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Technical Line

A closer look at the accounting for asset acquisitions

In this issue:

What you need to know

- The new definition of a business in ASC 805 has resulted in additional transactions being accounted for as asset acquisitions rather than business combinations. A transaction may be considered an asset acquisition under ASC 805 and an acquisition of a business for purposes of SEC reporting.
- Asset acquisitions are accounted for by allocating the cost of the acquisition to the individual assets acquired and liabilities assumed on a relative fair value basis. Goodwill is not recognized in an asset acquisition.
- Entities may need to reassess the design of their internal controls over asset acquisitions to make sure they sufficiently address the risks of material misstatements.
- This publication includes updated interpretive guidance on several practice issues, including noncash consideration, contingent consideration and exchanges of share-based payment awards in asset acquisitions.

Overview

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.

That is, 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.

Building a better working world

To determine whether they are acquiring a business or an asset or group of assets, entities need to apply the definition of a business in Accounting Standards Codification (ASC) 805-10, *Business Combinations — Overall*. When an acquired asset or group of assets does not meet that definition, the transaction is accounted for as an asset acquisition in accordance with ASC 805-50, *Business Combinations — Related Issues*.

The new definition of a business, which the Financial Accounting Standards Board (FASB or Board) created with Accounting Standard Update (ASU) 2017-01, *Business Combinations (Topic 805): Clarifying the Definition of a Business,* has resulted in additional acquisitions being accounted for as asset acquisitions rather than business combinations. There are many implications of this change. Companies may face unfamiliar financial reporting issues related to the accounting for asset acquisitions.

As a reminder, public business entities (PBEs) were required to adopt the standard in 2018, and it was effective for nonpublic entities for fiscal years beginning after 15 December 2018 and interim periods within fiscal years beginning after 15 December 2019.

FASB Phase 3 of the definition of a business project

The FASB is still evaluating whether certain differences between the accounting for asset acquisitions and business combinations can be aligned in the third phase of its project on the definition of a business.

These areas include contingent consideration and transaction costs. Initial deliberations are ongoing. In a recent meeting, the Board removed in-process research and development (IPR&D) from the scope of the project. Any decisions the Board makes in this project could affect the guidance in this publication. Readers should monitor developments.

As a reminder, Phases 1 and 2 of the definition of a business project are complete and resulted in the issuance of ASU 2017-01 and ASU 2017-05, *Other Income — Gains and Losses from the Derecognition of Nonfinancial Assets (Subtopic 610-20): Clarifying the Scope of Asset Derecognition Guidance and Accounting for Partial Sales of Nonfinancial Assets*.

This Technical Line provides guidance on how to apply ASC 805-50 to account for asset acquisitions. The publication has been updated to include interpretive guidance on several practice issues, including those related to noncash consideration, contingent consideration and exchanges of share-based payment awards in asset acquisitions.

While the facts and circumstances of an asset acquisition should always be considered in evaluating the accounting, it may be helpful for companies to consider the guidance in the context of the following framework:

- Determine that the transaction is an asset acquisition
- Measure the cost of the asset acquisition
- Allocate the cost of the asset acquisition
- Evaluate the difference between cost and fair value
- Present and disclose the asset acquisition

Scope (updated September 2020)

ASC 805-50 provides guidance on accounting for acquisitions in which the asset (or a group of assets) acquired and liabilities assumed do not meet the definition of a business. 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.

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).[1] 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.

For additional information about reverse acquisitions, refer to section 3 of our Financial reporting developments (FRD) publication, ***Business combinations***.

Initial consolidation of a VIE that is not a business

Under ASC 805-50-15-4, a primary beneficiary's initial consolidation of a variable interest entity (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. We provide interpretive guidance on the initial measurement and recognition by a primary beneficiary of a VIE that does not constitute a business in our FRD, ***Consolidation***.

Subsequent accounting for IPR&D and contingent consideration

While ASC 810, *Consolidation*, 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, *Intangibles — Goodwill and Other*. 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, *Research and Development*. That is, IPR&D intangible assets with no alternative future use are recognized as an expense at the acquisition date.

For contingent consideration obligations that are not subject to other guidance (e.g., ASC 815, *Derivatives and Hedging*), entities either look to the subsequent accounting guidance for contingent consideration in a business combination in ASC 805 to remeasure the obligation at fair value or recognize the obligation when the contingency is resolved and is paid or becomes payable or by applying the guidance in ASC 450, *Contingencies*.

How we see it

The FASB is considering the subsequent accounting for IPR&D and contingent consideration upon the initial consolidation of a VIE that is not a business, pursuant to ASC 810, in its project on improving the accounting for asset acquisitions and business combinations (Phase 3 of its definition of a business project). Entities should monitor developments.

Initial accounting

Determine that the transaction is an asset acquisition

To apply the asset acquisition guidance in ASC 805-50, an entity must first determine whether a transaction meets the definition of a business in accordance with ASC 805-10-55. To make that determination, an entity first evaluates 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 of assets and activities is *not* a business.

If the threshold is not met, the entity further evaluates whether the set meets the definition of a business. The guidance requires a business to include, at a minimum, an input and a substantive process that together significantly contribute to the ability to create outputs.[2] Because all asset acquisitions include inputs, the existence of a substantive process is what distinguishes a business from an asset or group of assets.

Additionally, entities can no longer presume, as they did under the legacy guidance, 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 new 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, when that element is missing, entities must meet a higher standard to conclude that a substantive process is present.

To apply the definition of a business, an entity must determine which elements are part of the acquired set and which are part of a separate transaction. Any inputs or processes provided through separate transactions are excluded from the "substantially all" 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. See the *Transactions that are separate from an asset acquisition* section below for further guidance on making this determination.

We provide detailed interpretive guidance on the definition of a business in our FRD, ***Business combinations***, which readers may find helpful when performing this evaluation. The remainder of this publication focuses on the guidance provided in ASC 805-50 to account for an acquisition of an asset or group of assets. Appendix A includes a summary of the most significant differences between the accounting for a business combination and that for an asset acquisition.

Definition of a business under SEC rules and regulations

When a registrant acquires an asset (or a group of assets), it must evaluate whether the asset (or group of assets) meets the definition of a business under Article 11-01(d) of Regulation S-X (Article 11) to determine whether financial statements of an acquired business and pro forma information are required in Securities and Exchange Commission (SEC) filings.

The SEC staff's analysis of whether an acquisition constitutes the acquisition of a business, rather than the acquisition of assets, focuses primarily on whether the nature of the revenue-producing activity associated with the acquired assets will remain generally the same after the acquisition. This definition of a business differs from the US GAAP definition. Therefore, it is possible for a registrant to reach a different conclusion about whether a business has been acquired under Article 11 and ASC 805.

Refer to the *SEC reporting considerations* section below for further discussion and to our SEC Financial Reporting Series publication, ***Pro forma financial information: a guide for applying Article 11 of Regulation S-X***, for guidance on the SEC's definition of a business.

Measure the cost of the asset acquisition

Entities may reach different conclusions about whether an acquired set meets the definition of a business under ASC 805 and Article 11.

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.

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, *Nonmonetary Transactions,* and ASC 610-20 (following the adoption of ASU 2014-09 and ASU 2017-05), *Other Income — Gains and Losses from the Derecognition of Nonfinancial Assets*).

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.

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.

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.

Equity interests issued in exchange for goods or services (added September 2020)

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. In this instance, an entity would apply either ASC 505-50, *Equity-Based Payments to Non-Employees* (before the adoption of ASU 2018-07), or ASC 718, *Compensation — Stock Compensation* (after the adoption of ASU 2018-07, *Compensation — Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting*), in measuring the equity interests issued. Applying ASC 718 may result in an earlier measurement date than the acquisition date (i.e., the grant date) for the shares transferred. Refer to our FRD, ***Share-based payment (after the adoption of ASU 2018-07,* Improvements to Nonemployee Share-Based Payment Accounting*)***, for additional details. We believe that it may be acceptable to apply either ASC 805-50 or the share-based payment guidance (ASC 505-50 or ASC 718, as applicable) to the issuance of shares in an asset acquisition.

Agenda request

In a recent agenda request, the FASB was asked to clarify how an entity should measure equity interests issued in acquiring an asset (or a group of assets that does not meet the definition of a business) and whether the entity should apply the stock compensation guidance in ASC 718 or the ASC 805-50 guidance in these situations. Readers should monitor developments.

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.[3] This concept is illustrated below.

Illustration 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.

Only transaction costs that are directly related to the asset acquisition and that otherwise wouldn't be incurred should be capitalized.

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 FRD, ***Issuer's accounting for debt and equity financings***, for further guidance on debt and equity issuance costs.

How we see it

The FASB is considering aligning the accounting for direct transaction costs incurred in an asset acquisition with the accounting for direct transaction costs incurred in a business combination. While it is unclear whether the Board will propose expensing these costs or capitalizing them in both situations, either approach would address the current lack of comparability in the accounting for direct transaction costs. Entities should monitor this project for developments.

Contingent consideration (updated September 2020)

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 the *Transactions that are separate from an asset acquisition* section below 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.[4]

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, *Distinguishing Liabilities from Equity*, 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.

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.[5] 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.

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.

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 (after the adoption of ASU 2017-12,*** **Targeted Improvements to Accounting for Hedging Activities*)***, 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 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).

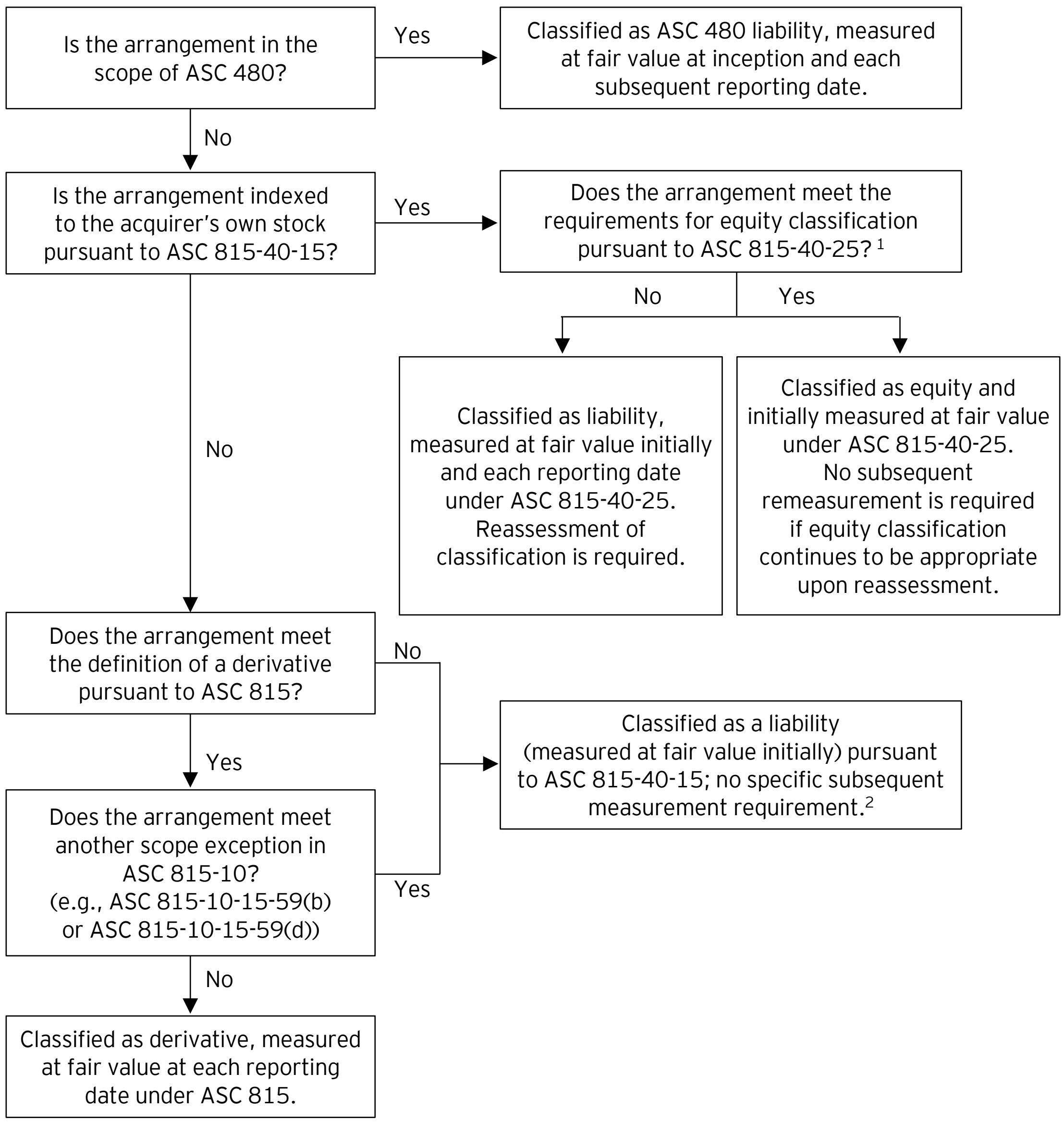
Conclusion

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 consolidation obligation when the contingency is resolved and the consideration is paid or becomes payable based on its accounting policy.

Contingent consideration arrangements settled in or indexed to equity shares

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 The FASB recently issued ASU 2020-06,[6] which simplifies the settlement assessment that entities are required to perform to determine whether a contract qualifies for equity classification.

2 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.

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 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 FRD, ***Issuer's accounting for debt and equity financings***, for further guidance.

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 FRD, ***Issuer's accounting for debt and equity financings***, 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 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.

How we see it

The FASB staff has presented the Board with several alternatives that it could consider to align the initial recognition of contingent consideration in an asset acquisition that isn't accounted for under other applicable US GAAP (e.g., ASC 480, ASC 815) with the initial recognition of contingent consideration in a business combination. The approaches include recognizing it at fair value or not recognizing it until the uncertainty is resolved and the consideration is paid or becomes payable.

The FASB staff also suggested several alternatives for the Board to consider for the subsequent measurement of a contingent consideration liability that is recognized on the acquisition date. In addition, the staff suggested that the Board consider providing guidance on where any changes in the value of the liability should be recognized in the financial statements (i.e., net income, other comprehensive income, or as an adjustment to the assets acquired). We encourage readers to monitor developments and to provide feedback as requested by the Board.

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 4 provides an example that may be helpful when determining how to account for such a transaction.

Illustration 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%).

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.

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.

A transaction is likely accounted for separately from an asset acquisition if it is entered into by or on behalf of the acquirer or is primarily for the benefit of the acquirer.

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 of our FRD, ***Business combinations***, 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.

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 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.

Research and development 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.

Allocate the cost of the asset acquisition

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, *Fair Value Measurement*. No goodwill should be recognized in an asset acquisition.[7]

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 aspects of asset acquisitions are discussed below.

Goodwill is not recognized in an asset acquisition.

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 that exceeds the fair value of the net assets acquired is allocated to the identifiable assets based on relative fair values.

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 FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises* (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.

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 IPR&D 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 are allocated a portion of the consideration transferred and capitalized.

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 2.4 of our FRD, ***Intangibles — goodwill and other***, for further discussions of the subsequent accounting.

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.

How we see it

The accounting for the acquisition of a right previously granted to the acquiree (i.e., a reacquired right) vs. the cancellation of a contract is different. Therefore, an acquirer must first determine whether the asset acquisition includes a reacquired right or represents a cancellation or rescission of the contract. This determination can be complex and often will require the exercise of professional judgment based on the particular facts and circumstances.

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.

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.

Accounting for leases in asset acquisitions

In an asset acquisition, a lessor or a lessee 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.

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.[8] (Refer to section 3, *Lease classification*, of our FRD*,* ***Lease accounting: Accounting Standards Codification 842,* Leases**, for further discussion.)

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, *Sale and leaseback transactions*, of our FRD, ***Lease accounting: Accounting Standards Codification 842,* Leases***,* to determine whether the transaction is a purchase or a financing of the asset.

Exchange of share-based payments in an asset acquisition (added September 2020)

In an asset acquisition, the acquirer may exchange its share-based payment awards for awards held by employees 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 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.

Refer to section 6.3 of our FRD, ***Business combinations***, for further information.

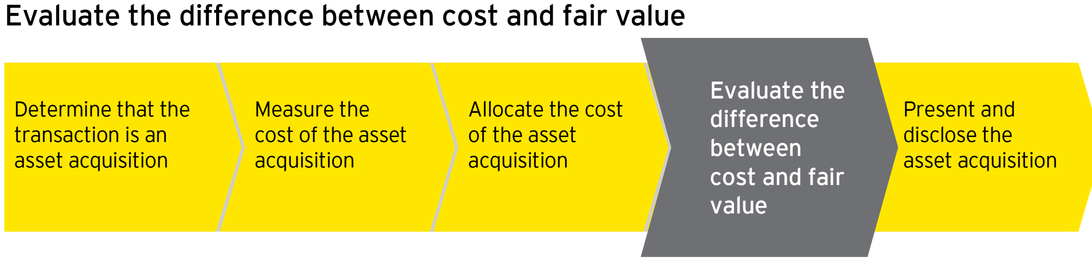
Acquired contingencies

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 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.

Deferred income taxes

Because goodwill is not recognized in an asset acquisition, the measurement of deferred income tax assets and liabilities 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.

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).

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. Prior to the adoption of ASU 2017-01, there was a presumption that if goodwill potentially existed, the acquired set is a business. The new definition of a business under ASU 2017-01 eliminates this presumption and instead states that the existence of more than an insignificant amount of potential goodwill in a transaction 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 acquirer should also carefully evaluate whether the premium it 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.

Entities should confirm that they identified and recognized all assets that meet the criteria in CON 5 before allocating consideration that exceeds the fair value of the net assets acquired.

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 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 under 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, *Balance Sheet*, 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 (see further discussion below), are subject to impairment testing pursuant to the guidance in ASC 360, *Property, Plant, and Equipment*. 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 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.

Entities need to evaluate if all liabilities assumed have been identified and recognized before determining that the fair value of the net assets acquired exceeds the cost of the acquisition.

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 that are 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 US 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 among those assets based on their fair value relative 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 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.

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 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 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.

Present and disclose the asset acquisition

Determine that the transaction is an asset acquisition → Measure the cost of the asset acquisition → Allocate the cost of the asset acquisition → Evaluate the difference between cost and fair value → **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.

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: Accounting Standards Codification 230***, for additional information.

Subsequent accounting

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.

Assets recognized based on the settlement of a contingent consideration arrangement

If contingent consideration 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 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 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 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 US 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 Jan 20X1[1]	$ 20,000	$ 20,000	$ 20,000	$ 20,000	$ 20,000
Incremental asset amount recognized on 1 Jan 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)].

Other considerations

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 of our FRD, ***Business combinations***, for additional guidance.

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.

Common control transactions

Common control transactions include a transfer of net assets or an exchange of equity interests between entities under common control. US GAAP does not define the term "common control." EITF Issue No. 02-5, *Definition of "Common Control" in Relation to FASB Statement No. 141* (EITF 02-5), summarizes the criteria for determining whether common control exists, based on a 1997 speech by a member of the SEC staff.[9] Although EITF 02-5 was not codified, due to the lack of other authoritative guidance, the SEC expects registrants to apply the guidance described in EITF 02-5, and the guidance is widely applied by both public and nonpublic companies. 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.

There is no measurement period for an asset acquisition.

Judgment is required to determine whether common control exists in situations other than those described above.

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.

Transfer of financial assets (updated September 2020)

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 the new revenue standard, 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.

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.[10] 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.

Refer to Appendix C of our FRD, ***Business combinations***, for a comprehensive discussion of accounting for common control transactions.

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.

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, ***Pro forma financial information: a guide for applying Article 11 of Regulation S-X,*** for guidance on the SEC's definition of a business.

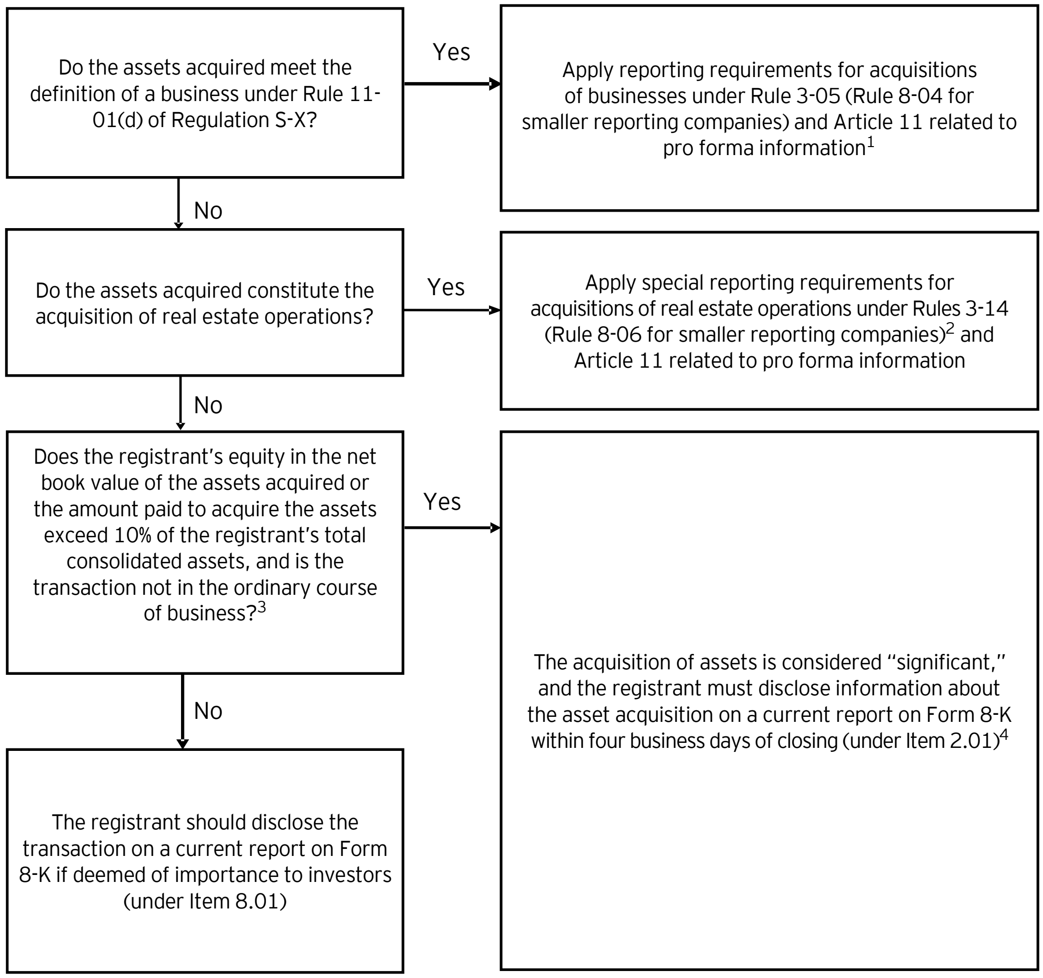
Rule 3-05 (Rule 8-04 for smaller reporting companies) of Regulation S-X, ***Financial Statements of Businesses Acquired or to be Acquired***, describes the SEC's requirements for registrants to provide audited financial statements of acquired or to-be-acquired businesses. Special considerations apply to acquisitions of businesses determined to be real estate operations under Rule 3-14 of Regulation S-X, ***Special instructions for real estate operations to be acquired***. 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 are effective 1 January 2021, but earlier compliance is permitted. See our To the Point publication, ***SEC streamlines disclosure requirements for acquisitions and disposals of businesses***, for more information.

The following decision tree may be helpful in determining the SEC reporting requirements for when a registrant acquires an asset or group of assets that does not meet the SEC's definition of a business:

Decision tree — 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 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.

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. 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.

Risk assessment

Obtaining a preliminary understanding of the transaction early in the process, including the business purpose, structure, key terms and timeline, will help an entity perform an appropriate risk assessment and design effective internal controls to mitigate risks of material misstatement.

Performing a thorough risk assessment is essential to define the risks related to the accounts affected by the asset acquisition. For example, when an entity performs a risk assessment over acquired intangible assets, it is helpful to perform a sensitivity analysis to determine which assumptions used in valuing these assets are significant.

Management review controls

Entities often identify controls to address the risks of material misstatement in an asset acquisition 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 identified. Management must document the nature of the review performed, including the criteria that the control owner uses to identify items for follow-up. Evidence needs to be retained as support that the criteria were applied and appropriate follow-up and resolution of matters identified occurred. If control descriptions use qualitative criteria to identify items for investigation, such as analyses reviewed for "significant and unusual items" or "for reasonableness," management should evaluate whether such criteria are sufficient and can be used to support the consistent and effective operation of the control.

Controls should be tailored to address the relevant risks of material misstatement of an asset acquisition.

Management review controls over an asset acquisition may not be designed with sufficient precision to, on their own, address the risks of material misstatement associated with the transaction. When a limited number of management review controls are designed over the accounting for an asset acquisition, it can be challenging to make sure that each of the individual risk factors is addressed (including consideration of the precision of the review). Therefore, it may be necessary to identify and evaluate a broader suite of management review controls and other controls.

Level of evidence

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[11] and the level of documentation necessary to support its controls. Generally, we would expect management's support and documentation to be more robust as the assessed risk of material misstatement increases.

The accounting for asset acquisitions often involves estimates that carry higher inherent risks. The unusual and/or infrequent nature of these transactions means that a company's policies, processes and controls may not be well defined, and management's documentation may be less rigorous than for more common classes of transactions. Further, Principle 12 of the internal control framework developed by the Committee of Sponsoring Organizations of the Treadway Commission states that while unwritten policies can be effective in certain circumstances, policies and procedures that are subject to external party review should 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. This may be challenging if the information is generated from an ineffective information technology system of the acquired entity.

Steps in an asset acquisition

Risks of misstatement in an asset acquisition can arise when entities (1) approve the transaction, (2) determine whether the transaction is a business combination or an asset acquisition, (3) measure the cost of the asset acquisition, (4) allocate the cost of the asset acquisition to the individual assets acquired and liabilities assumed, and (5) evaluate the difference between the cost of acquired assets and fair value. While the steps in an asset acquisition are not identical to the steps in a business combination, many of the potential risks and considerations in the design of controls that could mitigate those risks for each key step are similar to the steps in a business combination. See sections E.3 through E.8 of our FRD, ***Business combinations***, for further guidance on these audit matters. The considerations included therein are examples. Risks and controls identified should be customized based on the facts and circumstances specific to the entity and to the transaction.

Endnotes:

[1] ASC 805-10-55-5A.

[2] ASC 805-10-55-5.

[3] 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.

[4] 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.

[5] 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.

[6] ASU 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*. For PBEs other than smaller reporting companies as defined by the SEC, the guidance 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 in fiscal years beginning after 15 December 2020.

[7] ASC 805-50-30-3.

[8] 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.

[9] Comments by Donna L. Coallier, Professional Accounting Fellow at the SEC, 1997 Speeches by Commission Staff, 9 December 1997.

[10] This view is based on comments made about transfers between entities under common control by the SEC Observer to the EITF related to EITF Issue No. 85-21, *Changes of Ownership Resulting in a New Basis of Accounting*. Although Task Force members did not reach a consensus on the issue, this view is commonly applied in practice.

[11] 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 internal control over financial reporting.

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Appendix A: Summary of key differences between accounting for a business combination and an asset acquisition

	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 acquired (excluding non-qualifying assets).
Consideration transferred is less than the fair value of the net assets acquired (bargain purchase)	‣ 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 Concepts Statement No. 5 may be met even though the contractual-legal criterion or separability criterion in ASC 805 for business combinations has not been met.

	Business combination	Asset acquisition
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.
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.