from the transferring entity's perspective, there has been a change in reporting entity in a common control transaction. All criteria in the topic must be met for the transferring entity to conclude that it has a change in reporting entity, and the SEC staff often challenges a company's assertion that it has met all requirements. Therefore, it is more common for the transferring entity to conclude that the criteria are not met and account for the transfer as a disposal pursuant to ASC 360-10 and assess for discontinued operations reporting pursuant to ASC 205-20.

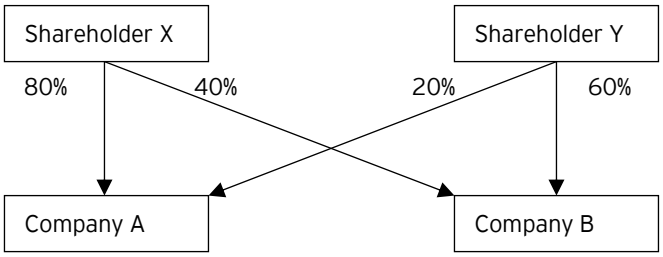
C.6 Transactions involving common ownership

When two or more entities have shareholders in common but no one shareholder controls the entities, the entities are said to have common ownership. Entities may have common ownership but not be under common control.

Illustration C-10: Identifying entities under common ownership

Assume Company A is owned 80% by Shareholder X and 20% by Shareholder Y. Company B is owned 40% by Shareholder X and 60% by Shareholder Y. Both Company A and Company B are voting interest entities (i.e., control is established through voting rights). Further assume Shareholders X and Y are not immediate family members nor do they have a written agreement to vote their shares in concert.

Ownership Interests	**Company A**	**Company B**
Shareholder X	**80%**	40%
Shareholder Y	20%	**60%**
	100%	100%



Company A and Company B are under common ownership but are not under common control because they are not controlled by the same shareholder or group. Shareholder X controls Company A and Shareholder Y controls Company B.

The accounting for a transaction between entities with common ownership is the same as the accounting for common control transactions (i.e., at carrying amounts) when shareholders would have exactly the same interest in the underlying businesses before and after the combination. Transactions in which shareholders have identical ownership interests before and after the transfer are accounted for in a manner similar to common control transactions because such transactions are considered to lack economic substance. For example, if the same two shareholders each owned 50% of both Company A and Company B, the combination of Companies A and B would reflect the combined assets and liabilities at their carrying amounts.

Illustration C-11: Transactions involving identical common ownership

Assume that Company A and Company B are owned 40% by Shareholder X and 30% by each of Shareholders Y and Z.

Analysis

Assuming no other exchanges of consideration or changes in relative ownership interests, a combination of Company A and Company B would result in the combined entity's assets and liabilities being recorded at their carrying amounts.

See section 20 of our FRD, ***Consolidation***, for further information on when combined financial statements may be appropriate for entities under common ownership.

C.6.1 Transactions *not* involving identical common ownership

When entities are under common ownership that is *not* identical, accounting for a transfer of net assets or exchange of equity interests between such entities will follow the guidance for asset acquisitions and business combinations in ASC 805. FTB 85-5 provided guidance for accounting for exchanges that lack commercial substance at their carrying amounts. While FTB 85-5 was nullified by Statement 141(R), *Business Combinations*, the SEC staff's historical position has been that a combination of entities under identical common ownership lacks economic substance. However, the SEC staff generally has not accepted accounting for combinations of entities that have *almost* identical common ownership at their carrying amounts. The SEC staff has permitted some exceptions to this general proposition when the relative ownership differences were clearly insignificant.

Illustration C-12: Transactions not involving identical common ownership

Company X enters into a transaction to acquire target Company Z and issues shares to purchase all of the outstanding stock of Company Z, which is a business. The ownership of Company X and Company Z is as follows:

Ownership Interests	Company X	Company Z
Shareholder A	60%	30%
Shareholder B	15%	20%
Shareholder C	15%	25%
Shareholder D	10%	25%
	100%	100%

Assume the shareholders are not immediate family members and do not have a written agreement to vote their shares in concert. Further assume that upon completion of the transaction, Shareholder A controls both Company X and Company Z.

Analysis

Prior to the transaction, Shareholder A controlled Company X and no shareholder controlled Company Z. Subsequent to the transaction, Shareholder A controls both Company X and Company Z. Under ASC 805, Company X (the accounting acquirer) would recognize the assets acquired, liabilities assumed and noncontrolling interests of Company Z (the accounting acquiree) as a business combination in accordance with the acquisition method as prescribed in ASC 805.

In situations involving transfers among entities with common ownership that is not identical but for which there is a change in control, the accounting would follow the guidance in ASC 805.

C.7 Income taxes

C.7.1 Deferred taxes

The guidance in ASC 805-50 does not specifically address the accounting for the deferred tax consequences that may result from a transfer of net assets or exchange of equity interests between entities under common control. Although Statement 141 eliminated the pooling-of-interest accounting alternative for business combinations, we believe that companies should apply the historical guidance in paragraphs 270-272 of Statement 109 (which was not codified), which addressed the income tax accounting effects of a pooling-of-interests transaction. For periods prior to the transfer or exchange date, deductible temporary differences and operating loss and tax credit carryforwards of one of the combining entities cannot offset taxable income of another combining entity because a consolidated tax return could not be filed for those periods. However, if the combining entities expect to file consolidated tax returns subsequent to the combination, the realizability of a deferred tax asset related to either of the combining entity's carryforwards and

deductible temporary differences in the restated period should be assessed presuming a consolidated tax return will be filed subsequent to the combination date. A valuation allowance would be recognized if it is more likely than not that a tax benefit will not be realized through offset of either (1) the other entity's deferred tax liability for taxable temporary differences that will reverse subsequent to the combination date or (2) combined taxable income subsequent to the combination date.

In this regard the valuation allowance recognized may be different than the sum of the valuation allowances in the separate financial statements of the combining entities prior to the combination date. The combining entities should evaluate deferred tax assets for realizability in each reporting period (including the restated periods prior to the combination date) and consider the facts and circumstances in existence at each balance sheet date. The general rule for a reduction in valuation allowances is the benefit is recognized as a component of income tax expense from continuing operations unless an exception applies.[81] This general rule is applicable to reductions in the valuation allowance of the combined entity in historical periods.

C.7.2 Tax basis differences

In a *taxable* transfer of net assets or exchange, the tax basis of the acquired company's assets and liabilities may be adjusted to fair value. Because a new basis is not established for book purposes, a change in tax basis results in temporary differences for which deferred taxes must be recognized. Based on the guidance in Statement 109, paragraph 272, we believe that as of the combination date, tax expense or benefit (including the effects of a valuation allowance, if necessary) resulting from changes in the tax basis are allocated to contributed capital. This allocation to contributed capital is consistent with accounting for the tax effects of transactions among or with shareholders. See section 15.3.6 in our FRD, ***Income taxes***, for further guidance.

C.8 Disclosures

The following disclosures are required in the standalone (consolidated) financial statements of the receiving entity in common control transactions under ASC 805-50.

Excerpt from Accounting Standards Codification

Business Combinations — Related Issues

Disclosure

805-50-50-2

The nature of and effects on earnings per share (EPS) of nonrecurring intra-entity transactions involving long-term assets and liabilities is not required to be eliminated under the guidance in paragraph 805-50-45-3 but shall be disclosed.

805-50-50-3

The notes to financial statements of the receiving entity shall disclose the following for the period in which the transfer of assets and liabilities or exchange of **equity interests** occurred:

a. The name and brief description of the entity included in the reporting entity as a result of the net asset transfer or exchange of equity interests

b. The method of accounting for the transfer of net assets or exchange of equity interests.

805-50-50-4

The receiving entity also shall consider whether additional disclosures are required in accordance with Section 850-10-50, which provides guidance on related party transactions and certain common control relationships.

[81] Section 15, *Intraperiod tax allocation*, of our FRD, ***Income taxes***, discusses exceptions to this general rule.

While the guidance on the combination of entities under common control included in ASC 805-50 addresses only the disclosures from the perspective of the receiving entity, we believe the transferring entity should consider similar disclosures.

C.9 Reporting unit and goodwill impairment

There is no specific guidance on the accounting by the transferring entity when a contribution of net assets or equity interests is made that constitute a business and is part of a larger reporting unit at a consolidated entity level. Pre-existing goodwill may have not been assigned at the transferring entity level; therefore, an appropriate method to allocate goodwill to the transferring entity needs to be made by the parent. For additional guidance on allocation of goodwill in a common control transaction, see section 3.14.2 before the adoption of ASU 2017-04 and section 3A.14.2 after the adoption of ASU 2017-04 of our FRD, ***Intangibles — goodwill and other***.

C.10 IFRS considerations

Like ASC 805, IFRS 3(R) provides a scope exemption for business combinations between entities under common control. However, unlike ASC 805, IFRS 3(R) does not go on to describe what method of accounting is appropriate when a business combination involves entities under common control.

Excerpt from Accounting Standards Codification

Business Combinations

IFRS 3(R) — Appendix B

B1 This IFRS does not apply to a business combination of entities or businesses under common control. A business combination involving entities or businesses under common control is a business combination in which all of the combining entities or businesses are ultimately controlled by the same party or parties both before and after the business combination, and that control is not transitory.

B2 A group of individuals shall be regarded as controlling an entity when, as a result of contractual arrangements, they collectively have the power to govern its financial and operating policies so as to obtain benefits from its activities. Therefore, a business combination is outside the scope of this IFRS when the same group of individuals has, as a result of contractual arrangements, ultimate collective power to govern the financial and operating policies of each of the combining entities so as to obtain benefits from their activities, and that ultimate collective power is not transitory.

B3 An entity may be controlled by an individual or by a group of individuals acting together under a contractual arrangement, and that individual or group of individuals may not be subject to the financial reporting requirements of IFRSs. Therefore, it is not necessary for combining entities to be included as part of the same consolidated financial statements for a business combination to be regarded as one involving entities under common control.

B4 The extent of non-controlling interests in each of the combining entities before and after the business combination is not relevant to determining whether the combination involves entities under common control. Similarly, the fact that one of the combining entities is a subsidiary that has been excluded from the consolidated financial statements is not relevant to determining whether a combination involves entities under common control.

IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*, requires that, in the absence of specific guidance in IFRS, management use its judgment in developing and applying an accounting policy that is relevant and reliable. In making that judgment, IAS 8 also states that in the absence of IFRS dealing with similar or related issues or guidance within the *Framework*,[82] management may also consider the most recent pronouncements of other standard-setting bodies that use a similar conceptual framework to develop accounting standards, to the extent that these do not conflict with the *Framework* or any other IFRS or Interpretation.

Accordingly, until the IASB prescribes an accounting method for common control transactions, we believe that entities should apply either the acquisition method (in accordance with IFRS 3(R)) or the pooling-of-interests method. We do not believe "fresh start accounting," whereby all combining businesses are restated to fair value, is an appropriate method for combinations between entities under common control.

In our view, when an entity selects the acquisition method of accounting, the transaction must have substance from the perspective of the reporting entity. Careful consideration is required of all of the facts and circumstances from the perspective of each entity before an entity concludes that a transaction has substance. If there is no substance to the transaction, the pooling-of-interests method is the only method that an entity may apply to that transaction.

For additional guidance on how to apply the acquisition method under IFRS 3(R) or how to apply the pooling-of-interests method, see chapter 10 of our International GAAP® (IGAAP) on common control business combinations. The IGAAP also provides guidance on evaluating whether a transaction has substance, whether control exists between family members and the meaning of transitory.

If the transaction is not a business combination because the entity or assets being acquired do not meet the definition of a business, it should be accounted for as an acquisition of assets in accordance with IFRS.

[82] *Framework for the Preparation and Presentation of Financial Statements*.

D Accounting alternatives

D.1 Overview

US GAAP allows private companies and NFPs to make several accounting policy elections (referred to as accounting alternatives) to simplify their accounting. Unless specified, references to business combinations throughout this appendix also include acquisitions by not-for-profit entities.

D.2 Definition of a private company, a public business entity and a not-for-profit entity

Excerpt from Accounting Standards Codification

Business Combinations — Identifiable Assets and Liabilities, and Any Noncontrolling Interest

Glossary

805-20-20

Pending Content:

Transition Guidance: 350-20-65-2

Private Company

An entity other than a **public business entity**, a **not-for-profit entity**, or an employee benefit plan within the scope of Topics 960 through 965 on plan accounting.

Public Business Entity

A public business entity is a business entity meeting any one of the criteria below. Neither a not-for-profit entity nor an employee benefit plan is a business entity.

a. It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing).

b. It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC.

c. It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer.

d. It has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market.

e. It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including notes) and make them publicly available on a periodic basis (for example, interim or annual periods). An entity must meet both of these conditions to meet this criterion.

An entity may meet the definition of a public business entity solely because its financial statements or financial information is included in another entity's filing with the SEC. In that case, the entity is only a public business entity for purposes of financial statements that are filed or furnished with the SEC.

Not-for-Profit Entity
An entity that possesses the following characteristics, in varying degrees, that distinguish it from a business entity:

a. Contributions of significant amounts of resources from resource providers who do not expect commensurate or proportionate pecuniary return

b. Operating purposes other than to provide goods or services at a profit

c. Absence of ownership interests like those of business entities.

Entities that clearly fall outside this definition include the following:

a. All investor-owned entities

b. Entities that provide dividends, lower costs, or other economic benefits directly and proportionately to their owners, members, or participants, such as mutual insurance entities, credit unions, farm and rural electric cooperatives, and employee benefit plans.

The FASB defined a private company as "an entity other than a public business entity, a not-for-profit entity, or an employee benefit plan within the scope of Topics 960 through 965 on plan accounting." Therefore, entities that are considering adopting an accounting alternative should carefully review the definition of a PBE because the definition includes several types of entities that would not be considered public under other definitions of a public company (or similar terms) in US GAAP. For example, the following entities would be considered PBEs and cannot use the accounting alternatives because their financial statements are included in a registrant's SEC filing:

- Significant acquirees under Rule 3-05 of Regulation S-X
- Significant equity method investees under Rule 3-09 of Regulation S-X
- Equity method investees whose summarized financial information is included in a registrant's SEC filing under Rule 4-08(g) of Regulation S-X

If an entity meets the definition of a PBE solely because its financial statements (or financial information) are included in another entity's SEC filing, the entity is a PBE for purposes of filing or furnishing information with the SEC (and therefore must adhere to PBE GAAP requirements in filings with the SEC). However, it can still elect the accounting alternatives in its standalone financial statements.

Because the definition of a PBE is broader than other definitions of a public entity (or similar terms) in GAAP, private companies should carefully evaluate whether they meet the definition of a private company, and whether they expect to continue to meet it for the foreseeable future. For example, if a company meets the definition of a private company (and therefore is currently eligible to apply the accounting alternatives) but later goes public, it would be required to retrospectively adjust its historical financial statements to comply with PBE GAAP, which could be costly and complex. For example, assume a private company adopts the goodwill amortization accounting alternative, as discussed in section D.3, and amortizes its goodwill over 10 years. If the private company were to later become a public business entity, it would be required to retrospectively adjust its financial statements to reverse the goodwill amortization that was recognized under the accounting alternative. It also would be required to test (or retest) its goodwill for impairment during each of the historical periods.

D.3 Goodwill amortization accounting alternative

US GAAP includes an accounting alternative (the goodwill amortization accounting alternative) that allows private companies and NFPs (as defined, and as further discussed in section D.2) to amortize goodwill and use a simplified one-step impairment test. See Appendix A of our FRD, ***Intangibles — goodwill and other***, for additional guidance on applying the goodwill amortization accounting alternative.

D.4 Intangible assets accounting alternative

D.4.1 Overview and scope

Excerpt from Accounting Standards Codification

Business Combinations — Identifiable Assets and Liabilities, and Any Noncontrolling Interest

Overview and Background

805-20-05-4

The Accounting Alternative Subsections of this Subtopic provide guidance for an entity within the scope of paragraph 805-20-15-2 that elects the accounting alternative for the recognition of identifiable intangible assets acquired in a business combination.

Scope and Scope Exceptions

805-20-15-1A

Paragraphs 805-20-15-2 through 15-4 and 805-20-25-29 through 25-33 provide guidance for an entity electing the accounting alternative in this Subtopic. See paragraph 805-20-65-2 for transition guidance for **private companies** and **not-for-profit entities** on applying the accounting alternative in this Subtopic.

805-20-15-2

A private company or not-for-profit entity may make an accounting policy election to apply the accounting alternative in this Subtopic. The guidance in the Accounting Alternative Subsections of this Subtopic applies when a private company or not-for-profit entity is required to recognize or otherwise consider the fair value of intangible assets as a result of any one of the following transactions:

a. Applying the acquisition method (as described in paragraph 805-10-05-4 for all entities and Subtopic 958-805 for additional guidance for not-for-profit entities)

b. Assessing the nature of the difference between the carrying amount of an investment and the amount of underlying equity in net assets of an investee when applying the equity method of accounting in accordance with Topic 323 on investments—equity method and joint ventures

c. Adopting fresh-start reporting in accordance with Topic 852 on reorganizations.

805-20-15-3

An entity that elects the accounting alternative shall apply all of the related recognition requirements upon election. The accounting alternative, once elected, shall be applied to all future transactions that are identified in paragraph 805-20-15-2.

US GAAP includes an accounting alternative (the intangible assets accounting alternative) that allows a private company or an NFP to limit the customer-related intangibles it recognizes to those that are capable of being sold or licensed independently from the other assets of the business. As a result, private companies and not-for-profit entities that elect the accounting alternative will subsume many of the types of customer-related intangible assets that they recognize separately under ASC 805 into goodwill. Under this accounting alternative, private companies and not-for-profit entities also wouldn't separately recognize noncompetition agreements acquired as part of the transaction.

Once elected, the intangible assets accounting alternative applies to (1) all future business combinations, (2) all future equity method investments for identifying basis differences, as discussed in section 5.4 of our FRD, ***Equity method investments and joint ventures***, and (3) any transactions in which fresh-start accounting is applied. That is, the intangible assets accounting alternative is an accounting policy choice that must be applied consistently to all future qualifying transactions.

D.4.1.1 Interaction with the goodwill amortization accounting alternative

Excerpt from Accounting Standards Codification

Business Combinations — Identifiable Assets and Liabilities, and Any Noncontrolling Interest

Scope and Scope Exceptions

805-20-15-4

An entity that elects this accounting alternative must adopt the accounting alternative for amortizing **goodwill** in the Accounting Alternatives Subsections of Topic 350-20 on intangibles—goodwill and other. If the accounting alternative for amortizing goodwill was not adopted previously, it should be adopted on a prospective basis as of the adoption of the accounting alternative in this Subtopic. For example, upon adoption, existing goodwill should be amortized on a straight-line basis over 10 years, or less than 10 years if the entity demonstrates that another useful life is more appropriate. However, an entity that elects the accounting alternative for amortizing goodwill is not required to adopt the accounting alternative in this Subtopic.

Private companies and not-for-profit entities that elect the intangible assets accounting alternative also are required to elect the goodwill amortization accounting alternative, which requires goodwill to be amortized over a period of 10 years or less (further discussed in section D.3). However, private companies and not-for-profit entities that elect the goodwill amortization accounting alternative are not required to elect the intangible assets accounting alternative.

The election of the intangible assets accounting alternative is linked to the election of the goodwill amortization accounting alternative to avoid subsuming intangible assets that are finite-lived in nature into indefinite-lived goodwill, because doing so would make financial reporting less meaningful and increase the risk of goodwill impairment.

D.4.2 Recognition

Excerpt from Accounting Standards Codification

Business Combinations — Identifiable Assets and Liabilities, and Any Noncontrolling Interest

Recognition

805-20-25-1

As of the **acquisition date**, the **acquirer** shall recognize, separately from **goodwill**, the **identifiable** assets acquired, the liabilities assumed, and any **noncontrolling interest** in the **acquiree**. Recognition of identifiable assets acquired and liabilities assumed is subject to the conditions specified in paragraphs 805-20-25-2 through 25-3. However, an entity (the acquirer) within the scope of paragraph 805-20-15-2 may elect to apply the accounting alternative for the recognition of identifiable intangible assets acquired in a business combination as described in paragraphs 805-20-25-29 through 25-33.

805-20-25-30

An **intangible asset** is **identifiable** if it meets either the separability criterion or the contractual-legal criterion described in the definition of identifiable. However, under the accounting alternative, an **acquirer** shall not recognize separately from **goodwill** the following intangible assets:

a. Customer-related intangible assets unless they are capable of being sold or licensed independently from other assets of a business

b. Noncompetition agreements.

If an entity elects the intangible assets accounting alternative, it would limit customer-related intangibles that are recognized separately to those that are capable of being sold or licensed independently from the other assets of the business. As such, companies that elect the alternative will subsume into goodwill many of the types of customer-related intangible assets that would otherwise be recognizable under ASC 805. See section D.4.2.1. In addition, an entity that elects the intangible assets accounting alternative would not separately recognize noncompetition agreements that are acquired as part of the business combination. See section D.4.2.2.

D.4.2.1 Application of the intangible assets accounting alternative to customer-related intangible assets

Excerpt from Accounting Standards Codification

Business Combinations — Identifiable Assets and Liabilities, and Any Noncontrolling Interest

Recognition

805-20-25-31

Customer-related intangible assets often would not meet criterion (a) in paragraph 805-20-25-30 for recognition. Customer-related intangible assets that would meet that criterion for recognition under this accounting alternative are those that are capable of being sold or licensed independently from the other assets of a business. Examples of customer-related intangible assets are listed in paragraph 805-20-55-20. Many of the customer-related intangible assets that would meet criterion (a) for recognition also would be considered contract-based intangible assets as described in paragraph 805-20-55-31. Customer-related intangible assets that may meet that criterion for recognition include but are not limited to:

a. Mortgage servicing rights

b. Commodity supply contracts

c. Core deposits

d. Customer information (for example, names and contact information).

The intangible assets accounting alternative includes a presumption that customer-related intangibles would not meet the criterion for separate recognition because they typically aren't capable of being sold or licensed separately from other assets. However, the guidance lists mortgage servicing rights, commodity supply contracts, core deposits and customer information (e.g., names and contact information) as examples of customer-related intangible assets that may meet this criterion.

Illustration D-1:	**Application of the intangible assets accounting alternative to customer-related intangible asset**

Company A acquires Target. Target has a practice of establishing customer relationships through contracts. In addition, Target operates in jurisdiction with confidentiality rules that prohibits the sale or transfer of these contracts. Company A is not a PBE and applies the intangible assets and goodwill amortization accounting alternatives.

Analysis

The customer relationships meet the contractual-legal criterion and therefore, would be recognized separately from goodwill under PBE GAAP. However, under the intangible assets accounting alternative, because the customer relationships aren't capable of being sold or licensed separately from other assets, Company A would not recognize them separately from goodwill. Therefore, Company A would subsume the customer relationships into goodwill, which would be amortized over 10 years or less under the goodwill amortization accounting alternative.

D.4.2.1.1 Off-market components

In some cases, a customer contract may include terms that are either favorable or unfavorable relative to market terms (generally referred to in practice as the off-market component). The off-market component of a favorable customer contract would be eligible to be subsumed into goodwill because it is an intangible asset. However, the off-market component of an unfavorable customer contract would not be eligible to be subsumed into goodwill because it is a liability and the scope of the intangible assets accounting alternative only includes items that would otherwise be recorded as an intangible asset.

Illustration D-2:	**Application of the intangible assets accounting alternative to customer-related intangible asset to off-market components**

Assume same facts as illustration D-1. In addition, Target had numerous long-term supply and service contracts with its customers in place as of the acquisition date. The contracts were entered into in different points in time and, therefore, as of the acquisition date, some are favorable and some are unfavorable to Target.

Analysis

The supply and service contracts meet the contractual-legal criterion and therefore, the off-market components would have been recognized separately from goodwill under PBE GAAP. However, under the intangible assets accounting alternative, because the contracts aren't capable of being sold or licensed separately from other assets, Company A would not recognize intangible assets for off-market components of favorable contracts separately from goodwill. Therefore, Acquirer would subsume those customer relationships into goodwill, which would be amortized over 10 years or less under the goodwill accounting alternative. Liabilities for off-market components of unfavorable contracts are not subject to the intangible assets accounting alternative and would be recognized separately from goodwill.

D.4.2.1.2 Contract assets and leases

Excerpt from Accounting Standards Codification

Business Combinations — Identifiable Assets and Liabilities, and Any Noncontrolling Interest

Recognition

805-20-25-32

Contract assets, as used in Topic 606 on revenue from contracts with customers, are not considered to be customer-related intangible assets for purposes of applying this accounting alternative. Therefore, contract assets are not eligible to be subsumed into goodwill and shall be recognized separately.

805-20-25-33

A **lease** is not considered to be a customer-related intangible asset for purposes of applying this accounting alternative. Therefore, favorable and unfavorable leases are not eligible to be subsumed into goodwill and shall be recognized separately.

Contract assets, as defined in ASC 606, and leases are not considered customer-related intangible assets and therefore would not be eligible to be subsumed into goodwill. Instead, any contract asset or favorable or unfavorable component of the lease would be separately recognized. A contract asset is not a customer-related intangible asset because the contract asset will be reclassified as a receivable when all performance obligations are satisfied.

D.4.2.2 Application of the intangible assets accounting alternative to noncompetition agreements

The intangible assets accounting alternative applies only to noncompetition agreements acquired as part of a business combination. In some cases, a noncompetition agreement may be entered into between the buyer and seller contemporaneously with the business combination. If a noncompetition agreement is deemed not to be a part of the business combination (which is often the conclusion when it is entered into contemporaneously with the transaction), it would not be subject to the accounting alternative and the private company or not-for-profit entity would account for the noncompetition agreement as a transaction separate from the business combination. See section 4.2.5.3.1.1, for further guidance on when a noncompetition agreement is part of or separate from the business combination.

Illustration D-3: Application of the intangible assets accounting alternative to noncompetition agreements

Company A acquires Target. In connection with a business combination, Company A enters into a noncompetition agreement (agreement A) with one of Target's shareholders who is the CFO of the Target but will not be employed by Company A after the acquisition. In addition, Target has a pre-existing noncompetition agreement with a former CEO of its subsidiary which it acquired a year before the acquisition by Company A (agreement B). Company A is not a PBE and applies the intangible assets and goodwill amortization accounting alternatives.

Analysis

Company A first determines whether the noncompetition agreements should be considered part of or separate from the business combination. Agreement A was entered into contemporaneously with the business combination and considered primarily for the benefit of Company A. Therefore, agreement A is accounted for as a transaction separate from the business combination. Agreement B was a pre-existing agreement related to a past acquisition by Target and is therefore considered an assumed contract as part of the business combination.

Because agreement A is accounted for as a transaction separate from the business combination, it is not subject to the intangible assets accounting alternative and consideration would be given to recognition as an intangible asset separate from the business combination.

Agreement B would have been recognized separately from goodwill under PBE GAAP, because it meets the contractual-legal criterion. However, under the intangible assets accounting alternative, Company A would not recognize agreement B separately from goodwill. Therefore, Company A would subsume agreement B into goodwill, which would be amortized over 10 years or less under the goodwill amortization accounting alternative.

D.4.3 Transition requirements

Excerpt from Accounting Standards Codification

Business Combinations — Identifiable Assets and Liabilities, and Any Noncontrolling Interest

Transition Related to Accounting Standards Update No. 2014-18, Business Combinations (Topic 805): Accounting for Identifiable Intangible Assets in a Business Combination, and No. 2019-06, Intangibles—Goodwill and Other (Topic 350), Business Combinations (Topic 805), and Not-for-Profit Entities (Topic 958): Extending the Private Company Accounting Alternatives on Goodwill and Certain Identifiable Intangible Assets to Not-for-Profit Entities

805-20-65-2

The following represents the transition information related to Accounting Standards Updates No. 2014-18, *Business Combinations (Topic 805): Accounting for Identifiable Intangible Assets in a Business Combination*, and No. 2019-06, *Intangibles—Goodwill and Other (Topic 350), Business Combinations (Topic 805), and Not-for-Profit Entities (Topic 958): Extending the Private Company Accounting Alternatives on Goodwill and Certain Identifiable Intangible Assets to Not-for-Profit Entities*, referenced in paragraph 805-20-15-1A:

a. Upon adoption of the Accounting Alternative Subsections of this Subtopic, that guidance shall be effective prospectively to the first transaction that is identified in paragraph 805-20-15-2 after the adoption of the accounting alternative.

b. Customer-related intangible assets and noncompetition agreements that exist as of the beginning of the period of adoption shall continue to be subsequently measured in accordance with Topic 350 on intangibles—goodwill and other. That is, existing customer-related intangible assets and noncompetition agreements should not be subsumed into goodwill upon adoption of the Accounting Alternative Subsections of this Subtopic.

c. Subparagraph superseded by Accounting Standards Update No. 2016-03.

d. A private company or not-for-profit entity that makes an accounting policy election to apply the guidance in the Accounting Alternative Subsections of this Subtopic for the first time need not justify that the use of the accounting alternative is preferable as described in paragraph 250-10-45-2.

Once elected, the intangible assets accounting alternative applies to all subsequent business combinations under ASC 805 and when applying fresh-start accounting under ASC 852. It also applies to allocation of basis differences when an equity method investment is acquired subsequent to the election (see section 5.4 of our FRD, ***Equity method investments and joint ventures***).

An entity would apply the intangible assets accounting alternative prospectively to the first qualifying transaction after the alternative is elected.

A private company or not-for-profit entity would not change its accounting for intangible assets that exist prior to adopting the intangible assets accounting alternative. That is, existing customer-related intangible assets and noncompetition agreements should not be subsumed into goodwill upon adoption of the accounting alternative.

A private company or not-for-profit entity that makes an accounting policy election to apply the intangible assets accounting alternative for the first time (and, if not previously adopted, also adopts the goodwill amortization accounting alternative) may forgo a preferability assessment (i.e., the company need not justify that the use of the accounting alternative is preferable as described in ASC 250-10-45-2). However, any change in accounting policy after an entity initially elects the accounting alternative will require a preferability assessment. Refer to our FRD, ***Accounting changes and error corrections***, for further discussion on preferability assessments.

E Internal control over financial reporting in a business combination

E.1 Introduction

Accounting for business combinations can be complex. An entity may infrequently enter into business combinations, and each acquisition may include different elements that must be accounted for depending on the nature of the business acquired. Thus, business combinations inherently represent a greater risk to financial reporting. Entities need to consider internal controls over business combinations in management's evaluation of the effectiveness of ICFR.

Controls with respect to accounting for a business combination should be designed and implemented to address risks of material misstatement to the financial statements at both a financial statement account and assertion[83] level. Management should assess the risk of a material misstatement for each transaction and may need to reassess the design of their ICFR for each business combination, including whether policies and procedures are sufficiently robust and well-defined, and the corresponding controls sufficiently address the risks of material misstatement.

Management of an acquirer must assess the effectiveness of controls and procedures related to the accounting for a business combination as part of its overall assessment of the effectiveness of ICFR. However, SEC registrants may exclude controls related to the acquired processes of the business from management's evaluation of the effectiveness of ICFR for the first year after an acquisition when it is not possible to conduct an assessment in the period between the consummation date and the date of management's assessment.[84]

E.2 Management review controls

Entities often identify controls to address the risks of material misstatement in a business combination that rely on reviews performed by management (management review controls). Those controls must be designed with sufficient precision to address the risks of material misstatement associated with a business combination. A single identified control may not be designed to address all of the risks of material misstatement for a business combination. Therefore, it may be necessary to identify and evaluate a broader suite of management review and other controls.

For example, senior management might review the classification and measurement of the consideration transferred in a business combination as part of its review of the overall accounting treatment. However, other members of management might analyze specific elements of the consideration transferred to determine whether a portion of the consideration represents a transaction separate from the business combination (e.g., compensation for future services). In this case, the second set of management review controls directly addresses the risk that consideration transferred by the acquirer is not properly classified and measured and together with the reviews performed by senior management addresses risks associated with the identification and classification of consideration.

---

[83] Some jurisdictions may describe financial statement assertions using such terms such as "existence or occurrence," "completeness, valuation or allocation," "rights and obligations," and "presentation and disclosure." *The 2013 Committee of Sponsoring Organizations of the Treadway Commission (COSO) Internal Control — Integrated Framework, Chapter 6 — Risk Assessment, Footnote 12.*

[84] SEC Division of Corporation Finance, Compliance and Disclosure Interpretations, Sarbanes-Oxley Act Section 404 and Related Rules, Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Frequently Asked Questions (revised September 24, 2007), Question 3.

In another example, senior management's review of an internal or third-party valuation report will also include consideration of the design and operating effectiveness of controls over the determination of significant assumptions the entity used to develop the PFI used in the valuation. However, it is likely that other management review controls address the reasonableness of each key assumption and the completeness and accuracy of the information used to develop the PFI. When other controls are important to the effective functioning of a management review control at a sufficient level of precision to address the risks of material misstatement, these controls also should be evaluated as a part of management's evaluation of ICFR.

Guidance on the evaluation of ICFR is included in:

- The 2013 Committee of Sponsoring Organizations of the Treadway Commission (COSO) Internal Control — Integrated Framework (the COSO Framework) — This document is recognized as a leading framework for designing, implementing and conducting internal control and assessing its effectiveness.
- Commission Guidance Regarding Management's Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934 (the Commission's guidance) (SEC Release No. 33-8810) — Published by the SEC in June 2007, this document provides guidance for management on evaluating ICFR.

Both resources contain guidance for management on topics including applying a risk-based approach when identifying relevant controls and gathering appropriate evidence of control effectiveness (i.e., determining the sufficiency of evidence based on ICFR risk). These concepts apply broadly to all controls, and as such, should be also applied to management review controls. In addition, both the Commission's guidance and the COSO Framework contain specific guidance for management review controls.

E.2.1 Assessing design effectiveness

As part of assessing the design and operating effectiveness of its controls over business combinations, management should assess the precision of the management review controls (i.e., their ability to individually, or in combination with other controls, detect and correct errors that could result in material misstatement of the financial statements). Evaluating precision includes understanding how the reviewer develops expectations to guide his or her review and understanding and evaluating the criteria used by the control owners to identify items for investigation and determine that errors and other identified matters are ultimately resolved. If control descriptions use qualitative criteria to identify items for investigation, such as analyses are reviewed for "significant and unusual items" or "for reasonableness," management should evaluate whether such criteria are sufficient and able to support the consistent and effective operation of the control.

SEC guidance states that management must maintain reasonable support for its internal control assessment, and documentation of the design of the controls is an integral part of reasonable support. Management should make sure it has a thorough understanding of the SEC guidance (referenced in section E.2) and the level of documentation necessary to support its controls.

Further, Principle 12 of the COSO Framework says that while unwritten policies can be effective in certain circumstances, such as when the policy is long-standing and well understood, policies and procedures subject to external party review would be expected to be formally documented. Therefore, a lack of written documentation or other readily available evidence may be a design deficiency.

Management also should understand what data and reports are used in the control (e.g., reports, information downloaded from a system into Excel), the systems that information is generated from and how the reviewer knows that the information is complete and accurate.

When evaluating the design of a management review control, management should consider whether it addresses all of the underlying risks. Management generally identifies multiple management review controls that collectively address the various risks of material misstatement associated with each step in

a business combination. Alternatively, management may design a single management review control that addresses the various WCGWs associated with each step in a business combination. For example, senior management might review an accounting memorandum that details the basis for the entity's conclusions regarding its accounting for a business combination. If this management review control is intended to address the various risks of material misstatement associated with the entire business combination, the control should be designed to ensure that each step of the business combination has been properly accounted for in accordance with the applicable accounting guidance.

E.3 Steps in a business combination

The risks of misstatement in a business combination primarily arise when an entity (1) approves the transaction; (2) determines whether the transaction is a business combination; (3) identifies the acquirer; (4) determines the acquisition date; (5) identifies, classifies and measures the consideration transferred; (6) recognizes and measures the identifiable assets acquired, liabilities assumed and any noncontrolling interests in the acquiree; (7) recognizes and measures goodwill or a gain from a bargain purchase; and (8) recognizes any subsequent adjustments.

The following table lays out potential risks and considerations in the design of controls that could mitigate those risks for each step of a business combination. The considerations we discuss are examples. In practice, the considerations should be customized based on the facts and circumstances, including the design of controls, specific to the entity. While it is necessary to consider the entire process when designing controls, it is important that management specifically identifies where the control occurs within the process rather than defining the entire process as the control itself.

Step	Risks	Control design considerations
Approve the transaction	▸ The transaction is not presented to the Board of Directors (BOD) or others with appropriate levels of authority for approval.	▸ What is the approval process and who has the authority to approve acquisition transactions?
Determine whether the transaction is a business combination (see section 2)	▸ The acquisition is accounted for as a business combination, but does not meet the definition of a business combination in ASC 805.	▸ What is the process for determining whether the acquisition should be accounted for as a business combination (rather than as an asset acquisition, common control transaction, transaction under common ownership)?
Identify the acquirer (see section 3.2)	▸ The accounting acquirer is not properly identified.	▸ What is the process for determining whether the acquisition should be accounted for as a business combination (rather than as an asset acquisition, common control transaction, transaction under common ownership)?
Determine the acquisition date (see section 3.3)	▸ The acquisition is not accounted for on the appropriate date.	▸ What is the process to determine the date in which the acquiring entity obtained control of the business?
Recognize and measure the identifiable assets acquired, liabilities assumed and any noncontrolling interests in the acquiree (see section 4)	▸ Assets acquired and liabilities assumed are not properly identified. ▸ Assets acquired and liabilities assumed are not properly recognized and measured. ▸ The valuation of assets acquired and liabilities assumed is performed by an internal or third-party valuation specialist who does not have the appropriate skills and expertise.	▸ What is the process to ensure all assets acquired and liabilities assumed have been identified (e.g., intangibles, contingencies) and exist (e.g., inventory)? ▸ After the adoption of ASU 2021-08, what is the acquirer's process to assess the target's accounting under ASC 606? When the acquirer cannot recognize the acquired contract assets and contract liabilities in the business combination at amounts consistent with those reported by the target immediately before the acquisition date, what is the acquirer's process to reevaluate the target's ASC 606 accounting for contract assets acquired and liabilities assumed at the acquisition date?

Step	Risks	Control design considerations
	▸ Key assumptions used in the valuation and development of PFI are unreasonable or not supported by the facts and circumstances. ▸ See section E.4 for further discussion of internal control considerations for valuation analyses.	▸ What is the process to determine the fair value of assets acquired and liabilities assumed (including the reasonableness of assumptions and estimates used in the valuation, such as PFI)? ▸ Who performs the fair value measurement and do these individuals have the appropriate skills and expertise? ▸ What procedures are performed to evaluate the reasonableness of the fair value measurement? Do the individuals performing the evaluation have the appropriate skills and expertise and is there segregation of incompatible duties? ▸ When valuations are based on PFI, who develops this information and who reviews it? Who determines that the PFI is consistent with the PFI used for other purposes (e.g., board model created during due diligence procedures)? ▸ Who evaluates the methods and assumptions used by the specialist for reasonableness and what is involved in that review? ▸ When external specialists are used, what is the process to ensure the information provided by the specialist is accurate and complete? ▸ See section E.4 for further discussion of internal control considerations for valuation analyses.
Identify, classify and measure the consideration transferred (see section 6)	▸ The consideration transferred by the acquirer is not properly identified. ▸ The consideration transferred by the acquirer is not properly measured. See section E.4 for further discussion of internal control considerations for valuation analyses. ▸ The consideration transferred by the acquirer is not properly authorized. ▸ The value of share-based payment replacement awards is not properly attributed to consideration transferred and post-combination compensation expense. ▸ The consideration transferred includes items that should be accounted for as separate transactions (e.g., transaction costs or compensation to employees or former owners for future services). ▸ The contingent consideration is not properly classified as a liability or equity.	▸ What is the approval process and who has the authority to approve the various forms of consideration transferred? ▸ What is the process to identify and evaluate transactions that should be accounted for separately from the business combination (e.g., settlements of preexisting relationships, compensation to employees or former owners for future services, reimbursement to acquiree for acquisition-related costs)? ▸ What is the process to identify and evaluate the accounting for share-based payment replacement awards including the implications of any change in control provisions either in the acquiree award or purchase agreement? ▸ What is the process to verify that the consideration transferred (including any contingent consideration and share-based payment replacement awards) is accurately measured (including the reasonableness of assumptions and estimates used in the valuation, such as PFI) as of the acquisition date? See section E.4 for further discussion of internal control considerations for valuation analyses. ▸ What is the process to determine the appropriate classification of contingent consideration as either a liability or equity?

Step	Risks	Control design considerations
Recognize and measure goodwill or a gain from a bargain purchase (see sections 7.1 and 7.2)	▸ Recognized goodwill or a bargain purchase does not agree with underlying support or is not calculated correctly. ▸ Noncontrolling interest is not properly measured and recorded. ▸ Previously held equity interests in the acquired entity and any related gain or loss are not properly measured or recorded.	▸ What is the process to verify that any goodwill or a gain from a bargain purchase is properly measured and recorded? ▸ What is the process to determine the fair value of any noncontrolling interest in the acquired entity? ▸ What is the process to determine the fair value of any previously held equity interest in the acquired entity? ▸ If the transaction results in a gain from a bargain purchase, is a thorough reassessment performed of all elements of the accounting for the acquisition? How is that reassessment performed? ▸ If after the thorough reassessment a bargain purchase gain still exists, what are the reasons that would justify the bargain purchase gain?
Recognize any subsequent adjustments (see section 7.3)	▸ Subsequent adjustments to the provisional amounts recorded at the acquisition date are not valid measurement period adjustments. ▸ Subsequent adjustments to the provisional amounts recorded at the acquisition date are not properly recorded.	▸ What is the process to verify that subsequent adjustments to the provisional amounts recorded at the acquisition date represent valid measurement period adjustments? ▸ What is the process to determine whether the measurement of an individual asset or liability is still provisional?

E.4 Internal control considerations for valuation analyses

Fair value measurement[85] requires significant judgment. Internal controls over valuation in a business combination (e.g., relating to valuing individual assets acquired and liabilities assumed, consideration transferred) should consider the appropriateness of the methods, assumptions and data used. When PFI is used to value a business combination (i.e., estimates of future cash flows of a business, operating unit or asset group and discounting those cash flows to develop a valuation at a particular date), controls over the development of the PFI also should be identified.

Many entities engage a specialist to determine valuations in a business combination because they do not have personnel with the valuation expertise. However, management is ultimately responsible for the appropriateness of the accounting and reporting of the valuation, including the underlying assumptions. Management also is responsible for implementing effective controls over the completeness and accuracy of the data provided to and received from specialists. Management should identify a valuation approach that is appropriate in the context (e.g., scope, specific facts and circumstances, standard of value,[86] premise of value).[87]

[85] The guidance in ASC 805 includes certain recognition and measurement exceptions to the general principle that assets acquired and liabilities assumed are measured at their acquisition date fair value. The exceptions are discussed in detail in section 4.

[86] The identification of the type of value being used in a specific engagement (e.g., fair market value, fair value, investment value).

[87] An assumption regarding the most likely set of transactional circumstances that may be applicable to the subject valuation (e.g., going concern, liquidation).

When the income approach is used in a valuation analysis, entities should consider the risks and the design of controls for the following (as applicable and where these areas represent a risk of material misstatement):

- Developing key assumptions applied to specific components of financial forecast. The table below lists typical components of a financial forecast and examples of assumptions applied to the components:

Component	Example assumptions
Revenue	▸ Annual revenue growth rates
Gross margin	▸ Annual gross margins as a percentage of revenue
Selling, general and administrative (SG&A) expense	▸ Annual SG&A as a percentage of revenue
EBITDA	▸ Annual EBITDA margins
Depreciation and amortization expense	▸ Annual depreciation and amortization as percentage of revenues
Income taxes	▸ Annual effective tax rate
Capital expenditures	▸ Annual effective tax rate
Capital expenditures	▸ Annual capital expenditures as a percentage of revenues
Debt-free net working capital requirements	▸ Annual debt-free net working capital requirements as a percentage of revenues

- Developing assumptions applied to the overall financial forecast or applied to specific components of the financial forecast, such as:
  - Discount rate
  - Weighted average cost of capital
  - Terminal growth rate
  - Customer attrition rate
  - Probability of technical success (e.g., for in-process research and development)
  - Royalty rate (e.g., for use of a trade name)
  - Contributory asset charges
- The process for evaluating revenue and cost synergies and challenging whether those synergies would be available to a market participant
- The process for reconciling the internal rate of return, weighted average cost of capital and weighted average return on assets
- The process for ensuring the clerical accuracy of the calculation
- The process for ensuring that the data used in the valuation is complete and accurate

When the market approach is used in a valuation analysis, entities should consider the risks and the design of controls for the following (as applicable and where these areas represent a risk of material misstatement):

- The selection of guideline entities and/or transactions
- The selection of comparable public entity data
- The multiples selected for the valuation

Many underlying assumptions are interrelated. As part of the design of its controls over valuation, management should consider procedures to evaluate whether assumptions supporting key components are consistent with other assumptions supporting PFI. For example, a slowdown in economic activity typically will not only cause a slowdown in sales volume but may also affect sales prices and the availability and cost of resources. The conditions assumed in arriving at the prospective revenue data should be consistent with conditions assumed in developing the prospective financial data for the cost of operations. Furthermore, the assumptions supporting the PFI should be consistent with other assumptions within the model used to develop the fair value measurement. For example, to avoid double counting or omitting the effects of risk factors, discount rates should reflect assumptions that are consistent with those inherent in the cash flows.

In addition, the PFI used in the valuation generally should be the same as PFI used in other analyses throughout the organization (e.g., forecasts shared with the board of directors or the analyst community). Management should consider designing procedures as part of its controls over valuation to verify that PFI is used consistently.

E.5 Controls to consider that may be within other processes

Accounting for a business combination and assessing the related internal controls over financial reporting may cross a number of different departments and processes within an organization. Thus, controls that may be relevant to other processes (e.g., financial statement close process, accounting for income taxes) also frequently mitigate risks associated with a business combination. Examples of those controls include:

- Reviewing an analysis of assigning assets acquired, liabilities assumed and goodwill to reporting units
- After the adoption of ASU 2021-08, reviewing contracts with customers to identify and recognize contract assets acquired and liabilities assumed in accordance with ASC 606
- Reviewing an analysis of the tax implications of the acquisition
- Reviewing and approving journal entries (including journal entries related to the tax implications of the acquisition) to reflect the accounting for the business combination
- Reviewing an analysis assigning the useful lives of acquired assets
- Reviewing and approving the completed disclosure checklist
- Reviewing an analysis of the segment reporting implications of the acquisition

F Illustrative disclosure for ASC 805

F.1 Comprehensive ASC 805 disclosure

(all numbers in $000s)

On 30 June 20X9 (the acquisition date), Alpha (a calendar year-end entity) acquired 100% of the outstanding common shares and voting interest of Beta. The results of Beta's operations have been included in the consolidated financial statements since that date. Beta is a provider of data networking products and services in Canada and Mexico. As a result of the acquisition, the Company will be the leading provider of data networking products and services in Canada and Mexico. The Company expects to achieve significant synergies and cost reductions by eliminating redundant processes and facilities.

The acquisition-date fair value of the consideration transferred totaled $9,400, which consisted of the following:

Fair value of consideration transferred	
Cash	$6,000
Common stock (100,000 shares)	2,400
Contingent consideration	1,000
Total	$9,400

The fair value of the 100,000 common shares issued was determined based on the closing market price of the Company's common shares on the acquisition date.

The contingent consideration arrangement requires the Company to pay $2,000 of additional consideration to Beta's former shareholders, if Beta's revenues increase by a compound annual growth rate of 30% over a three-year period. The fair value of the contingent consideration arrangement at the acquisition date was $1,000. We estimated the fair value of the contingent consideration using a probability-weighted discounted cash flow model. This fair value measurement is based on significant inputs not observable in the market and thus represents a Level 3 measurement as defined in ASC 820. The key assumptions in applying the income approach are as follows: 22.5% discount rate and probability adjusted revenues in Beta between $10,050 and $15,100. As of 31 December 20X9, there were no significant changes in the range of outcomes for the contingent consideration recognized as a result of the acquisition of Beta, although the recognized amount increased to $1,100 as a result of minor changes in estimates and the passage of time (reduced impact of discounting).

The following table summarizes the estimated fair values of the assets acquired and liabilities assumed at the acquisition date. Alpha is in the process of obtaining third-party valuations of certain intangible assets; thus, the provisional measurements of intangible assets, goodwill and deferred income tax assets are subject to change.

At 30 June 20X9	
Accounts receivables	$1,300
Inventory	1,100
Property, plant and equipment	1,500
Intangible assets	4,900
Total identifiable assets acquired	8,800
Current liabilities	(500)
Long-term debt	(1,000)
Contingencies	(100)
Total liabilities assumed	(1,600)
Net identifiable assets acquired	$7,200
Goodwill	2,200
Net assets acquired	$9,400

Of the $4,900 of acquired intangible assets, $1,400 was provisionally assigned to registered trademarks that are not subject to amortization and $1,000 was provisionally assigned to in-process research and development assets that were both recognized at fair value on the acquisition date. The remaining $2,500 of acquired intangible assets is subject to a weighted-average useful life of approximately four years. Those definite-lived intangible assets include acquired licenses of $1,500 (three-year useful life), patents of $800 (seven-year useful life), and other assets of $200 (five-year weighted-average useful life). As noted earlier, the fair value of the acquired identifiable intangible assets is provisional pending receipt of the final valuations for these assets.

Acquired contingencies relate to pending patent infringement lawsuits in which Beta is the defendant. The Company has determined that the range of the potential loss on such contingencies is $0 to $500 and the acquisition date fair value of the contingencies is $100, based on a probability-weighted discounted cash flow valuation technique. Immediately before the acquisition, Beta was named as a defendant in a second patent infringement lawsuit that is still in the discovery phase. The Company believes there is a reasonable possibility that a loss has been incurred, however, cannot estimate the fair value of the potential loss or a range of the possible loss due to the lack of information on the asserted claims available at this time.

The $2,200 of goodwill was assigned to the technology and communications segments in the amounts of $1,300 and $900, respectively. The goodwill recognized is attributable primarily to expected synergies and the assembled workforce of Beta. None of the goodwill is expected to be deductible for income tax purposes. As of 31 December 20X9, there were no changes in the recognized amounts of goodwill resulting from the acquisition of Beta.

The fair value of accounts receivables acquired is $1,300, with the gross contractual amount being $1,375. The Company expects $75 to be uncollectible.

The Company recognized $105 of acquisition related costs that were expensed in the current period. These costs are included in the consolidated income statement in the line item entitled "Acquisition related costs." The Company also recognized $100 in costs associated with issuing and registering the shares issued as consideration in the business combination. Those costs were deducted from the recognized proceeds of issuance within stockholders' equity.

The amounts of revenue and earnings of Beta included in the Company's consolidated income statement from the acquisition date to the period ending 31 December 20X9 are as follows:

	Revenue and earnings included in the consolidated income statement from 1 July 20X9 to 31 December 20X9
Revenue	$4,520
Earnings	$510

The following represents the pro forma consolidated income statement as if Beta had been included in the consolidated results of the Company for the entire years ending 31 December 20X9 and 31 December 20X8:

	Pro forma consolidated income statement	
	Year ended	
	31 December 20X8	31 December 20X9
Revenue	$21,420	$22,100
Earnings	1,850	2,100

These amounts have been calculated after applying the Company's accounting policies and adjusting the results of Beta to reflect the additional depreciation and amortization that would have been charged assuming the fair value adjustments to property, plant and equipment and intangible assets had been applied on 1 January 2008, together with the consequential tax effects.

Prior to the acquisition, the Company had a preexisting relationship with Beta. Beta provided the Company's customers in Mexico with data networking services under a five-year supply contract. At the date of the acquisition, the Company had amounts payable to Beta of $200 for services provided prior to the acquisition. The Company disputed Beta's claim of the ultimate amount payable and believed the amount was $160. As a result of the acquisition, the disputed amount was effectively settled for its fair value, which the Company has estimated to be $180 on the acquisition date, based on a probability-weighted projection of potential outcomes of the dispute. As a result of the effective settlement, the Company recognized a gain of $20. The gain was recognized separately from the business combination and included in "Other gains (losses)" in the consolidated income statement.

Acquisition of less than 100% of the stock of the acquired company (includes noncontrolling interest)

Assume that Alpha only acquired 80% of Beta. Include all of the same disclosures as above in addition to the following:

> The fair value of the 20% noncontrolling interest in Beta is estimated to be $1,880. The fair value of the noncontrolling interest was estimated using a combination of the income approach and a market approach. As Beta is a private company, the fair value measurement is based on significant inputs that are not observable in the market and thus represents a Level 3 measurement as defined in ASC 820. The fair value estimates are based on (a) a discount rate range of 18% to 22%, (b) a terminal value based on a range of terminal EBITDA multiples between 2.5 and 5 times (or long-term sustainable growth rates ranging between two and five percent), (c) financial multiples of companies in the same industry as Beta and (d) adjustments because of the lack of control or lack of marketability that market participants would consider when estimating the fair value of the noncontrolling interest in Beta.

Business combination achieved in stages

Assume that prior to the acquisition, Alpha owned 30% of Beta and after the acquisition, Alpha owns 80% of Beta. Include all of the same disclosures as above in addition to the following:

> Prior to the acquisition date, the Company accounted for its 30% interest in Beta as an equity-method investment. The acquisition-date fair value of the previous equity interest was $3,050 and is included in the measurement of the consideration transferred. The Company recognized a gain of $410 as a result of remeasuring its prior equity interest in Beta held before the business combination. The gain is included in the line item "Other gains (losses)" in the consolidated income statement.

Bargain purchase

Although we believe bargain purchases are rare, we have expanded the example to consider such disclosures for completeness. Assume that Alpha acquired 100% of Beta and that the fair value of identifiable assets acquired and liabilities assumed exceeds the consideration transferred by $640. Include all of the same disclosures as above with the exception of the goodwill disclosure, in addition to the following:

> Because the Company purchased 100% of Beta in a forced liquidation from its previous owners, the fair value of identifiable assets acquired and liabilities assumed exceeded the fair value of the consideration transferred. Consequently, the Company reassessed the recognition and measurement of identifiable assets acquired and liabilities assumed and concluded that all acquired assets and assumed liabilities were recognized and that the valuation procedures and resulting measures were appropriate. As a result, the Company recognized a gain of $640. The gain is included in the line item "Gain on acquisition of business" in the consolidated income statement.

F.2 Adjustment to provisional amount disclosure

Acquirer completes its merger with Target on 1 October 20X9. As part of its measurement process, Acquirer hires a third-party valuation firm to assist it in estimating the fair value of the intangible assets acquired in the merger. The valuation of customer related intangible asset is not complete by the time the financial statements are issued for the year ended 31 December 20X9. In the financial statements for the year ended 31 December 20X9, Acquirer recognizes a provisional amount for the customer related intangible asset of $120,000 based on a draft report from the valuation firm.

The customer-related intangible assets are determined to have a remaining useful life of seven years. On 1 March 20X0, Acquirer receives the final valuation report, which indicated that the estimated fair value of the customer relationship intangible assets is $141,000.

Analysis

Acquirer must adjust the provisional amounts recorded and the related effects on earnings in its interim financial statements for the quarter ended March 31, 20X0.

The carrying amount of the customer-related intangible assets is increased by $19,500. This amount represents the $21,000 fair value adjustment, less the additional amortization on the fair value adjustment of $1,500 ($21,000 / 7-year useful life x 6/12 of a year). Amortization expense for the period ended 31 March 20X0 is increased by $1,500 to reflect the effect on earnings as a result of the change to the provisional amount recognized. The carrying amount of goodwill is decreased by $21,000 as of 31 March 20X0.

Acquirer must present or disclose, by line item, the amount of the adjustment reflected in the current-period income statement that would have been recognized in previous periods if the adjustment to provisional amounts had been recognized as of the acquisition date. This amount is $750 ($21,000/7-year useful life x 3/12 of a year) relating to the period ended 31 December 20X9.

Acquirer also must disclose the following in its notes to the financial statements in the 20X9 and 20X0 financial statements, in accordance with the disclosure requirements of ASC 805:

31 December 20X9 Financial Statements

The accounting for our merger with Target has not been completed because we have not finalized the valuation of acquired customer-related intangible assets.

Presentation in the 31 March 20X0 Financial Statements

After the 31 December 20X9 financial statements were issued, we received a final valuation report from a third-party valuation firm. After considering the results of that valuation report, we have estimated that the fair value of the customer-related intangible assets acquired as part of the merger with Target to be $141,000. As a result, the fair value of the customer-related intangible assets was increased by $21,000 on 31 March 20X0, due to this new information, with a corresponding decrease to goodwill. In addition, the change to the provisional amount resulted in an increase in amortization expense and accumulated amortization of $1,500, of which $750 relates to a previous reporting period.

This adjustment represents additional amortization expense from the acquisition date through 31 March 20X0 based on the revised measurement of the customer-related intangible assets.

G Summary of important changes

The following highlights important changes to this FRD publication since the June 2022 edition:

- Section 2.1.3.1.4 was updated to clarify that gross assets acquired should not include a bargain purchase gain when evaluating the definition of a business.
- Section 2.2.1 was updated to highlight the FASB's project on joint venture formations.
- Section 3.2.2.2.5.1 was updated to include accounting acquirer considerations when a SPAC merger transaction is consummated as a result of the SPAC obtaining control via the consolidation of a VIE.
- Section 4.2.2 was updated to highlight the FASB's project on accounting for acquired financial assets under ASC 326.
- Section 4.2.7.1 was updated to clarify how an acquirer subsequently accounts for an indemnification asset when the indemnified costs are accounted for as a capital asset.
- Section 7.4.2.1 was updated to include additional guidance on calculating a control premium.
- Section 8.5.4.3.2 was added to include guidance on pro forma periods to be presented under ASC 805 for a business combination.
- Section B.7.1.1 was updated to discuss the target's and the acquirer's accounting for costs contingent on the consummation of a business combination.
- Section C.3.3 was added to discuss the impact of ASU 2023-01 on common control lease arrangements.

H Differences between ASC 805 and IFRS 3(R) (updated June 2022)

Guidance	ASC 805	IFRS 3(R)
Scope exception for non-for-profit organizations	The guidance in ASC 805 does not apply to mergers of not-for-profit entities. Those transactions are addressed in ASC 958-805. ASC 958-805 also provides incremental guidance on the accounting for acquisitions by not-for-profit entities. [ASC 805-10-15-4(d)]	IFRSs generally do not have scope limitations for not-for-profit activities in the private or public sector. Therefore, this scope exception is not necessary for IFRS 3(R).
Definition of acquirer and identifying the acquirer	The guidance in ASC 810-10 related to determining the existence of a controlling financial interest is used to identify the acquirer, or the entity that obtains control of the acquiree. If a business combination has occurred but applying that guidance does not clearly indicate which of the combining entities is the acquirer, the factors in ASC 805-10-55-11 through 55-15 are considered in making that determination. However, in a business combination in which a VIE is acquired (consolidated), the primary beneficiary of that entity always is the acquirer. The determination of which party, if any, is the primary beneficiary of a VIE is made in accordance with the guidance on VIEs in 810-10. [805-10-25-5]	The guidance on control in IFRS 10 is used to identify the acquirer. IFRS 3(R) does not have guidance for primary beneficiaries because it does not have consolidation guidance equivalent to ASC 810. [Appendix A and paragraph 7]
Definition of control	Control has the meaning of controlling financial interest in ASC 810-10-15-8. [Master Glossary in ASC 805]	Control is defined as the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. [Appendix A]
Definition of a business	*Mandatory threshold test* An entity must first evaluate whether substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets. If that threshold is met, the set is not a business and does not require further evaluation. Gross assets acquired should exclude cash and cash equivalents, deferred tax assets and any goodwill that would be created in a business combination from the recognition of deferred tax liabilities. If that threshold is not met, the entity must further evaluate whether it meets the definition of a business.	*Optional threshold test* An entity may elect to apply the threshold test on a transaction-by-transaction basis. If an entity elects to apply the threshold test, it first evaluates whether substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets. If that threshold is met, the set is not a business and does not require further evaluation. Gross assets acquired should exclude cash and cash equivalents, deferred tax assets and any goodwill that would be created in a business combination from the recognition of deferred tax liabilities. If that threshold is not met or if the entity elects to not apply the test, the entity must evaluate whether it meets the definition of a business.

Guidance	ASC 805	IFRS 3(R)
		Since the threshold test is optional under IFRS, an entity may reach a different conclusion about whether an acquired set meets the definition of a business under IFRS and US GAAP.
Operating leases (before the adoption of ASU 2016-02)	Regardless of whether the acquiree is the lessee or the lessor, the guidance in ASC 805 requires the acquirer to recognize separately from the leased asset an intangible asset if the terms of an operating lease are favorable relative to market terms or a liability if the terms are unfavorable relative to market terms. Accordingly, an acquirer measures the acquisition-date fair value of an asset that is subject to an operating lease in which the acquiree is the lessor separately from the lease contract. [ASC 805-20-25-12 and 20-30-5]	IFRS 3(R) requires the acquirer to consider the terms of a lease in measuring the acquisition-date fair value of an asset that is subject to an operating lease in which the acquiree is the lessor. This is consistent with the guidance in IAS 40. Accordingly, IFRS 3(R) does not require the acquirer of an operating lease in which the acquiree is the lessor to recognize a separate asset or liability if the terms of an operating lease are favorable or unfavorable compared to market terms as is required for leases in which the acquiree is the lessee. [paragraphs B29 and B42]
Operating leases (after the adoption of ASU 2016-02)	If the acquiree is the lessor, the guidance in ASC 805 requires the acquirer to recognize separately from the leased asset an intangible asset if the terms of an operating lease are favorable relative to market terms or a liability if the terms are unfavorable relative to market terms. Accordingly, an acquirer measures the acquisition-date fair value of an asset that is subject to an operating lease in which the acquiree is the lessor separately from the lease contract. [ASC 805-20-25-12]	IFRS 3(R) requires the acquirer to consider the terms of a lease in measuring the acquisition-date fair value of an asset that is subject to an operating lease in which the acquiree is the lessor. This is consistent with the guidance in IAS 40. Accordingly, IFRS 3(R) does not require the acquirer of an operating lease in which the acquiree is the lessor to recognize a separate asset or liability if the terms of an operating lease are favorable or unfavorable compared to market terms. [paragraph B42]
Contract assets and contract liabilities (after the adoption of ASU 2021-08)	*Initial recognition* ASC 805 requires entities to apply ASC 606 to recognize and measure contract assets and contract liabilities from contracts with customers in a business combination. This also applies to other acquired contracts in which the provisions of ASC 606 apply. [ASC 805-20-25-28C and 20-30-27]	*Initial recognition* IFRS 3(R) requires the acquirer to measure contract assets and contract liabilities acquired at fair value.
Noncontrolling interest in an acquiree	*Initial recognition* ASC 805 requires the noncontrolling interest in an acquiree to be measured at fair value. [ASC 805-20-30-1]	*Initial recognition* IFRS 3(R) permits an acquirer to measure the noncontrolling interest components that are present ownership interests and entitle their holders to a proportionate share of the acquiree's net assets in the event of liquidation either at fair value, including goodwill, or at the noncontrolling interest's proportionate share of the fair value of the acquiree's identifiable net assets, exclusive of goodwill. All other components of noncontrolling interest are measured at fair value unless another measurement basis is required by IFRS. [paragraph 19]

Guidance	ASC 805	IFRS 3(R)
	Disclosures ASC 805 requires an acquirer to disclose the valuation technique(s) and significant inputs used to measure fair value. [ASC 805-20-50-1(e)]	*Disclosures* Because an acquirer is permitted to choose between two measurement bases for the noncontrolling interest in an acquiree, IFRS 3(R) requires an acquirer to disclose the measurement basis used. If the noncontrolling interest is measured at fair value, the acquirer must disclose the valuation techniques and key model inputs used. [paragraph B64(o)]
Assets and liabilities arising from contingencies	*Initial recognition* Preacquisition contingent assets and liabilities are recognized at the acquisition date at fair value if the acquisition-date fair value of the asset or liability can be determined during the measurement period. If the acquisition-date fair value of a preacquisition contingent asset or liability cannot be determined at the acquisition date or during the measurement period, that contingent asset or liability is recognized if (1) information prior to the end of the measurement period indicates that it is probable that an asset existed or a liability had been incurred at the acquisition date and (2) the amount of the asset or liability can be reasonably estimated. The recognition and measurement guidance in ASC 450 should be used to determine whether criteria (1) and (2) have been met. [ASC 805-20-25-19 through 25-20a]	*Initial recognition* IFRS 3(R) generally requires the acquirer to recognize a contingent liability assumed in a business combination if it is a present obligation that arises from past events and its fair value can be measured reliably, even if it is not probable that an outflow of resources will be required to settle the obligation. IFRS 3(R) has an exception to the recognition principle that requires an acquirer to apply IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, and International Financial Reporting Interpretations Committee (IFRIC) 21, *Levies*, to identify the contingent liabilities it has assumed in a business combination (if those contingent liabilities would be in the scope of IAS 37 or IFRIC 21 if incurred separately). If the fair value cannot be measured reliably, the contingent liability is not recognized. Contingent assets are not recognized. [paragraphs 21A through 23A]
	Subsequent measurement If amounts are initially recognized at fair value, an acquirer should develop a systematic and rational basis for subsequently measuring and accounting for assets and liabilities arising from contingencies depending on their nature. [ASC 805-20-35-3] If amounts are initially recognized and measured under ASC 450, the subsequent accounting and measurement should be based on ASC 450.	*Subsequent measurement* IFRS 3(R) carries forward the existing requirements that a contingent liability recognized in a business combination must be measured subsequently at the higher of (1) the amount that would be recognized in accordance with IAS 37 or (2) the amount initially recognized less, if appropriate, the cumulative amount of income recognized in accordance with IFRS 15. [paragraph 56]
	Disclosures ASC 805's disclosures related to assets and liabilities arising from contingencies are slightly different from those required by IFRS 3(R) because the IASB's disclosures are based on the requirements in IAS 37. [ASC 805-20-50-1(d); IFRS 3(R), paragraph B64(j) and B67(c)]	
Assets and liabilities for which the acquirer applied other US GAAP or IFRSs rather than the recognition and measurement principles	The guidance in ASC 805 and IFRS 3(R) provide exceptions to the recognition and measurement principles for particular assets and liabilities that the acquirer accounts for in accordance with other US GAAP or IFRSs. For example, income taxes and employee benefit arrangements are accounted for in accordance with existing US GAAP or IFRSs. Differences in the existing guidance might result in differences in the amounts recognized in a business combination. For example, differences between the recognition and measurement guidance in ASC 740 and IAS 12 might result in differences in the amounts recognized in a business combination related to income taxes. [ASC 805-740-30-1 and ASC 805-20-25-22; IFRS 3(R), paragraphs 24-26]	

Guidance	ASC 805	IFRS 3(R)
Replacement share-based payment awards	The guidance in ASC 805 requires an acquirer to account for share-based payment awards that it exchanges for awards held by employees of the acquiree in accordance with the guidance in ASC 718 and IFRS 3(R) requires the acquirer to account for those awards in accordance with IFRS 2. Differences between ASC 718 and IFRS 2 might cause differences in the accounting for share-based payment awards entered into as part of the business combination. For example, if the share-based payment awards exchanged were subject to graded vesting requirements, the company's US GAAP accounting policy for such awards may cause differences in the allocation of the cost of the replacement award to the consideration transferred and post-combination compensation cost. For awards subject to graded vesting ASC 718 permits the use of the "accelerated" approach or the "straight-line" approach whereas IFRS 2 requires the use of the "accelerated" approach. In addition, the implementation guidance differs because of the differences in ASC 718 and IFRS 2. [ASC 805-20-30-21, ASC 805-30-30-9 through 30-13, ASC 805-30-55-6 through 55-13 and ASC 805-30-55-17 through 55-24; IFRS 3(R), paragraphs 30 and B56-B62B]	
Contingent consideration	The guidance in ASC 805 and IFRS 3(R) require an acquirer to classify contingent consideration as an asset, a liability, or equity on the basis of other US GAAP or IFRSs, respectively. Differences in the related US GAAP or IFRSs might cause differences in the initial classification and, therefore, might cause differences in the subsequent accounting. [ASC 805-30-25-6; IFRS 3(R), paragraph 40]	
Subsequent measurement and accounting for assets, liabilities or equity instruments	In general, after a business combination, an acquirer measures and accounts for assets acquired, liabilities assumed or incurred, and equity instruments issued in accordance with other applicable US GAAP or IFRSs, depending on their nature. Differences in the other applicable guidance might cause differences in the subsequent measurement and accounting for those assets, liabilities and equity instruments. [ASC 805-10-35-1, ASC 805-20-35-5 through 35-7 and ASC 805-30-35-1 through 35-3; IFRS 3(R), paragraphs 54 and B63]	
Goodwill by reportable segment disclosures	The guidance in ASC 805 requires that the acquirer disclose for each business combination that occurs during the period or in the aggregate for individually immaterial business combinations that are material collectively and that occur during the period, the amount of goodwill by reportable segment, if the combined entity is required to disclose segment information in accordance with the guidance in ASC 280, unless such disclosure is impracticable. Similar to IAS 36, ASC 350-30-50-1 requires disclosure of this information in the aggregate by each reportable segment. There is no requirement to disclose this information for each material business combination that occurs during the period, nor in the aggregate for individually immaterial business combinations that occur during the period and are material collectively. [ASC 805-30-50-1(e)]	The disclosure by reportable segment is not required by IFRS 3(R). Paragraph 134 of IAS 36 requires an entity to disclose the aggregate carrying amount of goodwill allocated to each cash-generating unit (group of units) for which the carrying amount of goodwill allocated to that unit (group of units) is significant in comparison with the entity's total carrying amount of goodwill. This information is not required to be disclosed for each material business combination that occurs during the period or in the aggregate for individually immaterial business combination that are material collectively and occur during the period.
Pro forma disclosures	The disclosures required by this paragraph apply only to acquirers that are public entities, as defined in the Master Glossary section ASC 805-10-20. If comparative financial statements are presented, the guidance in ASC 805 requires disclosure of revenue and earnings of the combined entity for the comparable prior reporting period as if the acquisition date for all business combinations occurred as of the beginning of the comparable prior annual reporting period (supplemental pro forma information). [ASC 805-10-50-2(h)]	The disclosures required by this paragraph apply to all acquirers. IFRS 3(R) does not require the disclosure of revenue and profit or loss of the combined entity for the comparable prior period even if comparative financial statements are presented. [paragraph B64(q)]

Guidance	ASC 805	IFRS 3(R)
Disclosures of the financial effects of adjustments to the amounts recognized in a business combination	ASC 805 does not require this disclosure.	IFRS 3(R) requires the acquirer to disclose the amount and an explanation of any gain or loss recognized in the current period that (1) relates to the identifiable assets acquired or liabilities assumed in a business combination that was effected in the current or previous reporting period and (2) is of such a size, nature, or incidence that disclosure is relevant to understanding the combined entity's financial statements. [paragraph B67(e)]
Income taxes	The guidance in ASC 805 and IFRS 3(R) require the subsequent recognition of acquired deferred tax benefits in accordance with the guidance in ASC 740 or IAS 12, respectively. Differences between ASC 740 and IAS 12 might cause differences in the subsequent recognition. Also, in accordance with US GAAP, the acquirer is required to recognize changes in the acquired income tax positions in accordance with ASC 740. [ASC 805-10-65-1; IFRS 3(R), paragraph 67]	
Pushdown accounting	An acquired entity can choose to apply pushdown accounting in its separate financial statements when an acquirer obtains control of it or later. However, an entity's election to apply pushdown accounting is irrevocable.	No guidance exists and, therefore, it is unclear whether pushdown accounting is acceptable under IFRS. However, the general view is that entities may not use the hierarchy in IAS 8 to refer to US GAAP and apply pushdown accounting in the separate financial statements of an acquired subsidiary because the application of pushdown accounting will result in the recognition and measurement of assets and liabilities in a manner that conflicts with certain IFRS standards and interpretations. For example, the application of pushdown accounting generally will result in the recognition of internally generated goodwill and other internally generated intangible assets at the subsidiary level, which conflicts with the guidance in IAS 38.
Adjustments to provisional amounts within the measurement period	Acquirers must recognize measurement period adjustments during the period in which they determine the amounts, including the effect on earnings of any amounts they would have recorded in previous periods if the accounting had been completed at the acquisition date.	IFRS 3(R) requires an acquirer to recognize adjustments to provisional amounts during the measurement period on a retrospective basis. The acquirer must then revise comparative information for any prior periods presented, including revisions for any effects on the prior-period income statement.
Combination of entities under common control	The receiving entity records the net assets at their carrying amounts in the accounts of the transferor (historical cost).	Outside the scope of IFRS 3(R), *Business Combinations*.[88] In practice, either follow an approach similar to US GAAP (historical cost) or apply the acquisition method (fair value) if there is substance to the transaction (policy election).

[88] The IASB issued a Discussion Paper, *Business Combinations under Common Control*, in November 2020. The comment period for this Discussion Paper ended in September 2021, and the IASB began considering the feedback received. The IASB will continue its redeliberations and decide on the project's direction at a future meeting. Readers should monitor this project for developments.

I Abbreviations used in this publication

Abbreviation	FASB Accounting Standards Codification
ASC 205	FASB ASC Topic 205, *Presentation of the Financial Statements*
ASC 210	FASB ASC Topic 210, *Balance Sheet*
ASC 220	FASB ASC Topic 220, *Income Statement — Reporting Comprehensive Income*
ASC 230	FASB ASC Topic 230, *Statement of Cash Flows*
ASC 235	FASB ASC Topic 235, *Notes to Financial Statements*
ASC 250	FASB ASC Topic 250, *Accounting Changes and Error Corrections*
ASC 260	FASB ASC Topic 260, *Earnings Per Share*
ASC 280	FASB ASC Topic 280, *Segment Reporting*
ASC 310	FASB ASC Topic 310, *Receivables*
ASC 321	FASB ASC Topic 321, *Investments — Equity Securities*
ASC 323	FASB ASC Topic 323, *Investments — Equity Method and Joint Ventures*
ASC 325	FASB ASC Topic 325, *Investments — Other*
ASC 326	FASB ASC Topic 326, *Financial Instruments — Credit Losses*
ASC 330	FASB ASC Topic 330, *Inventory*
ASC 340	FASB ASC Topic 340, *Other Assets and Deferred Costs*
ASC 350	FASB ASC Topic 350, *Intangibles — Goodwill and Other*
ASC 360	FASB ASC Topic 360, *Property, Plant, and Equipment*
ASC 405	FASB ASC Topic 405, *Liabilities*
ASC 410	FASB ASC Topic 410, *Asset Retirement and Environmental Obligations*
ASC 420	FASB ASC Topic 420, *Exit or Disposal Cost Obligations*
ASC 450	FASB ASC Topic 450, *Contingencies*
ASC 460	FASB ASC Topic 460, *Guarantees*
ASC 470	FASB ASC Topic 470, *Debt*
ASC 480	FASB ASC Topic 480, *Distinguishing Liabilities from Equity*
ASC 505	FASB ASC Topic 505, *Equity*
ASC 606	FASB ASC Topic 606, *Revenue from Contracts with Customers*
ASC 610	FASB ASC Topic 610, *Other Income*
ASC 710	FASB ASC Topic 710, *Compensation — General*
ASC 712	FASB ASC Topic 712, *Compensation — Nonretirement Postemployment Benefits*
ASC 715	FASB ASC Topic 715, *Compensation — Retirement Benefits*
ASC 718	FASB ASC Topic 718, *Compensation — Stock Compensation*
ASC 730	FASB ASC Topic 730, *Research and Development*
ASC 740	FASB ASC Topic 740, *Income Taxes*
ASC 805	FASB ASC Topic 805, *Business Combinations*
ASC 808	FASB ASC Topic 808, *Collaborative Arrangements*
ASC 810	FASB ASC Topic 810, *Consolidation*
ASC 815	FASB ASC Topic 815, *Derivatives and Hedging*
ASC 820	FASB ASC Topic 820, *Fair Value Measurement*
ASC 825	FASB ASC Topic 825, *Financial Instruments*
ASC 835	FASB ASC Topic 835, *Interest*
ASC 840	FASB ASC Topic 840, *Leases*
ASC 842	FASB ASC Topic 842, *Leases*
ASC 845	FASB ASC Topic 845, *Nonmonetary Transactions*
ASC 852	FASB ASC Topic 852, *Reorganizations*
ASC 860	FASB ASC Topic 860, *Transfers and Servicing*
ASC 930	FASB ASC Topic 930, *Extractive Activities — Mining*

Abbreviation	FASB Accounting Standards Codification
ASC 932	FASB ASC Topic 932, *Extractive Activities — Oil and Gas*
ASC 944	FASB ASC Topic 944, *Financial Services — Insurance*
ASC 950	FASB ASC Topic 950, *Financial Services — Title Plant*
ASC 954	FASB ASC Topic 954, *Health Care Entities*
ASC 958	FASB ASC Topic 958, *Not-for-Profit Entities*
ASC 960	FASB ASC Topic 960, *Plan Accounting — Defined Benefit Pension Plans*
ASC 962	FASB ASC Topic 962, *Plan Accounting — Defined Contribution Pension Plans*
ASC 965	FASB ASC Topic 965, *Plan Accounting — Health and Welfare Benefit Plans*
ASC 970	FASB ASC Topic 970, *Real Estate — General*
ASC 980	FASB ASC Topic 980, *Regulated Operations*

Abbreviation	Other Authoritative Standards
CON 5	FASB Statement of Financial Accounting Concepts No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*
CON 6	FASB Statement of Financial Accounting Concepts No. 6, *Elements of Financial Statements*
CON 8.4	Chapter 4, *Elements of Financial Statements,* of FASB Statement of Financial Accounting Concepts No. 8, *Conceptual Framework for Financial Reporting*
ASU 2010-02	Accounting Standards Update No. 2010-02, *Consolidation (Topic 810): Accounting and Reporting for Decreases in Ownership of a Subsidiary — a Scope Clarification*
ASU 2010-29	Accounting Standards Update No. 2010-29, *Business Combinations (Topic 805): Disclosure of Supplementary Pro Forma Information for Business Combinations (a consensus of the FASB Emerging Issues Task Force)*
ASU 2012-06	Accounting Standards Update No. 2012-06, *Business Combinations (Topic 805): Subsequent Accounting for an Indemnification Asset Recognized at the Acquisition Date as a Result of a Government-Assisted Acquisition of a Financial Institution (a consensus of the FASB Emerging Issues Task Force)*
ASU 2014-09	Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*
ASU 2014-17	Accounting Standards Update No. 2014-17, *Business Combinations (Topic 805): Pushdown Accounting (a consensus of the FASB Emerging Issues Task Force)*
ASU 2016-02	Accounting Standards Update No. 2016-02, *Leases (Topic 842)*
ASU 2016-13	Accounting Standards Update No. 2016-13, *Financial Instruments — Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*
ASU 2017-04	Accounting Standards Update No. 2017-04, *Intangibles — Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment*
ASU 2019-10	Accounting Standards Update No. 2019-10, *Financial Instruments — Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): Effective Dates*
ASU 2020-05	Accounting Standards Update No. 2020-05, *Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities*
ASU 2020-06	Accounting Standards Update No. 2020-06, *Debt — Debt with Conversion and Other Options (Subtopic 470-20) and Derivatives and Hedging — Contracts in Entity's Own Equity (Subtopic 815-40): Accounting for Convertible Instruments and Contracts in an Entity's Own Equity*
ASU 2021-08	Accounting Standards Update No. 2021-08, *Business Combinations (Topic 805): Accounting for Contract Assets and Contract Liabilities from Contracts with Customers*
ASU 2023-01	Accounting Standards Update No. 2023-01, *Leases (Topic 842): Common Control Arrangements*
IAS 8	International Accounting Standard No. 8, *Accounting Policies, Changes in Accounting Estimates and Errors*
IAS 12	International Accounting Standard No. 12, *Income Taxes*
IAS 36	International Accounting Standard No. 36, *Impairment of Assets*
IAS 37	International Accounting Standard No. 37, *Provisions, Contingent Liabilities and Contingent Assets*
IAS 38	International Accounting Standard No. 38, *Intangible Assets*
IAS 40	International Accounting Standard No. 40, *Investment Property*

Abbreviation	Other Authoritative Standards
IFRIC 21	International Financial Reporting Interpretations Committee 21, *Levies*
IFRS 2	International Financial Reporting Standard No. 2, *Share-Based Payment*
IFRS 3(R)	International Financial Reporting Standard No. 3(R), *Business Combinations*
IFRS 10	International Financial Reporting Standard No. 10, *Consolidated Financial Statements*
IFRS 15	International Financial Reporting Standard No. 15, *Revenue from Contracts with Customers*
Regulation S-X	SEC Regulation S-X, *Form and content of and requirements for financial statements*
Rule 3-05	Financial statements of businesses acquired or to be acquired
Rule 3-09	Separate financial statements of subsidiaries not consolidated and 50 percent or less owned persons
Rule 3-14	Special instructions for real estate operations to be acquired
Rule 4-08	General notes to financial statements
Rule 4-08(g)	Summarized financial information of subsidiaries not consolidated and 50 percent or less owned persons
Rule 5-02	Balance Sheets
Rule 8-04	Financial statements of businesses acquired or to be acquired
Rule 8-06	Real estate operations acquired or to be acquired
Rule 11-01	Presentation requirements
Rule 11-02	Preparation requirements
SAB 108	SEC Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*
SAB Topic 2.A.6	SEC Staff Accounting Bulletin Topic 2.A.6, *Debt issue costs*
SAB Topic 5.A	SEC Staff Accounting Bulletin Topic 5.A, *Expenses of Offering*
SAB Topic 5.L	SEC Staff Accounting Bulletin Topic 5.L, *LIFO Inventory Practices*
SAB Topic 5.Z.7	SEC Staff Accounting Bulletin Topic 5.Z.7, *Accounting for the spin-off of a subsidiary*

Abbreviation	Non-Authoritative Standards
APB 16	APB Opinion No. 16, *Business Combinations*
APB 20	APB Opinion No. 20, *Accounting Changes*
EITF 95-3	EITF Issue No. 95-3, *Recognition of Liabilities in Connection with a Purchase Business Combination*
EITF 95-8	EITF Issue No. 95-8, *Accounting for Contingent Consideration Paid to the Shareholders of an Acquired Enterprise in a Purchase Business Combination*
EITF 97-2	EITF Issue No. 97-2, *Application of FASB Statement No. 94 and APB Opinion No. 16 to Physician Practice Management Entities and Certain Other Entities with Contractual Management Arrangements*
EITF 01-3	EITF Issue No. 01-3, *Accounting in a Business Combination for Deferred Revenue of an Acquiree*
EITF 02-5	EITF Issue No. 02-5, *Definition of "Common Control" in Relation to FASB Statement No. 141*
EITF 03-17	EITF Issue No. 03-17, *Subsequent Accounting for Executory Contracts That Have Been Recognized on an Entity's Balance Sheet*
EITF 08-7	EITF Issue No. 08-7, *Accounting for Defensive Intangible Assets*
FIN 21	FASB Interpretation No. 21, *Accounting for Leases in a Business Combination*
FSP FAS 141(R)	FASB Staff Position No. 141(R)-1, *Accounting for Assets Acquired and Liabilities Assumed in a Business Combination That Arise from Contingencies*
FTB 85-5	FASB Technical Bulletin No. 85-5, *Issues Relating to Accounting for Business Combinations*
Statement 38	FASB Statement No. 38, *Accounting for Preacquisition Contingencies of Purchased Enterprises*
Statement 109	FASB Statement No. 109, *Accounting for Income Taxes*
Statement 141	FASB Statement No. 141, *Business Combinations*
Statement 141(R)	FASB Statement No. 141(R), *Business Combinations*
Statement 142	FASB Statement No. 142, *Goodwill and Other Intangible Assets*

J Glossary

This Appendix includes a list of terms defined in the Master Glossary of ASC 805 (shown as an excerpt from the ASC), followed by a list of additional terms defined in other sections of the ASC Master Glossary and used in this publication. Note that if a defined term is repeated in more than one Subtopic of ASC 805, it is listed below only in the first Subtopic in which it appears as a defined term. For example, "Acquiree" is included in the Glossary section of Subtopics 805-10, 805-20 and 805-30, but is listed only in the 805-10-20 section below.

Excerpt from Accounting Standards Codification

Business Combinations — Overall

Glossary

805-10-20

Acquiree
The business or businesses that the acquirer obtains control of in a business combination. This term also includes a nonprofit activity or business that a not-for-profit acquirer obtains control of in an acquisition by a not-for-profit entity.

Acquirer
The entity that obtains control of the acquiree. However, in a business combination in which a variable interest entity (VIE) is acquired, the primary beneficiary of that entity always is the acquirer.

Acquisition by a Not-for-Profit Entity
A transaction or other event in which a not-for-profit acquirer obtains control of one or more nonprofit activities or businesses and initially recognizes their assets and liabilities in the acquirer's financial statements. When applicable guidance in Topic 805 is applied by a not-for-profit entity, the term business combination has the same meaning as this term has for a for-profit entity. Likewise, a reference to business combinations in guidance that links to Topic 805 has the same meaning as a reference to acquisitions by not-for-profit entities.

Acquisition Date
The date on which the acquirer obtains control of the acquiree.

Business
Paragraphs 805-10-55-3A through 55-6 and 805-10-55-8 through 55-9 define what is considered a business.

Business Combination
A transaction or other event in which an acquirer obtains control of one or more businesses. Transactions sometimes referred to as true mergers or mergers of equals also are business combinations. See also Acquisition by a Not-for-Profit Entity.

Collateralized Financing Entity
A variable interest entity that holds financial assets, issues beneficial interests in those financial assets, and has no more than nominal equity. The beneficial interests have contractual recourse only to the related assets of the collateralized financing entity and are classified as financial liabilities. A collateralized financing entity may hold nonfinancial assets temporarily as a result of default by the debtor on the underlying debt instruments held as assets by the collateralized financing entity or in an effort to restructure the debt instruments held as assets by the collateralized financing entity. A collateralized financing entity also may hold other financial assets and financial liabilities that are incidental to the operations of the collateralized financing entity and have carrying values that approximate fair value (for example, cash, broker receivables, or broker payables).

Conduit Debt Securities
Certain limited-obligation revenue bonds, certificates of participation, or similar debt instruments issued by a state or local governmental entity for the express purpose of providing financing for a specific third party (the conduit bond obligor) that is not a part of the state or local government's financial reporting entity. Although conduit debt securities bear the name of the governmental entity that issues them, the governmental entity often has no obligation for such debt beyond the resources provided by a lease or loan agreement with the third party on whose behalf the securities are issued. Further, the conduit bond obligor is responsible for any future financial reporting requirements.

Contingent Consideration
Usually an obligation of the acquirer to transfer additional assets or equity interests to the former owners of an acquiree as part of the exchange for control of the acquiree if specified future events occur or conditions are met. However, contingent consideration also may give the acquirer the right to the return of previously transferred consideration if specified conditions are met.

Contract
An agreement between two or more parties that creates enforceable rights and obligations.

Control
The same as the meaning of controlling financial interest in paragraph 810-10-15-8.

Control
The direct or indirect ability to determine the direction of management and policies through ownership, contract, or otherwise.

Control of a Not-for-Profit Entity
See Control.

Pending Content:

Transition Guidance: 842-10-65-1

Direct Financing Lease
From the perspective of a lessor, a lease that meets none of the criteria in paragraph 842-10-25-2 but meets the criteria in paragraph 842-10-25-3(b).

Transition Guidance: 842-10-65-5

Direct Financing Lease
From the perspective of a lessor, a lease that meets none of the criteria in paragraph 842-10-25-2 but meets the criteria in paragraph 842-10-25-3(b) and is not an operating lease in accordance with paragraph 842-10-25-3A.

Equity Interests
Used broadly to mean ownership interests of investor-owned entities; owner, member, or participant interests of mutual entities; and owner or member interests in the net assets of not-for-profit entities.

Fair Value
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.

Financial Asset
Cash, evidence of an ownership interest in an entity, or a contract that conveys to one entity a right to do either of the following:

a. Receive cash or another financial instrument from a second entity

b. Exchange other financial instruments on potentially favorable terms with the second entity.

Foreign Entity
An operation (for example, subsidiary, division, branch, joint venture, and so forth) whose financial statements are both:

a. Prepared in a currency other than the reporting currency of the reporting entity

b. Combined or consolidated with or accounted for on the equity basis in the financial statements of the reporting entity.

Goodwill
An asset representing the future economic benefits arising from other assets acquired in a business combination or an acquisition by a not-for-profit entity that are not individually identified and separately recognized. For ease of reference, this term also includes the immediate charge recognized by not-for-profit entities in accordance with paragraph 958-805-25-29.

Identifiable
An asset is identifiable if it meets either of the following criteria:

a. It is separable, that is, capable of being separated or divided from the entity and sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract, identifiable asset, or liability, regardless of whether the entity intends to do so.

b. It arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

Intangible Asset Class

A group of intangible assets that are similar, either by their nature or by their use in the operations of an entity.

Intangible Assets
Assets (not including financial assets) that lack physical substance. (The term intangible assets is used to refer to intangible assets other than goodwill.)

Lease
An agreement conveying the right to use property, plant, or equipment (land and/or depreciable assets) usually for a stated period of time.

Pending Content:

Transition Guidance: 842-10-65-1

Lease
A contract, or part of a contract, that conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration.

Legal Entity
Any legal structure used to conduct activities or to hold assets. Some examples of such structures are corporations, partnerships, limited liability companies, grantor trusts, and other trusts.

Pending Content:
Transition Guidance: 842-10-65-1

Lessee
An entity that enters into a contract to obtain the right to use an underlying asset for a period of time in exchange for consideration.

Pending Content:
Transition Guidance: 842-10-65-1

Lessor
An entity that enters into a contract to provide the right to use an underlying asset for a period of time in exchange for consideration.

Market Participants
Buyers and sellers in the principal (or most advantageous) market for the asset or liability that have all of the following characteristics:

a. They are independent of each other, that is, they are not related parties, although the price in a related-party transaction may be used as an input to a fair value measurement if the reporting entity has evidence that the transaction was entered into at market terms

b. They are knowledgeable, having a reasonable understanding about the asset or liability and the transaction using all available information, including information that might be obtained through due diligence efforts that are usual and customary

c. They are able to enter into a transaction for the asset or liability

d. They are willing to enter into a transaction for the asset or liability, that is, they are motivated but not forced or otherwise compelled to do so.

Merger of Not-for-Profit Entities
A transaction or other event in which the governing bodies of two or more not-for-profit entities cede control of those entities to create a new not-for-profit entity.

Noncontrolling Interest
The portion of equity (net assets) in a subsidiary not attributable, directly or indirectly, to a parent. A noncontrolling interest is sometimes called a minority interest.

Nonfinancial Asset
An asset that is not a financial asset. Nonfinancial assets include land, buildings, use of facilities or utilities, materials and supplies, intangible assets, or services.

Nonprofit Activity
An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing benefits, other than goods or services at a profit or profit equivalent, as a fulfillment of an entity's purpose or mission (for example, goods or services to beneficiaries, customers, or members). As with a not-for-profit entity, a nonprofit activity possesses characteristics that distinguish it from a business or a for-profit business entity.

Not-for-Profit Entity
An entity that possesses the following characteristics, in varying degrees, that distinguish it from a business entity:

a. Contributions of significant amounts of resources from resource providers who do not expect commensurate or proportionate pecuniary return

b. Operating purposes other than to provide goods or services at a profit

c. Absence of ownership interests like those of business entities.

Entities that clearly fall outside this definition include the following:

a. All investor-owned entities

b. Entities that provide dividends, lower costs, or other economic benefits directly and proportionately to their owners, members, or participants, such as mutual insurance entities, credit unions, farm and rural electric cooperatives, and employee benefit plans.

Orderly Transaction
A transaction that assumes exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (for example, a forced liquidation or distress sale).

Owners
Used broadly to include holders of ownership interests (equity interests) of investor-owned entities, mutual entities, or not-for-profit entities. Owners include shareholders, partners, proprietors, or members or participants of mutual entities. Owners also include owner and member interests in the net assets of not-for-profit entities.

Public Business Entity
A public business entity is a business entity meeting any one of the criteria below. Neither a not-for-profit entity nor an employee benefit plan is a business entity.

a. It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing).

b. It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC.

c. It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer.

d. It has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market.

e. It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including notes) and make them publicly available on a periodic basis (for example, interim or annual periods). An entity must meet both of these conditions to meet this criterion.

An entity may meet the definition of a public business entity solely because its financial statements or financial information is included in another entity's filing with the SEC. In that case, the entity is only a public business entity for purposes of financial statements that are filed or furnished with the SEC.

Public Entity
A business entity or a not-for-profit entity that meets any of the following conditions:

a. It has issued debt or equity securities or is a conduit bond obligor for conduit debt securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets).

b. It is required to file financial statements with the Securities and Exchange Commission (SEC).

c. It provides financial statements for the purpose of issuing any class of securities in a public market.

Related Parties
Related parties include:

a. Affiliates of the entity

b. Entities for which investments in their equity securities would be required, absent the election of the fair value option under the Fair Value Option Subsection of Section 825-10-15, to be accounted for by the equity method by the investing entity

c. Trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management

d. Principal owners of the entity and members of their immediate families

e. Management of the entity and members of their immediate families

f. Other parties with which the entity may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests

g. Other parties that can significantly influence the management or operating policies of the transacting parties or that have an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

Reverse Acquisition
An acquisition in which the entity that issues securities (the legal acquirer) is identified as the acquiree for accounting purposes based on the guidance in paragraphs 805-10-55-11 through 55-15. The entity whose equity interests are acquired (the legal acquiree) must be the acquirer for accounting purposes for the transaction to be considered a reverse acquisition.

Sales-Type Lease
From the perspective of a lessor, a lease that meets either of the conditions in paragraph 840-10-25-43(a).

Pending Content:

Transition Guidance: 842-10-65-1

Sales-Type Lease

From the perspective of a lessor, a lease that meets one or more of the criteria in paragraph 842-10-25-2.

Transition Guidance: 842-10-65-5

Sales-Type Lease

From the perspective of a lessor, a lease that meets one or more of the criteria in paragraph 842-10-25-2 and is not an operating lease in accordance with paragraph 842-10-25-3A.

Security
A share, participation, or other interest in property or in an entity of the issuer or an obligation of the issuer that has all of the following characteristics:

a. It is either represented by an instrument issued in bearer or registered form or, if not represented by an instrument, is registered in books maintained to record transfers by or on behalf of the issuer.

b. It is of a type commonly dealt in on securities exchanges or markets or, when represented by an instrument, is commonly recognized in any area in which it is issued or dealt in as a medium for investment.

c. It either is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations.

Pending Content:

Transition Guidance: 842-10-65-1

Underlying Asset

An asset that is the subject of a lease for which a right to use that asset has been conveyed to a lessee. The underlying asset could be a physically distinct portion of a single asset.

Variable Interest Entity
A legal entity subject to consolidation according to the provisions of the Variable Interest Entities Subsections of Subtopic 810-10.

Business Combinations — Identifiable Assets and Liabilities, and Any Noncontrolling Interest

Glossary

805-20-20

Bargain Purchase Option
A provision allowing the lessee, at his option, to purchase the leased property for a price that is sufficiently lower than the expected fair value of the property at the date the option becomes exercisable that exercise of the option appears, at lease inception, to be reasonably assured.

Pending Content:

Transition Guidance: 842-10-65-1

Bargain Purchase Option

Glossary term superseded by Accounting Standards Update No. 2016-02

Bargain Renewal Option
A provision allowing the lessee, at his option, to renew the lease for a rental sufficiently lower than the fair rental of the property at the date the option becomes exercisable that exercise of the option appears, at lease inception, to be reasonably assured. Fair rental of a property in this context shall mean the expected rental for equivalent property under similar terms and conditions.

Pending Content:

Transition Guidance: 842-10-65-1

Bargain Renewal Option

Glossary term superseded by Accounting Standards Update No. 2016-02

Capital Lease
From the perspective of a lessee, a lease that meets any of the four lease classification criteria in paragraph 840-10-25-1.

Pending Content:

Transition Guidance: 842-10-65-1

Capital Lease

Glossary term superseded by Accounting Standards Update No. 2016-02

Contingency
An existing condition, situation, or set of circumstances involving uncertainty as to possible gain (gain contingency) or loss (loss contingency) to an entity that will ultimately be resolved when one or more future events occur or fail to occur.

Contract Asset

An entity's right to consideration in exchange for goods or services that the entity has transferred to a customer when that right is conditioned on something other than the passage of time (for example, the entity's future performance).

Contract Liability

An entity's obligation to transfer goods or services to a customer for which the entity has received consideration (or the amount is due) from the customer.

Customer

A party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration.

Defensive Intangible Asset
An acquired intangible asset in a situation in which an entity does not intend to actively use the asset but intends to hold (lock up) the asset to prevent others from obtaining access to the asset.

Pending Content:

Transition Guidance: 842-10-65-1

Finance Lease

From the perspective of a lessee, a lease that meets one or more of the criteria in paragraph 842-10-25-2.

Financial Statements Are Available to Be Issued
Financial statements are considered available to be issued when they are complete in a form and format that complies with GAAP and all approvals necessary for issuance have been obtained, for example, from management, the board of directors, and/or significant shareholders. The process involved in creating and distributing the financial statements will vary depending on an entity's management and corporate governance structure as well as statutory and regulatory requirements.

Gain Contingency
An existing condition, situation, or set of circumstances involving uncertainty as to possible gain to an entity that will ultimately be resolved when one or more future events occur or fail to occur.

Indirectly Related to the Leased Property
The provisions or conditions that in substance are guarantees of the lessor's debt or loans to the lessor by the lessee that are related to the leased property but are structured in such a manner that they do not represent a direct guarantee or loan. Examples include a party related to the lessee guaranteeing the lessor's debt on behalf of the lessee, or the lessee financing the lessor's purchase of the leased asset using collateral other than the leased property.

Pending Content:

Transition Guidance: 842-10-65-1

Indirectly Related to the Leased Property

Glossary term superseded by Accounting Standards Update No. 2016-02

Pending Content:

Transition Guidance: 842-10-65-1

Lease Liability

A lessee's obligation to make the lease payments arising from a lease, measured on a discounted basis.

Pending Content:

Transition Guidance: 842-10-65-1

Lease Payments

See paragraph 842-10-30-5 for what constitutes lease payments from the perspective of a lessee and a lessor.

Pending Content:

Transition Guidance: 842-10-65-1

Lease Receivable

A lessor's right to receive lease payments arising from a sales-type lease or a direct financing lease plus any amount that a lessor expects to derive from the underlying asset following the end of the lease term to the extent that it is guaranteed by the lessee or any other third party unrelated to the lessor, measured on a discounted basis.

Lease Term
The fixed noncancelable lease term plus all of the following, except as noted in the following paragraph:

a. All periods, if any, covered by bargain renewal options.

b. All periods, if any, for which failure to renew the lease imposes a penalty on the lessee in such amount that a renewal appears, at lease inception, to be reasonably assured.

c. All periods, if any, covered by ordinary renewal options during which any of the following conditions exist:

    1. A guarantee by the lessee of the lessor's debt directly or indirectly related to the leased property is expected to be in effect.

    2. A loan from the lessee to the lessor directly or indirectly related to the leased property is expected to be outstanding.

d. All periods, if any, covered by ordinary renewal options preceding the date as of which a bargain purchase option is exercisable.

e. All periods, if any, representing renewals or extensions of the lease at the lessor's option.

The lease term shall not be assumed to extend beyond the date a bargain purchase option becomes exercisable.

Pending Content:

Transition Guidance: 842-10-65-1

Lease Term

The noncancellable period for which a lessee has the right to use an underlying asset, together with all of the following:

a. Periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option

b. Periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option

c. Periods covered by an option to extend (or not to terminate) the lease in which exercise of the option is controlled by the lessor.

Loss Contingency
An existing condition, situation, or set of circumstances involving uncertainty as to possible loss to an entity that will ultimately be resolved when one or more future events occur or fail to occur. The term loss is used for convenience to include many charges against income that are commonly referred to as expenses and others that are commonly referred to as losses.

Mineral Rights
The legal right to explore, extract, and retain at least a portion of the benefits from mineral deposits.

Pending Content:

Transition Guidance: 842-10-65-1

Net Investment in the Lease

For a sales-type lease, the sum of the lease receivable and the unguaranteed residual asset.

For a direct financing lease, the sum of the lease receivable and the unguaranteed residual asset, net of any deferred selling profit.

Noncancelable Lease Term
That portion of the lease term that is cancelable only under any of the following conditions:

a. Upon the occurrence of some remote contingency

b. With the permission of the lessor

c. If the lessee enters into a new lease with the same lessor

d. If the lessee incurs a penalty in such amount that continuation of the lease appears, at inception, reasonably assured.

Pending Content:

Transition Guidance: 842-10-65-1

Noncancelable Lease Term

Glossary term superseded by Accounting Standards Update No. 2016-02

Operating Lease

From the perspective of a lessee, any lease other than a capital lease.

From the perspective of a lessor, a lease that meets the conditions in paragraph 840-10-25-43(d).

Pending Content:

Transition Guidance: 842-10-65-1

Operating Lease

From the perspective of a lessee, any lease other than a finance lease.

From the perspective of a lessor, any lease other than a sales-type lease or a direct financing lease.

Penalty

Any requirement that is imposed or can be imposed on the lessee by the lease agreement or by factors outside the lease agreement to do any of the following:

a. Disburse cash

b. Incur or assume a liability

c. Perform services

d. Surrender or transfer an asset or rights to an asset or otherwise forego an economic benefit, or suffer an economic detriment. Factors to consider in determining whether an economic detriment may be incurred include, but are not limited to, all of the following:

    1. The uniqueness of purpose or location of the property

    2. The availability of a comparable replacement property

    3. The relative importance or significance of the property to the continuation of the lessee's line of business or service to its customers

    4. The existence of leasehold improvements or other assets whose value would be impaired by the lessee vacating or discontinuing use of the leased property

    5. Adverse tax consequences

    6. The ability or willingness of the lessee to bear the cost associated with relocation or replacement of the leased property at market rental rates or to tolerate other parties using the leased property.

Pending Content:

Transition Guidance: 842-10-65-1

Penalty

Any requirement that is imposed or can be imposed on the lessee by the lease agreement or by factors outside the lease agreement to do any of the following:

a. Disburse cash

b. Incur or assume a liability

c. Perform services

d. Surrender or transfer an asset or rights to an asset or otherwise forego an economic benefit, or suffer an economic detriment. Factors to consider in determining whether an economic detriment may be incurred include, but are not limited to, all of the following:

   1. The uniqueness of purpose or location of the underlying asset
   2. The availability of a comparable replacement asset
   3. The relative importance or significance of the underlying asset to the continuation of the lessee's line of business or service to its customers
   4. The existence of leasehold improvements or other assets whose value would be impaired by the lessee vacating or discontinuing use of the underlying asset
   5. Adverse tax consequences
   6. The ability or willingness of the lessee to bear the cost associated with relocation or replacement of the underlying asset at market rental rates or to tolerate other parties using the underlying asset.

Performance Obligation
A promise in a contract with a customer to transfer to the customer either:

a. A good or service (or a bundle of goods or services) that is distinct

b. A series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.

Pending Content:

Transition Guidance: 350-20-65-2

Private Company
An entity other than a public business entity, a not-for-profit entity, or an employee benefit plan within the scope of Topics 960 through 965 on plan accounting.

Pending Content:

Transition Guidance: 326-10-65-1

Purchased Financial Assets with Credit Deterioration

Acquired individual financial assets (or acquired groups of financial assets with similar risk characteristics) that as of the date of acquisition have experienced a more-than-insignificant deterioration in credit quality since origination, as determined by an acquirer's assessment. See paragraph 326-20-55-5 for more information on the meaning of similar risk characteristics for assets measured on an amortized cost basis.

Reinsurance
A transaction in which a reinsurer (assuming entity), for a consideration (premium), assumes all or part of a risk undertaken originally by another insurer (ceding entity). For indemnity reinsurance, the legal rights of the insured are not affected by the reinsurance transaction and the insurance entity issuing the insurance contract remains liable to the insured for payment of policy benefits. Assumption or novation reinsurance contracts that are legal replacements of one insurer by another extinguish the ceding entity's liability to the policyholder.

Pending Content:

Transition Guidance: 842-10-65-1

Right-of-Use Asset

An asset that represents a lessee's right to use an underlying asset for the lease term.

Standalone Selling Price
The price at which an entity would sell a promised good or service separately to a customer.

Sublease
A transaction in which a leased property is re-leased by the original lessee to a third party, and the lease agreement between the two original parties remains in effect.

Pending Content:

Transition Guidance: 842-10-65-1

Sublease

A transaction in which an underlying asset is re-leased by the lessee (or intermediate lessor) to a third party (the sublessee) and the original (or head) lease between the lessor and the lessee remains in effect.

Transaction Price
The amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties.

Pending Content:

Transition Guidance: 842-10-65-1

Unguaranteed Residual Asset

The amount that a lessor expects to derive from the underlying asset following the end of the lease term that is not guaranteed by the lessee or any other third party unrelated to the lessor, measured on a discounted basis.

Business Combinations — Goodwill or Gain from Bargain Purchase, Including Consideration Transferred

Glossary

805-30-20

Mutual Entity
An entity other than an investor-owned entity that provides dividends, lower costs, or other economic benefits directly and proportionately to its owners, members, or participants. Mutual insurance entities, credit unions, and farm and rural electric cooperatives are examples of mutual entities.

Requisite Service Period
The period or periods during which an employee is required to provide service in exchange for an award under a share-based payment arrangement. The service that an employee is required to render during that period is referred to as the requisite service. The requisite service period for an award that has only a service condition is presumed to be the vesting period, unless there is clear evidence to the contrary. If an award requires future service for vesting, the entity cannot define a prior period as the requisite service period. Requisite service periods may be explicit, implicit, or derived, depending on the terms of the share-based payment award.

Business Combinations — Related Issues

Glossary

805-50-20

Change in Accounting Principle
A change from one generally accepted accounting principle to another generally accepted accounting principle when there are two or more generally accepted accounting principles that apply or when the accounting principle formerly used is no longer generally accepted. A change in the method of applying an accounting principle also is considered a change in accounting principle.

Dropdown
A transfer of certain net assets from a sponsor or general partner to a master limited partnership in exchange for consideration.

Financial Statements Are Issued
Financial statements are considered issued when they are widely distributed to shareholders and other financial statement users for general use and reliance in a form and format that complies with GAAP. (U.S. Securities and Exchange Commission [SEC] registrants also are required to consider the guidance in paragraph 855-10-S99-2.)

In Substance Nonfinancial Asset

Paragraphs 610-20-15-5 through 15-8 define an in substance nonfinancial asset.

Pushdown Accounting
Use of the acquirer's basis in the preparation of the acquiree's separate financial statements.

Reorganization
A way to create a master limited partnership in which all of the assets of an entity are placed into a master limited partnership and that entity ceases to exist.

Rollout
A way to create a master limited partnership in which certain assets of a sponsor are placed into a limited partnership and units are distributed to the shareholders.

Rollup
A way to create a master limited partnership in which two or more legally separate limited partnerships are combined into one master limited partnership.

Securities and Exchange Commission (SEC) Filer
An entity that is required to file or furnish its financial statements with either of the following:

a. The Securities and Exchange Commission (SEC)

b. With respect to an entity subject to Section 12(i) of the Securities Exchange Act of 1934, as amended, the appropriate agency under that Section.

Financial statements for other entities that are not otherwise SEC filers whose financial statements are included in a submission by another SEC filer are not included within this definition.

In addition to the terms defined in the Master Glossary of ASC 805, the following terms are defined elsewhere in the ASC Master Glossary:

Asset Group — An asset group is the unit of accounting for a long-lived asset or assets to be held and used, which represents the lowest level for which identifiable cash flows are largely independent of the cash flows of other groups of assets and liabilities.

Change in the Reporting Entity — A change that results in financial statements that, in effect, are those of a different reporting entity. A change in the reporting entity is limited mainly to the following:

a. Presenting consolidated or combined financial statements in place of financial statements of individual entities

b. Changing specific subsidiaries that make up the group of entities for which consolidated financial statements are presented

c. Changing the entities included in combined financial statements.

Neither a business combination accounted for by the acquisition method nor the consolidation of a VIE pursuant to Topic 810 is a change in reporting entity.

Deferred Tax Asset — The deferred tax consequences attributable to deductible temporary differences and carryforwards. A deferred tax asset is measured using the applicable enacted tax rate and provisions of the enacted tax law. A deferred tax asset is reduced by a valuation allowance if, based on the weight of evidence available, it is more likely than not that some portion or all of a deferred tax asset will not be realized.

Deferred Tax Liability — The deferred tax consequences attributable to taxable temporary differences. A deferred tax liability is measured using the applicable enacted tax rate and provisions of the enacted tax law.

Disposal Group — A disposal group for a long-lived asset or assets to be disposed of by sale or otherwise represents assets to be disposed of together as a group in a single transaction and liabilities directly associated with those assets that will be transferred in the transaction. A disposal group may include a discontinued operation along with other assets and liabilities that are not part of the discontinued operation.

Entry Price — The price paid to acquire an asset or received to assume a liability in an exchange transaction.

Estimated Residual Value — The estimated fair value of the leased property at the end of the lease term.

Event — A happening of consequence to an entity. The term encompasses both transactions and other events affecting an entity.

Exit Price — The price that would be received to sell an asset or paid to transfer a liability.

Firm Commitment — An agreement with an unrelated party, binding on both parties and usually legally enforceable, with the following characteristics:

a. The agreement specifies all significant terms, including the quantity to be exchanged, the fixed price and the timing of the transaction. The fixed price may be expressed as a specified amount of an entity's functional currency or of a foreign currency. It may also be expressed as a specified interest rate or specified effective yield. The binding provisions of an agreement are regarded to include those legal rights and obligations codified in the laws to which such an agreement is subject. A price that varies with the market price of the item that is the subject of the firm

commitment cannot qualify as a fixed price. For example, a price that is specified in terms of ounces of gold would not be a fixed price if the market price of the item to be purchased or sold under the firm commitment varied with the price of gold.

b. The agreement includes a disincentive for nonperformance that is sufficiently large to make performance probable. In the legal jurisdiction that governs the agreement, the existence of statutory rights to pursue remedies for default equivalent to the damages suffered by the nondefaulting party, in and of itself, represents a sufficiently large disincentive for nonperformance to make performance probable for purposes of applying the definition of a firm commitment.

Highest and Best Use — The use of a nonfinancial asset by market participants that would maximize the value of the asset or the group of assets and liabilities (for example, a business) within which the asset would be used.

Impairment — Impairment is the condition that exists when the carrying amount of a long-lived asset (asset group) exceeds its fair value.

Kick-Out Rights (voting interest entity definition) — The rights underlying the limited partner's or partners' ability to dissolve (liquidate) the limited partnership or otherwise remove the general partners without cause.

Lease Inception — The date of the lease agreement or commitment, if earlier. For purposes of this definition, a commitment shall be in writing, signed by the parties in interest to the transaction and shall specifically set forth the principal provisions of the transaction. If any of the principal provisions are yet to be negotiated, such a preliminary agreement or commitment does not qualify for purposes of this definition.

Lease Modification (after adoption of ASC 842) — A change to the terms and conditions of a contract that results in a change in the scope of or the consideration for a lease (for example, a change to the terms and conditions of the contract that adds or terminates the right to use one or more underlying assets or extends or shortens the contractual lease term).

Leveraged Lease (after adoption of ASC 842) — From the perspective of a lessor, a lease that was classified as a leveraged lease in accordance with leases guidance in effect before the effective date and for which the commencement date is before the effective date.

Primary Beneficiary — An entity that consolidates a VIE. See paragraphs 810-10-25-38 through 25-38J for guidance on determining the primary beneficiary.

Replacement Award — An award of share-based compensation that is granted (or offered to grant) concurrently with the cancellation of another award.

Reporting Unit — The level of reporting at which goodwill is tested for impairment. A reporting unit is an operating segment or one level below an operating segment (also known as a component).

Research and Development — Research is planned search or critical investigation aimed at discovery of new knowledge with the hope that such knowledge will be useful in developing a new product or service (referred to as product) or a new process or technique (referred to as process) or in bringing about a significant improvement to an existing product or process. Development is the translation of research findings or other knowledge into a plan or design for a new product or process or for a significant improvement to an existing product or process whether intended for sale or use. It includes the conceptual formulation, design, and testing of product alternatives, construction of prototypes, and operation of pilot plants.

Residual Value — The estimated fair value of an intangible asset at the end of its useful life to an entity, less any disposal costs.

Subsidiary — An entity, including an unincorporated entity such as a partnership or trust, in which another entity, known as its parent, holds a controlling financial interest. (Also, a VIE that is consolidated by a primary beneficiary.)

Temporary Difference — A difference between the tax basis of an asset or liability computed pursuant to the requirements in Subtopic 740-10 for tax positions, and its reported amount in the financial statements that will result in taxable or deductible amounts in future years when the reported amount of the asset or liability is recovered or settled, respectively. Paragraph 740-10-25-20 cites examples of temporary differences. Some temporary differences cannot be identified with a particular asset or liability for financial reporting (see paragraphs 740-10-05-10 and 740-10-25-24 through 25-25), but those temporary differences do meet both of the following conditions:

a. Result from events that have been recognized in the financial statements

b. Will result in taxable or deductible amounts in future years based on provisions of the tax law.

Some events recognized in financial statements do not have tax consequences. Certain revenues are exempt from taxation and certain expenses are not deductible. Events that do not have tax consequences do not give rise to temporary differences.

Unit of Account — The level at which an asset or a liability is aggregated or disaggregated in a Topic for recognition purposes.

Useful Life — The period over which an asset is expected to contribute directly or indirectly to future cash flows.

K Index of ASC references in this publication

ASC Paragraph	Section	
805-10-50-5	8.4.1	Overview
805-10-50-5	8.5.9	ASC 820 disclosure considerations
805-10-50-7	1.8	Disclosure requirements
805-10-50-7	8.4	General disclosure requirements
805-10-55-2	2.1	What is a business combination?
805-10-55-3	2.1	What is a business combination?
805-10-55-3A	2.1.3.2	The elements of a business
805-10-55-4	2.1.3.2	The elements of a business
805-10-55-5	2.1.3.2.1	Minimum requirements to be a business
805-10-55-5A	2.1.3.1	Applying the 'substantially all' threshold
805-10-55-5A	A.1	Scope
805-10-55-5B	2.1.3.1.2	Single identifiable assets
805-10-55-5C	2.1.3.1.3	Group of similar identifiable assets
805-10-55-5D	2.1.3.3.1	When the set is not generating outputs
805-10-55-5E	2.1.3.3.2	When the set is generating outputs
805-10-55-5F	2.1.3.3.2	When the set is generating outputs
805-10-55-6	2.1.3.2	The elements of a business
805-10-55-8	2.1.3.2.1	Minimum requirements to be a business
805-10-55-9	2.1.3.3.4	Presence of goodwill
805-10-55-10	3.2	Identifying the acquirer
805-10-55-11	2.1	What is a business combination?
805-10-55-11	3.2	Identifying the acquirer
805-10-55-11	3.2.2	Identifying the acquirer if the acquiree is a voting interest entity
805-10-55-11	3.2.2.1	Identifying the acquirer when the acquirer is not "obvious"
805-10-55-11	3.2.2.2.4.1	Earnings per share (EPS)
805-10-55-11	3.2.2.2.5.1	Special purpose acquisition companies
805-10-55-11	3.2.2.3	Combinations of more than two entities
805-10-55-11	A.1	Scope
805-10-55-11	B.3	Recognition
805-10-55-12	2.1	What is a business combination?
805-10-55-12	3.2	Identifying the acquirer
805-10-55-12	3.2.2	Identifying the acquirer if the acquiree is a voting interest entity
805-10-55-12	3.2.2.1	Identifying the acquirer when the acquirer is not 'obvious'
805-10-55-12	3.2.2.2.4.1	Earnings per share (EPS)
805-10-55-12	3.2.2.2.5.1	Special purpose acquisition companies
805-10-55-12	3.2.2.3	Combinations of more than two entities
805-10-55-12	A.1	Scope
805-10-55-12	B.3	Recognition
805-10-55-12(a)	3.2.2.1.1	Relative voting rights
805-10-55-12(b)	3.2.2.1.2	Size of single minority voting interest
805-10-55-12(c)	3.2.2.1.3	Composition of the governing body
805-10-55-12(d)	3.2.2.1.4	Composition of management
805-10-55-12(e)	3.2.2.1.5	Terms of the exchange of equity interests
805-10-55-13	2.1	What is a business combination?
805-10-55-13	3.2	Identifying the acquirer
805-10-55-13	3.2.2	Identifying the acquirer if the acquiree is a voting interest entity

ASC Paragraph	Section	
805-10-55-31	4.5.1.1	Examples of settlements of contractual relationships in a business combination
805-10-55-32	4.5.1.1	Examples of settlements of contractual relationships in a business combination
805-10-55-33	4.5.1.1	Examples of settlements of contractual relationships in a business combination
805-10-55-52	2.1.3.4	Application of the definition of a business
805-10-55-53	2.1.3.4	Application of the definition of a business
805-10-55-54	2.1.3.4	Application of the definition of a business
805-10-55-55	2.1.3.4	Application of the definition of a business
805-10-55-56	2.1.3.4	Application of the definition of a business
805-10-55-57	2.1.3.4	Application of the definition of a business
805-10-55-58	2.1.3.4	Application of the definition of a business
805-10-55-59	2.1.3.4	Application of the definition of a business
805-10-55-60	2.1.3.4	Application of the definition of a business
805-10-55-61	2.1.3.4	Application of the definition of a business
805-10-55-65	2.1.3.1.4	Gross assets acquired
805-10-55-66	2.1.3.1.4	Gross assets acquired
805-10-55-67	2.1.3.4	Application of the definition of a business
805-10-55-68	2.1.3.4	Application of the definition of a business
805-10-55-69	2.1.3.4	Application of the definition of a business
805-10-55-70	2.1.3.4	Application of the definition of a business
805-10-55-71	2.1.3.4	Application of the definition of a business
805-10-55-72	2.1.3.4	Application of the definition of a business
805-10-55-88	2.1.3.4	Application of the definition of a business
805-10-55-89	2.1.3.4	Application of the definition of a business
805-10-55-90	2.1.3.4	Application of the definition of a business
805-10-55-91	2.1.3.4	Application of the definition of a business
805-10-55-92	2.1.3.4	Application of the definition of a business
805-10-55-93	2.1.3.4	Application of the definition of a business
805-10-55-94	2.1.3.4	Application of the definition of a business
805-10-55-95	2.1.3.4	Application of the definition of a business
805-10-55-96	2.1.3.4	Application of the definition of a business
805-20-05-4	D.4.1	Overview and scope
805-20-15-1A	D.4.1	Overview and scope
805-20-15-2	D.4.1	Overview and scope
805-20-15-3	D.4.1	Overview and scope
805-20-15-4	D.4.1.1	Interaction with the goodwill amortization accounting alternative
805-20-25-1	3.4	Recognizing and measuring the identifiable assets acquired, the liabilities assumed and any noncontrolling interest in the acquiree
805-20-25-1	4.2.6.2	Application of AICPA Accounting & Valuation Guide, Asset Acquired to Be Used in Research and Development Activities (the Guide)
805-20-25-1	4.2.6.2.1	Attributes of an acquired IPR&D project
805-20-25-1	D.4.2	Recognition
805-20-25-2	3.4.1.1	Meaning of 'an asset or liability at the acquisition date'
805-20-25-2	4.2.6.2	Application of AICPA Accounting & Valuation Guide, Asset Acquired to Be Used in Research and Development Activities (the Guide)
805-20-25-2	4.2.6.2.1	Attributes of an acquired IPR&D project
805-20-25-2	4.3.2	Cost of restructuring an acquired company
805-20-25-3	3.4.1.2	Meaning of 'part of the business combination'

ASC Paragraph	Section	
805-20-25-3	4.2.6.2	Application of AICPA Accounting & Valuation Guide, Asset Acquired to Be Used in Research and Development Activities (the Guide)
805-20-25-3	4.2.6.2.1	Attributes of an acquired IPR&D project
805-20-25-4	3.4.1.1	Meaning of 'an asset or liability at the acquisition date'
805-20-25-6	3.4.1.3	Classification or designation of assets acquired and liabilities assumed
805-20-25-7	3.4.1.3	Classification or designation of assets acquired and liabilities assumed
805-20-25-8	3.4.1.3	Classification or designation of assets acquired and liabilities assumed
805-20-25-10	4.2.5	Intangible assets
805-20-25-10A	4.4.4.2	Inherent fair value in executory contracts
805-20-25-10A	4.4.4.4.2	Recognition and measurement of acquired leases
805-20-25-10A	4.4.4.4.2.1	Acquiree in a business combination is a lessee in a finance or operating lease
805-20-25-11	4.4.4.3	Leases (before to the adoption of ASC 842)
805-20-25-11	4.4.4.4.2	Recognition and measurement of acquired leases
805-20-25-12	4.4.4.3	Leases (before to the adoption of ASC 842)
805-20-25-12	4.4.4.3.2	Lessor accounting
805-20-25-12	4.4.4.4.2	Recognition and measurement of acquired leases
805-20-25-13	4.4.4.2	Inherent fair value in executory contracts
805-20-25-13	4.4.4.3	Leases (before to the adoption of ASC 842)
805-20-25-14	4.2.5.3.7	Reacquired rights
805-20-25-15	4.2.5.3.7	Reacquired rights
805-20-25-15A	6.4.8	Assumed contingent consideration arrangements
805-20-25-16	3.4.2	Measurement principles
805-20-25-16	3.4.3	Exceptions to the recognition and measurement principles
805-20-25-18A	4.4.1	Preacquisition contingencies
805-20-25-19	4.4.1	Preacquisition contingencies
805-20-25-20	4.4.1	Preacquisition contingencies
805-20-25-20A	4.4.1	Preacquisition contingencies
805-20-25-20B	4.4.1	Preacquisition contingencies
805-20-25-22	4.3.1	Pension, postretirement obligations and bonuses
805-20-25-23	4.3.1	Pension, postretirement obligations and bonuses
805-20-25-24	4.3.1	Pension, postretirement obligations and bonuses
805-20-25-25	4.3.1	Pension, postretirement obligations and bonuses
805-20-25-26	4.3.1	Pension, postretirement obligations and bonuses
805-20-25-27	4.2.7	Indemnification assets
805-20-25-28	4.2.7	Indemnification assets
805-20-25-28A	4.4.4.4.2	Recognition and measurement of acquired leases
805-20-25-28B	4.4.4.4.2	Recognition and measurement of acquired leases
805-20-25-28C	4.4.3A	Contracts with customers (after the adoption of ASU 2021-08)
805-20-25-30	D.4.2	Recognition
805-20-25-31	D.4.2.1	Application of the intangible assets accounting alternative to customer-related intangible assets
805-20-25-32	D.4.2.1.2	Contract assets and leases
805-20-25-33	D.4.2.1.2	Contract assets and leases
805-20-30-1	3.4.2	Measurement principles
805-20-30-4	4.2.2	Assets with uncertain cash flows (valuation allowances)
805-20-30-4A	4.2.2	Assets with uncertain cash flows (valuation allowances)

ASC Paragraph	Section	
805-30-25-6	6.4.3.1	The roadmap of applicable sections of the Codification to consider in determining the appropriate classification of contingent consideration
805-30-25-6	6.4.8	Assumed contingent consideration arrangements
805-30-25-6	8.3.2.1	Contingent consideration classified as equity
805-30-25-6	A.1.1	Initial consolidation of a VIE that is not a business
805-30-25-7	6.4.3	Classification of contingent consideration
805-30-25-7	8.3.2.1	Contingent consideration classified as equity
805-30-25-7	A.1.1	Initial consolidation of a VIE that is not a business
805-30-30-1	3.5.1	Goodwill
805-30-30-1	7.1.2	Measurement
805-30-30-1	7.4.2.1	Remeasurement of previously held interest
805-30-30-1(a)(2)	6.3.2.3	Acquirer does not replace acquiree's share-based payment awards (i.e., acquiree awards remain outstanding)
805-30-30-2	3.5.1	Goodwill
805-30-30-3	3.5.1	Goodwill
805-30-30-5	7.2.1	Required reassessment of identification and measurement of all aspects of the transaction
805-30-30-6	7.2.1	Required reassessment of identification and measurement of all aspects of the transaction
805-30-30-7	6.1	Measurement of consideration transferred
805-30-30-8	6.1.4	Recognizing gains or losses on noncash assets transferred
805-30-30-9	6.3.2	Replacement of share-based payment awards
805-30-30-10	6.3.2.4	Acquiree share-based payment awards expire as a result of the business combination
805-30-30-11	6.3.2.1	Acquirer is obligated to replace acquiree's share-based payment awards issued to employees
805-30-30-11	6.3.2.2	Acquirer is obligated to replace acquiree's share-based payment awards issued to nonemployees
805-30-30-12	6.3.2.1	Acquirer is obligated to replace acquiree's share-based payment awards issued to employees
805-30-30-12	6.3.2.2	Acquirer is obligated to replace acquiree's share-based payment awards issued to nonemployees
805-30-30-13	6.3.2.1	Acquirer is obligated to replace acquiree's share-based payment awards issued to employees
805-30-30-13	6.3.2.2	Acquirer is obligated to replace acquiree's share-based payment awards issued to nonemployees
805-30-35-1	6.4.6	Accounting for contingent consideration after initial recognition
805-30-35-1	6.4.8	Assumed contingent consideration arrangements
805-30-35-1	8.3.2.2	Remeasurement of contingent consideration classified as a liability or an asset
805-30-35-1A	6.4.6	Accounting for contingent consideration after initial recognition
805-30-35-2	4.7	Subsequent accounting for assets acquired and liabilities assumed in a business combination
805-30-35-3	4.7	Subsequent accounting for assets acquired and liabilities assumed in a business combination
805-30-50-1	8.5.2	Disclosure requirements for goodwill, bargain purchase gains and consideration transferred
805-30-50-1	8.5.6	Business combinations after the balance sheet date
805-30-50-2	8.5.2	Disclosure requirements for goodwill, bargain purchase gains and consideration transferred
805-30-50-3	8.5.6	Business combinations after the balance sheet date

ASC Paragraph	Section	
805-30-50-4	8.5.2	Disclosure requirements for goodwill, bargain purchase gains and consideration transferred
805-30-55-2	6.1.5	Consideration transferred in a business combination achieved without the transfer of consideration
805-30-55-3	6.1.5.1.1	Applying the acquisition method to combinations of mutual entities
805-30-55-4	6.1.5.1.1	Applying the acquisition method to combinations of mutual entities
805-30-55-5	6.1.5.1.1	Applying the acquisition method to combinations of mutual entities
805-30-55-8	6.3.2.1	Acquirer is obligated to replace acquiree's share-based payment awards issued to employees
805-30-55-9	6.3.2.1	Acquirer is obligated to replace acquiree's share-based payment awards issued to employees
805-30-55-9	6.3.2.3	Acquirer does not replace acquiree's share-based payment awards (i.e., acquiree awards remain outstanding)
805-30-55-9A	6.3.2.2	Acquirer is obligated to replace acquiree's share-based payment awards issued to nonemployees
805-30-55-10	6.3.2.1	Acquirer is obligated to replace acquiree's share-based payment awards issued to employees
805-30-55-10	6.3.2.2	Acquirer is obligated to replace acquiree's share-based payment awards issued to nonemployees
805-30-55-11	6.3.2.1.2	Accounting for forfeitures
805-30-55-12	6.3.2.1.1	Graded vesting
805-30-55-12	6.3.2.1.2	Accounting for forfeitures
805-30-55-13	6.3.2.1.2	Accounting for forfeitures
805-30-55-18	6.3.3.1	No required post-combination service, all requisite service for acquiree awards rendered as of acquisition date
805-30-55-19	6.3.3.1	No required post-combination service, all requisite service for acquiree awards rendered as of acquisition date
805-30-55-20	6.3.3.2	Post-combination service required, all requisite service for acquiree awards rendered as of acquisition date
805-30-55-21	6.3.3.3	Post-combination service required, all requisite service for acquiree awards not rendered as of acquisition date
805-30-55-22	6.3.3.3	Post-combination service required, all requisite service for acquiree awards not rendered as of acquisition date
805-30-55-23	6.3.3.4	No required post-combination service, all requisite service for acquiree awards not rendered as of acquisition date
805-30-55-24	6.3.3.4	No required post-combination service, all requisite service for acquiree awards not rendered as of acquisition date
805-30-55-27	6.3.4.1	No required post-combination vesting, vesting condition for acquiree awards has been met as of acquisition date
805-30-55-28	6.3.4.1	No required post-combination vesting, vesting condition for acquiree awards has been met as of acquisition date
805-30-55-29	6.3.4.1	No required post-combination vesting, vesting condition for acquiree awards has been met as of acquisition date
805-30-55-30	6.3.4.2	Post-combination vesting required, vesting condition for acquiree awards has been met as of acquisition date
805-30-55-31	6.3.4.2	Post-combination vesting required, vesting condition for acquiree awards has been met as of acquisition date
805-30-55-32	6.3.4.3	Post-combination vesting required, vesting condition for acquiree awards has not been met as of acquisition date
805-30-55-33	6.3.4.3	Post-combination vesting required, vesting condition for acquiree awards has not been met as of acquisition date
805-30-55-34	6.3.4.4	No required post-combination vesting, vesting condition for acquiree awards has not been met as of acquisition date

ASC Paragraph	Section	
805-50-15-11	B.2	Scope
805-50-25-1	A.2	Measure the cost of the asset acquisition
805-50-25-1	A.2.1.3	Equity interests issued in exchange for goods or services
805-50-25-2	A.7	Other considerations
805-50-25-4	B.3	Recognition
805-50-25-5	B.3	Recognition
805-50-25-6	B.3	Recognition
805-50-25-7	B.3	Recognition
805-50-25-8	B.3	Recognition
805-50-25-9	B.3	Recognition
805-50-30-1	A.2	Measure the cost of the asset acquisition
805-50-30-2	A.2	Measure the cost of the asset acquisition
805-50-30-2	A.2.1	Noncash consideration
805-50-30-3	2.1.3.1	Applying the 'substantially all' threshold
805-50-30-3	A.3	Allocate the cost of the asset acquisition
805-50-30-3	A.3.1	Cost assignment in asset acquisitions
805-50-30-3	A.3.1.1.3	Defensive intangible assets
805-50-30-3	A.4	Evaluate the difference between cost and fair value
805-50-30-3	A.6.1	Assets recognized based on the settlement of a contingent consideration arrangement
805-50-30-5	A.7	Other considerations
805-50-30-5	C.4	Accounting and reporting by the receiving entity
805-50-30-6	A.7	Other considerations
805-50-30-6	C.4	Accounting and reporting by the receiving entity
805-50-30-7	2.2.4	Change of accounting basis in master limited partnerships
805-50-30-8	2.2.4	Change of accounting basis in master limited partnerships
805-50-30-9	2.2.4	Change of accounting basis in master limited partnerships
805-50-30-10	B.4	Measurement
805-50-30-11	B.4	Measurement
805-50-30-12	B.4	Measurement
805-50-30-12	B.4.2	Acquisition-related liabilities incurred by acquirer
805-50-30-12	B.4.3	Treatment of a contingent consideration asset or liability
805-50-35-1	A.6	Subsequent accounting
805-50-35-2	B.4	Measurement
805-50-35-2	B.4.7	Subsequent accounting
805-50-45-2	C.4.2	Financial statement presentation by the receiving entity
805-50-45-3	C.4.2	Financial statement presentation by the receiving entity
805-50-45-4	C.4.2	Financial statement presentation by the receiving entity
805-50-45-5	C.4.2	Financial statement presentation by the receiving entity
805-50-50-2	C.8	Disclosures
805-50-50-3	C.8	Disclosures
805-50-50-4	C.8	Disclosures
805-50-50-5	B.5	Disclosure
805-50-50-6	B.5	Disclosure
805-50-S99-4	A.7	Other considerations
805-740-25-10	6.3.2.5	Income tax effects of replacement awards classified as equity

ASC Paragraph	Section	
825-10-25-5	B.4.4	Treatment of a parent's fair value option election in acquiree's financial statements
835-30-35-2	A.2.2	Direct transaction costs
835-30-35-3	A.2.2	Direct transaction costs
835-30-45-1A	6.2	Acquisition-related costs
835-30-45-3	6.2	Acquisition-related costs
840-10-25-1	4.4.4.3.1.1	Measurement of property under capital lease
840-10-25-27	4.4.4.3	Leases (before the adoption of ASC 842)
840-10-35-4	4.4.4.3	Leases (before the adoption of ASC 842)
840-10-35-4	4.4.4.3.4	Lease modifications in connection with a business combination
840-10-35-5	4.4.4.3	Leases (before the adoption of ASC 842)
840-10-35-5	4.4.4.3.4	Lease modifications in connection with a business combination
840-10-35-5	A.1.2	Summary of key differences between accounting for a business combination and an asset acquisition
840-30-25-10	4.4.4.3.7	Leveraged lease acquired in a business combination or an acquisition by a not-for-profit entity
840-30-30-15	4.4.4.3.7	Leveraged lease acquired in a business combination or an acquisition by a not-for-profit entity
840-30-35-32	4.4.4.3.7	Leveraged lease acquired in a business combination or an acquisition by a not-for-profit entity
840-30-55-50	4.4.4.3.7	Leveraged lease acquired in a business combination or an acquisition by a not-for-profit entity
840-30-55-51	4.4.4.3.7	Leveraged lease acquired in a business combination or an acquisition by a not-for-profit entity
840-30-55-52	4.4.4.3.7	Leveraged lease acquired in a business combination or an acquisition by a not-for-profit entity
840-30-55-53	4.4.4.3.7	Leveraged lease acquired in a business combination or an acquisition by a not-for-profit entity
840-30-55-54	4.4.4.3.7	Leveraged lease acquired in a business combination or an acquisition by a not-for-profit entity
840-30-55-55	4.4.4.3.7	Leveraged lease acquired in a business combination or an acquisition by a not-for-profit entity
840-30-55-56	4.4.4.3.7	Leveraged lease acquired in a business combination or an acquisition by a not-for-profit entity
842-10-25-3	A.3.1.3.1	Accounting for leases in asset acquisitions
842-10-25-8	A.1.2	Summary of key differences between accounting for a business combination and an asset acquisition
842-10-55-11	4.4.4.4.1	Classification of acquired leases
842-20-35-13	4.4.4.4.4	Acquired leasehold improvement
842-50-25-2	4.4.4.4.6	Leveraged lease acquired in a business combination or an acquisition by a not-for-profit entity
842-50-30-2	4.4.4.4.6	Leveraged lease acquired in a business combination or an acquisition by a not-for-profit entity
842-50-35-1	4.4.4.4.6	Leveraged lease acquired in a business combination or an acquisition by a not-for-profit entity
842-50-55-27	4.4.4.4.6	Leveraged lease acquired in a business combination or an acquisition by a not-for-profit entity
842-50-55-28	4.4.4.4.6	Leveraged lease acquired in a business combination or an acquisition by a not-for-profit entity
842-50-55-29	4.4.4.4.6	Leveraged lease acquired in a business combination or an acquisition by a not-for-profit entity

ASC Paragraph	Section	
842-50-55-30	4.4.4.4.6	Leveraged lease acquired in a business combination or an acquisition by a not-for-profit entity
842-50-55-31	4.4.4.4.6	Leveraged lease acquired in a business combination or an acquisition by a not-for-profit entity
842-50-55-32	4.4.4.4.6	Leveraged lease acquired in a business combination or an acquisition by a not-for-profit entity
842-50-55-33	4.4.4.4.6	Leveraged lease acquired in a business combination or an acquisition by a not-for-profit entity
845-10-30-10	C.5.1	Impairment considerations
845-10-50-1	A.5	Present and disclose the asset acquisition
860-10-40-5	A.7.2.1	Transfer of financial assets
860-10-40-5	C.3.1	Transfer of financial assets
860-10-55-78	A.7.2.1	Transfer of financial assets
860-10-55-78	C.3.1	Transfer of financial assets
932-360-25-7	6.2	Acquisition-related costs
944-805-50-1	8.4.1	Overview
958-810-25-4	2.2.5	Not-for-profit organizations
958-810-25-4	B.2	Scope

EY | Building a better working world

EY exists to build a better working world, helping to create long-term value for clients, people and society and build trust in the capital markets.

Enabled by data and technology, diverse EY teams in over 150 countries provide trust through assurance and help clients grow, transform and operate.

Working across assurance, consulting, law, strategy, tax and transactions, EY teams ask better questions to find new answers for the complex issues facing our world today.

SCORE no. BB1616
(Revised June 2023)

This and many of the publications produced by our US Professional Practice Group, are available free on AccountingLink at ey.com/en_us/assurance/accountinglink.