# A GUIDE TO ACCOUNTING FOR BUSINESS COMBINATIONS

July 2023

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# 1. General

## 1.1 Information about the guide

### 1.1.1 Purpose of the guide

This guide was developed and designed to help assist middle market companies in their application of FASB Accounting Standards Codification (ASC) 805, which includes the guidance applicable to accounting for business combinations. Some of the complexities involved in applying ASC 805 include the following:

- The required use of a fair-value model to account for business combinations often requires the involvement of valuation specialists—both related to management's accounting for a business combination and the auditor's testing of the amounts recognized (see Section 8.1).
- It is extremely important for the buyer to determine as *early* in the acquisition process as possible whether it has acquired a business within the scope of the business combination accounting guidance, because whether a business has been acquired or not has significant accounting implications (see Section 4.1 and Section 4.3).
- The definition of a business is one of the more challenging aspects of the business combination accounting guidance to implement in practice because that definition encompasses much more than just a group of assets or net assets that could function together as a standalone business. A significant amount of judgment may need to be exercised in determining whether a business has been acquired (see Section 4.1).
- The accounting for contingent consideration involves a number of potentially complex steps, including measuring it at fair value initially, classifying it appropriately as either an asset, liability or equity and subsequently adjusting it to fair value if it is classified as an asset or liability (see Section 12.4).

These observations and many others underscore the level of effort required to account for a business combination, as well as the complexities involved in that accounting. This guide is designed to help middle market companies work through those complexities and apply ASC 805 more efficiently and effectively.

### 1.1.2 Topics covered in the guide

As the table of contents shows, the list of topics explored in this guide spans the entire spectrum of issues involved in the accounting for a business combination—from identifying whether a business combination has occurred to determining the amount of goodwill to be recognized to accounting for certain acquired items after the acquisition date. For each of these topics, the requirements in ASC 805 or other literature are described in plain English, and as appropriate, additional explanation, examples and summary tables are provided. In addition, included as appendices to this guide are the following aids:

- *Appendix A: Application checklist for ASC 805.* Highlights the key concepts in ASC 805 that must be considered in accounting for a business combination
- *Appendix B: ASC 805 disclosure checklists and illustration.* Provides user-friendly disclosure checklists for ASC 805 as well as an illustration that is cross-referenced to the disclosure checklist applicable to business combinations
- *Appendix C: Pushdown accounting.* Provides answers to the key questions that arise with respect to pushdown accounting, including: (a) what is pushdown accounting, (b) who can apply pushdown accounting, (c) when may pushdown accounting be applied, (d) how is pushdown

accounting applied and (e) when should acquisition debt or a contingent consideration liability be recognized by the target

- *Appendix D: US GAAP vs. IFRS Comparison*
- *Appendix E: Acronyms, literature and technical accounting guide references*
- *Appendix F: Summary of significant changes since last edition*
- *Appendix G: Definitions*

### 1.1.3 Tips on using the guide

Here are a few tips on how to use this guide:

- Identify the sections or appendices that are most relevant to your question by scanning the table of contents
- Consult the relevant guidance in ASC 805, as the guide is a supplement to ASC 805, not a substitute for it
- Keep in mind that this guide reflects information available as of June 30, 2023 and that the FASB's website (www.fasb.org) should be referred to for the most-recent information available
- Use the application checklist in Appendix A to help you efficiently and effectively account for a business combination
- Refer to Appendix E for (a) an acronym legend, which lists the acronyms used throughout this guide and their corresponding definition, (b) a literature listing, which lists the guidance referred to throughout this guide and the corresponding titles, and (c) a listing of our other technical accounting guides referred to throughout this guide.

## 1.2 Background information on ASC 805

Statement 141R was issued by the FASB in 2007. This standard fundamentally affected how virtually all companies account for mergers or acquisitions of businesses. In addition, the issuance of this standard was the culmination of the FASB's and IASB's efforts to converge their respective guidance on the accounting for business combinations, which was demonstrated by the IASB's issuance of IFRS 3 shortly after the FASB issued Statement 141R. While some differences exist between Statement 141R and IFRS 3, the issuance of both standards as a result of a joint project represented a significant accomplishment. Appendix D, US GAAP vs. IFRS comparison, provides a high-level summary of the significant differences between ASC 805 and IFRS 3.

The FASB released its Codification after the issuance of Statement 141R. The guidance in Statement 141R, and the amendments made to that guidance since its issuance, have been codified in ASC 805.

# 2. Definition and key steps

## 2.1 Definition of a business combination

The Master Glossary of the Codification defines a business combination as follows: "A transaction or other event in which an acquirer obtains control of one or more businesses. Transactions sometimes referred to as true mergers or mergers of equals also are business combinations. See also Acquisition by a Not-for-Profit Entity." For purposes of determining whether control has been obtained, the focus is on whether one entity has obtained a controlling financial interest in one or more businesses. The definition of a business is discussed and illustrated in detail in Section 4.1.

There are primarily two models in U.S. GAAP that are used by for-profit entities to determine whether one entity has a controlling financial interest in a business (even if the legal form of the business is a limited partnership or similar entity): (a) the variable interest entity (VIE) consolidation model and (b) the voting interest consolidation model. The models used by a not-for-profit entity to determine whether it controls another not-for-profit entity or a for-profit entity are discussed in ASC 958-810. The remainder of the discussion in this section is focused on the consolidation models used by for-profit entities. For additional information about how not-for-profit entities account for mergers and acquisitions, see Section 3.3.

The first consolidation model that should be considered is the VIE consolidation model (except as discussed in Section 2.1.1). Under this model, the buyer must first determine whether the business being evaluated for business combination accounting is a VIE. If the business is a VIE, the buyer must next apply the guidance in ASC 810-10 to determine whether it has a controlling financial interest in the VIE. Under this guidance, an entity has a controlling financial interest in a VIE if it has: (a) the power to direct the activities of the VIE that most significantly affect the VIE's economic performance (the power criterion) and (b) the obligation to absorb losses or the rights to receive benefits that could be significant to the VIE (the economics criterion). The entity that has a controlling financial interest in the VIE is considered the primary beneficiary (PB) of the VIE. While an entity usually obtains a controlling financial interest in a VIE as a result of a specific transaction, sometimes it results from an other event or change in circumstances, such as the lapsing of kick-out rights or the expiration of a contract. If the buyer obtains a controlling financial interest in a business that is a VIE, the transaction or other event giving rise to that controlling financial interest should be accounted for as a business combination (unless the PB and VIE are under common control). Exploring the VIE consolidation model in more detail is beyond the scope of this guide. Reference should be made to ASC 810-10 for additional guidance related to the VIE consolidation model. Section 3.1.3 discusses the initial consolidation of a VIE.

If the business being evaluated for business combination accounting is not a VIE, the voting interest consolidation model should be used to determine whether the buyer has obtained a controlling financial interest in that business. In most such situations, determining whether the buyer has obtained a controlling financial interest in a business requires reference to the guidance in ASC 810-10-15-8 and 15-8A, which states:

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

Generally, if a transaction or other event satisfies the definition of a business combination, then the buyer (i.e., the entity that obtained control over one or more businesses) in the business combination accounts for that transaction or other event using the acquisition method (see Section 2.2). However, there are certain transactions or events that may otherwise satisfy the definition of a business combination that are, nonetheless, explicitly excluded from the scope of ASC 805. These scope exceptions, as well as examples of the types of transactions and other events that do or do not satisfy the definition of a business combination, are discussed in detail in Section 3.1.

A key part of the definition of a business combination is that control is obtained through a transaction or other event. While the most common way for a business combination to occur is through a specific transaction (e.g., a buyer transfers cash or equity securities to acquire 100% of a target), it is not uncommon for a business combination to occur through an event other than a transaction. For example, an entity may obtain control of a business through contract alone (see Section 3.1.2). In addition, as discussed earlier, an entity may obtain control of a VIE as a result of kick-out rights lapsing or a contract expiring.

Because the definition of a business combination is focused on whether control has been obtained, the acquisition method is not used when a parent acquires an additional 10% interest in a consolidated subsidiary in which it already owns a 55% interest. In this situation, the parent did not obtain control of the subsidiary as a result of acquiring the additional 10% interest because they already had control of the subsidiary as a result of one or more previous transactions or other events. As discussed in Section 16.1, this increase in the parent's ownership interest should be accounted for as an equity transaction. ASC 805 places significant accounting importance on the event of gaining control by requiring use of the acquisition method of accounting when control is obtained. For additional discussion regarding the accounting significance of gaining control, as well as the accounting significance of losing control, see Chapter 16.

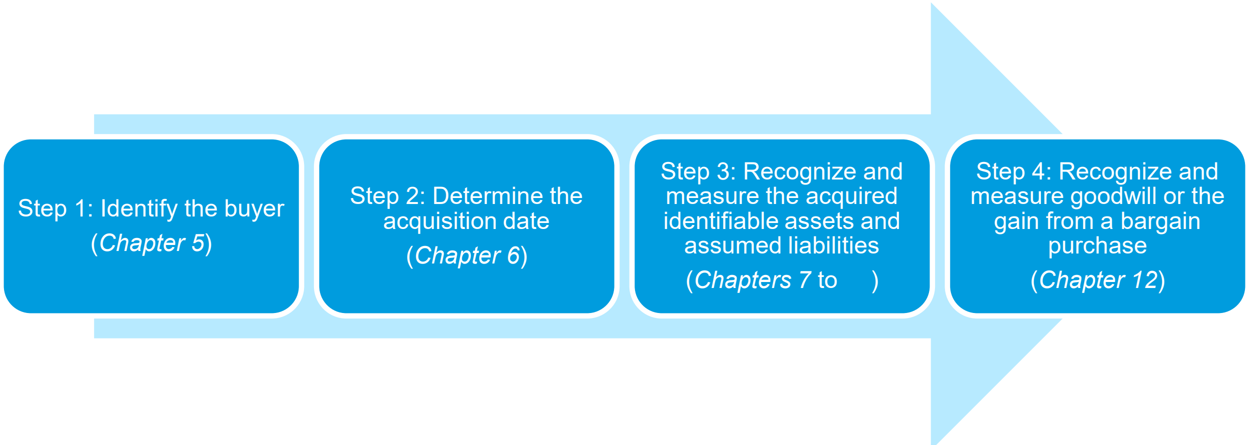
### 2.1.1 Private-company consolidation alternative

A consolidation alternative exists for private companies, which, if elected, would result in the reporting entity not applying the VIE consolidation model to arrangements between legal entities under common control if certain criteria are met. Under the alternative, the reporting entity should continue to apply other relevant consolidation guidance, such as the voting interest consolidation model. In other words, election of the alternative does not exempt a private company from considering the need to consolidate an entity under other applicable consolidation guidance.

Section 3.2.1 discusses the approach used in practice to determine whether two entities are under common control for purposes of accounting for combinations or transfers between entities under common control in accordance with ASC 805-50. While that is the starting point for purposes of determining whether two entities are under common control for purposes of applying the private-company consolidation alternative, the FASB has indicated that the definition of common control for purposes of applying the alternative was meant to be broader, without providing any specificity other than to indicate that common control could exist if the reporting entity is owned by the grandparent of the grandchild that owns the legal entity. For additional information about determining whether two entities are under common control for purposes of applying the private-company consolidation alternative, and for additional information about the alternative in general, refer to our white paper, Private company accounting for common control arrangements.

## 2.2 Key steps in applying the acquisition method

The acquisition method is the approach that must be used to account for a transaction or other event that: (a) meets the definition of a business combination (see Section 2.1) and (b) falls within the scope of ASC 805 (see Section 3.1). The key steps the buyer must apply in accounting for a business combination using the acquisition method, as well as the chapters that provide additional guidance on that step, are as follows:


Step 1: Identify the buyer
(*Chapter 5*)
Step 2: Determine the acquisition date
(*Chapter 6*)
Step 3: Recognize and measure the acquired identifiable assets and assumed liabilities
(*Chapters 7* to )
Step 4: Recognize and measure goodwill or the gain from a bargain purchase
(*Chapter 12*)

# 3. Scope

## 3.1 Scope of transactions affected by ASC 805

### 3.1.1 General

Examples of the types of transactions or other events that might meet the definition of a business combination are included in several places within ASC 805. Some of these transactions or other events, which might meet the definition of a business combination, are specifically excluded from the scope of ASC 805. Listed in the following table are various transactions and other events, along with an indication as to whether the acquisition method in ASC 805 applies to that transaction or other event:

| Transaction or other event | Does the acquisition method apply? | Where in the Codification is this transaction or other event discussed? |
|---|---|---|
| A true merger or merger of equals | Yes | Definition of a business combination in the Master Glossary |
| An acquisition in which no consideration is transferred (e.g., a business combination achieved by contract alone) | Yes (Section 3.1.2 and Section 12.5) | ASC 805-10-55-2(e) |
| The formation of a joint venture | No (Section 3.4) | ASC 805-10-15-4(a) |
| An acquisition of an asset or group of assets and liabilities that does not meet the definition of a business | No (Section 15.1) | ASC 805-10-15-4(b) |
| A combination or transfer between entities (including businesses or nonprofit activities) under common control | No (Section 3.2) | ASC 805-10-15-4(c) |
| Mergers and acquisitions of not-for-profit entities | Section 3.3 | ASC 954-805, ASC 958-805 and ASC 805-10-15-4(d) |
| A transaction or other event in which a not-for-profit entity gains control of another not-for-profit entity, but is not permitted or chooses not to consolidate the entity as discussed in ASC 958-810-25-4 (Note 1) | No | ASC 805-10-15-4(e) |
| A reverse acquisition | Yes (Section 5.2) | ASC 805-10-55-12 |
| The initial consolidation of a VIE in which: (a) the VIE meets the definition of a business and (b) the PB of the VIE and the VIE are not under common control | Yes (Section 3.1.3) | ASC 810-10-30-2 |
| The initial consolidation of a VIE in which: (a) the VIE meets the definition of a business and (b) the PB of the VIE and the VIE are under common control | No (Section 3.1.3) | ASC 810-10-30-1 |
| The initial consolidation of a VIE that does not meet the definition of a business | Partially (Section 3.1.3) | ASC 810-10-30-3 |

| Transaction or other event | Does the acquisition method apply? | Where in the Codification is this transaction or other event discussed? |
|---|---|---|
| Financial assets and liabilities of a consolidated VIE that is a collateralized financing entity (as defined) for which specific guidance in ASC 810-10 applies | No | ASC 805-10-15-4(f) |
| A combination between mutual entities (Note 2) | Yes | ASC 805-30-30-3 and ASC 805-30-55-3 to 55-5 |
| A leveraged buyout | Yes | No scope exception in ASC 805-10-15 |
| An exchange of a business for a business | Yes | ASC 805-10-55-2(a) |

**Note 1:** Consider a situation in which a not-for-profit entity gains control over another not-for-profit entity, but decides not to consolidate the other not-for-profit entity at that point in time in accordance with ASC 958-810-25-4. If this not-for-profit entity decides to consolidate the other not-for-profit entity in a later financial reporting period, ASC 805 would not apply.

**Note 2:** The Master Glossary of the Codification defines a mutual entity as "An entity other than an investor-owned entity that provides dividends, lower costs, or other economic benefits directly and proportionately to its owners, members, or participants. Mutual insurance entities, credit unions, and farm and rural electric cooperatives are examples of mutual entities."

### 3.1.2 Business combination achieved without transferring consideration

ASC 805 explicitly includes within its scope business combinations that are achieved without the transfer of consideration. Some examples of business combinations that are achieved without the transfer of consideration include when an investor who accounts for its investment in an investee using the equity method of accounting obtains control of the investee as a result of: (a) the investee acquiring its own shares or (b) the lapsing of minority veto rights. In both of these situations, the investor is the buyer in the business combination and the investee is the target.

Concluding that business combinations can occur without the buyer transferring consideration introduces the possibility of an entity being the buyer in a business combination through no direct action of its own. For example, assume Company A has a 45% ownership interest in Company B. Company A accounts for this investment using the equity method. Company B buys back enough of its stock such that Company A's ownership interest in Company B increases to 51% immediately after the stock buyback. In this situation, Company A has taken no direct action (e.g., it has not transferred consideration to the owners of Company B) to bring about increasing its ownership interest in Company B from 45% to 51%. However, if the 51% ownership interest results in Company A controlling Company B, then Company A is the buyer in a business combination and must use the acquisition method to account for gaining control over Company B. Business combinations occurring through no direct action of the buyer present a risk that an entity could be the buyer in a business combination without knowing it. To prevent this situation from occurring, an entity should have procedures in place to monitor its current ownership percentage in investees at each reporting date.

For guidance on the application of the acquisition method to a business combination achieved by contract alone, see Section 12.5.

### 3.1.3 Initial consolidation of a variable interest entity (VIE)

Application of the acquisition method of accounting (in whole or in part) upon the initial consolidation of a VIE depends on whether the PB of the VIE and the VIE are under common control. If the PB and VIE are under common control (see Section 3.2.1), then the acquisition method is not applied (in whole or in part) to the initial consolidation of the VIE. Instead, ASC 810-10-30-1 uses a model that relies on the carryover bases of the assets, liabilities and any noncontrolling interest (NCI) involved in the acquisition.

If the PB and VIE are not under common control, then the extent to which the acquisition method is applied depends on whether the VIE meets the definition of a business (see Section 4.1). If the VIE meets the definition of a business, then the whole of ASC 805 applies to the initial consolidation of that VIE. If the VIE does not meet the definition of a business, then ASC 810-10-30-3 and 30-4 require the use of some, but not all, of the requirements in ASC 805. The most notable difference is that goodwill is not recognized, while a gain or loss might be recognized. More specifically, the PB uses the following model if the VIE does not meet the definition of a business:

- For any assets or liabilities that the PB transferred to the VIE from shortly before to shortly after the buyer became the PB of the VIE, the PB uses a carryover basis measurement model. As a result, no gain or loss is recognized related to those assets and liabilities.
- For all other identifiable assets and liabilities of the VIE, the PB recognizes and measures them in accordance with the recognition and measurement principles (and related exceptions to those principles) included in ASC 805.
- The PB recognizes a gain or loss as follows:

| | |
|---|---|
| | Fair value of the consideration paid |
| + | Fair value of the NCI |
| + | Reported amount of the PB’s previously held interests |
| - | Net amount of the VIE’s identifiable assets and liabilities that the PB recognized and measured in accordance with ASC 805 |
| = | Gain or loss |

The amount of this gain or loss must be disclosed by the PB (see Section 14.6).

In essence, there is no distinction between the accounting for the acquisition of a business that is not a VIE and the accounting for the acquisition of a business that is a VIE. In other words, if the target is deemed to be a business, then whether that business is a VIE is of no consequence when considering the applicability of the acquisition method. This method is not used when accounting for the initial consolidation by the PB of a VIE that is not a business. While some of the recognition and measurement guidance used by the buyer in a business combination would be used by the PB when the VIE is not a business, the PB would not recognize goodwill, but would instead recognize a gain or loss as a result of the initial consolidation.

## 3.2 Combinations or transfers between entities under common control

### 3.2.1 What is common control for purposes of determining whether there has been a combination or transfer between entities under common control?

As noted in the table in Section 3.1.1, the acquisition method is not applied to combinations or transfers between entities under common control. While that scope exclusion is included in ASC 805, a definition of what constitutes common control is not provided in ASC 805 or elsewhere in U.S. GAAP. However, the following are examples of transactions between entities under common control as described in ASC 805-50-15-6:

- An entity charters a newly-formed entity and then transfers some or all of its net assets to that newly-chartered entity.

- A parent transfers the net assets of a wholly-owned subsidiary into the parent and liquidates the subsidiary. That transaction is a change in legal organization but not a change in the reporting entity.
- A parent transfers its controlling interest in several partially-owned subsidiaries to a new wholly-owned subsidiary. That also is a change in legal organization but not in the reporting entity.
- A parent exchanges its ownership interests or the net assets of a wholly-owned subsidiary for additional shares issued by the parent's less-than-wholly-owned subsidiary, thereby increasing the parent's percentage of ownership in the less-than-wholly-owned subsidiary but leaving all of the existing noncontrolling interest outstanding.
- A parent's less-than-wholly-owned subsidiary issues its shares in exchange for shares of another subsidiary previously owned by the same parent, and the noncontrolling shareholders are not party to the exchange. That is not a business combination from the perspective of the parent.
- A limited liability company is formed by combining entities under common control.
- Two or more not-for-profit entities (NFPs) that are effectively controlled by the same board members transfer their net assets to a new entity, dissolve the former entities, and appoint the same board members to the newly combined entity.

The Emerging Issues Task Force (EITF) attempted to define common control in EITF 02-5. While the EITF did not reach a consensus on the definition of common control, the SEC staff's approach to determining what constitutes common control was captured in the final abstract for EITF 02-5. In considering whether two entities are under common control (e.g., Company A and Company B), the SEC staff's approach would require consideration of the following:

- *Does the same individual or entity own more than 50% of both Company A and Company B?* If so, then Company A and Company B are under common control.
- *Do immediate family members own more than 50% of both Company A and Company B and if so, is there no evidence that the immediate family members would do anything other than vote their interests as a block?* If so, then Company A and Company B are under common control. When there is evidence that the immediate family members would not vote their interests as a block, then Company A and Company B are not under common control. For purposes of what constitutes immediate family members, a married couple and their children are considered immediate family members. However, the married couple's grandchildren would not be considered immediate family members. To the extent Company A and Company B are owned by a combination of brothers and sisters and their children, whether Company A and Company B are under common control would depend on the substance of the ownership and voting relationships between the brothers and sisters and their children.
- *Does a group of shareholders own more than 50% of both Company A and Company B and if so, is there contemporaneous written evidence that the group of shareholders plans to vote a majority of the entities' ownership interests as a block?* If so, then Company A and Company B are under common control. When there is not contemporaneous written evidence that the group of shareholders would vote the majority of the entities' ownership interests as a block, Company A and Company B are not under common control.

These are not the only situations under which common control exists. In other words, there may be other situations that could give rise to Company A and Company B being under common control. When these other situations arise, all of the facts and circumstances should be considered in assessing whether Company A and Company B are under common control.

While the approach captured in the preceding paragraphs is the SEC staff's approach to determining what constitutes common control, we believe it is also appropriate to use this approach when determining whether two private companies are under common control. Also, while a broader definition of common control is used to determine whether two private companies are under common control for purposes of the private-company consolidation alternative (see Section 2.1.1), such broader definition may not be used for purposes of applying the guidance in ASC 805-50 related to combinations or transfers between entities under common control.

**Example 3-1: Determining whether entities are under common control**

Consider the following three scenarios with respect to the ownership structure of Company A and Company B and whether Company A and Company B are under common control. Assume in all scenarios that Owners X, Y and Z are unrelated third parties.

*Scenario 1*

| | Ownership interests in each company by owner | | |
|---|---|---|---|
| | Owner X | Owner Y | Owner Z |
| Company A | 90% | 5% | 5% |
| Company B | 52% | 24% | 24% |

In this scenario, Company A and Company B are under common control because Owner X controls both companies.

*Scenario 2*

| | Ownership interests in each company by owner | | |
|---|---|---|---|
| | Owner X | Owner Y | Owner Z |
| Company A | 40% | 40% | 20% |
| Company B | 100% | - | - |

In this scenario, Company A and Company B are not under common control. While Owner X controls Company B, it does not control Company A.

*Scenario 3*

| | Ownership interests in each company by owner | | |
|---|---|---|---|
| | Owner X | Owner Y | Owner Z |
| Company A | 40% | 40% | 20% |
| Company B | 40% | 40% | 20% |

In this scenario, the two companies are not under common control because none of the owners individually control either Company A or Company B. However, because each owner's ownership interest in Company A and Company B is the same, there is a high degree of common ownership between the two companies. As discussed in Section 3.2.2.1, when there is a high degree of common ownership between two companies, a transfer between those companies is accounted for in the same manner as a transfer between entities under common control.

### 3.2.2 Accounting for combinations or transfers between entities under common control

If a combination or transfer occurs between entities under common control, the accounting model applied depends on whether the combination results in a change in the reporting entity, which is defined in the Master Glossary of the Codification as:

> A change that results in financial statements that, in effect, are those of a different reporting entity. A change in the reporting entity is limited mainly to the following:
>
> a. Presenting consolidated or combined financial statements in place of financial statements of individual entities
>
> b. Changing specific subsidiaries that make up the group of entities for which consolidated financial statements are presented
>
> c. Changing the entities included in combined financial statements.
>
> Neither a business combination accounted for by the acquisition method nor the consolidation of a variable interest entity (VIE) pursuant to Topic 810 is a change in reporting entity.

We understand that the evaluation performed in practice as to whether a change in reporting entity has occurred when there is a combination or transfer between entities under common control generally relies on whether what was combined or transferred between the entities meets the definition of a business. As such, we understand that a change in reporting entity is generally said to have occurred in practice when what was combined or transferred meets the definition of a business. Conversely, we also understand that a change in reporting entity is generally said not to have occurred in practice when what was combined or transferred between the entities does not meet the definition of a business.

If the combination or transfer does not result in a change in the reporting entity, then it is accounted for prospectively as a combination or transfer of assets recorded at carryover basis. If the combination or transfer results in a change in the reporting entity, then the entity receiving the net assets or equity interests should follow the guidance in the sections of ASC 805-50 under the heading of “Transactions Between Entities Under Common Control.”

Application of the guidance on transactions between entities under common control in ASC 805-50 generally results in the entity that receives net assets or equity interests in the combination or transfer between entities under common control:

- Recognizing the carrying amounts of the net assets combined or transferred in its accounting for the transfer or combination
- Combining the financial statements of the entities under common control as if the combination or transfer occurred at the beginning of the periods presented, to the extent the entities were under common control during those periods, and eliminating any intercompany balances and transactions

The carrying amounts used for purposes of accounting for a combination of or transfer between entities under common control should reflect the carrying amounts reflected in the parent’s consolidated financial statements for what was combined or transferred. For example, assume Parent controls Subsidiary A and Subsidiary B and is combining both those subsidiaries into one subsidiary. Further assume that Parent acquired Subsidiary B five years ago and accounted for the acquisition as a business combination, but Subsidiary B did not apply pushdown accounting. When combining Subsidiary A and Subsidiary B, the carrying amounts for Subsidiary B’s assets and liabilities should reflect the adjustments needed to make those carrying amounts equal to the amounts reflected in Parent’s consolidated financial statements for Subsidiary B’s assets and liabilities.

Additional procedural guidance on how to account for a combination or transfer between entities under common control is provided in the relevant sections of ASC 805-50. In addition, the disclosure requirements in ASC 805-50-50 that are applicable to transactions between entities under common control are included in Section 2 of Appendix B.

**Example 3-2: Transfer between entities under common control**

[**Note:** The purpose of this example is to illustrate the accounting for a transfer between entities under common control at carryover basis either prospectively or retrospectively. To do so, a very simple fact pattern and set of assumptions are used in this example. It is important to note that any change in the facts or assumptions could have a significant effect on the accounting for the transfer.]

Parent has owned 100% of Subsidiary A and Subsidiary B for the last five years. Other than intercompany activity and balances eliminated in consolidation, there are no differences between the carrying amounts of the assets and liabilities recorded by Subsidiary A and Subsidiary B and those carrying amounts reflected in Parent's consolidated financial statements for Subsidiary A's and Subsidiary B's assets and liabilities. All three entities have a calendar year end and prepare financial statements with one comparative period. On December 31, 20X2, through an equity transaction, Parent causes Subsidiary A to transfer assets to Subsidiary B. The following table captures the carrying amount of those assets on the date they were transferred and as of the end of the previous reporting period (December 31, 20X1). The table also captures the carrying amount of Subsidiary B's assets, liabilities and equity on those dates.

| | December 31, 20X2 | December 31, 20X1 |
|---|---|---|
| Carrying amount of Subsidiary A's assets transferred to Subsidiary B | $10,500,000 | $9,800,000 |
| Carrying amount of Subsidiary B's (before the transfer): | | |
| • Assets | $42,700,000 | $40,900,000 |
| • Liabilities | $29,100,000 | $28,200,000 |
| • Equity | $13,600,000 | $12,700,000 |

On January 1, 20X1, the carrying amount of Subsidiary A's assets transferred to Subsidiary B was $8.9 million. There are no intercompany balances between Subsidiary A and Subsidiary B as of December 31, 20X1 or 20X2. In addition, Subsidiary A and Subsidiary B follow the same accounting policies.

Because Subsidiary A and Subsidiary B are under the common control of Parent, the transfer of assets is not accounted for as a business combination using the acquisition method in ASC 805. Instead, the transaction will be accounted for at carryover basis. Whether that accounting is effectuated prospectively or retrospectively depends on whether the transaction results in a change in reporting entity. To illustrate the difference between prospectively accounting for the transfer at carryover basis (when there has not been a change in reporting entity) and retrospectively accounting for the transfer at carryover basis (when there has been a change in reporting entity), two scenarios are presented next. It is important to note that whether a transfer results in a change in reporting entity is not a free choice, and Subsidiary B would perform an appropriate analysis based on additional facts and circumstances to determine whether the transfer does or does not result in a change in reporting entity.

*Transfer of assets does not result in a change in reporting entity*

When the transfer of assets from Subsidiary A to Subsidiary B does not result in a change in reporting entity, the transfer is prospectively accounted for at carryover basis starting on the date the transfer occurs. As a result, the amounts reported in Subsidiary B's balance sheet for December 31, 20X2 and December 31, 20X1 (for comparative purposes) after the transfer occurs are as follows:

| | December 31, 20X2 | December 31, 20X1 |
|---|---|---|
| Carrying amount of Subsidiary B's (after the transfer): | | |
| • Assets (Note 1) | $53,200,000 | $40,900,000 |
| • Liabilities (Note 2) | $29,100,000 | $28,200,000 |
| • Equity (Note 3) | $24,100,000 | $12,700,000 |

**Note 1:** Carrying amount of Subsidiary B's assets at December 31, 20X2 of $42,700,000 + carryover basis of transferred assets at December 31, 20X2 of $10,500,000.
**Note 2:** There were no liabilities included in what was transferred from Subsidiary A to Subsidiary B and Subsidiary B did not incur any liabilities in connection with the transfer, so the carrying amount of Subsidiary B's liabilities were unaffected by the transfer.
**Note 3:** Carrying amount of Subsidiary B's equity at December 31, 20X2 of $13,600,000 + additional equity resulting from the transfer of $10,500,000 of net assets.

Prospectively accounting for the transfer from Subsidiary A to Subsidiary B at carryover basis was effectuated by adding the carryover basis of the transferred assets to the carrying amounts of Subsidiary B's assets on the date of transfer, which was December 31, 20X2. Because the transfer occurred on December 31, 20X2, which was also the fiscal year end for Subsidiary B, there would be at most one day of income statement activity related to the transferred assets in Subsidiary B's income statement for the year ending December 31, 20X2. For purposes of this example, we assumed there was no income statement activity.

*Transfer of assets result in a change in reporting entity*

When the assets transferred from Subsidiary A to Subsidiary B result in a change in reporting entity, the transfer is retrospectively accounted for at carryover basis. As a result, the amounts reported in Subsidiary B's balance sheet for December 31, 20X2 and for December 31, 20X1 (for comparative purposes) are as follows:

| | December 31, 20X2 | December 31, 20X1 |
|---|---|---|
| Carrying amount of Subsidiary B's (after the transfer): | | |
| • Assets (Note 1 for 20X2, Note 2 for 20X1) | $53,200,000 | $50,700,000 |
| • Liabilities (Note 3) | $29,100,000 | $28,200,000 |
| • Equity (Note 4 for 20X2, Note 5 for 20X1) | $24,100,000 | $22,500,000 |

**Note 1:** Carrying amount of Subsidiary B's assets at December 31, 20X2 of $42,700,000 + carryover basis of transferred assets at December 31, 20X2 of $10,500,000.
**Note 2:** Carrying amount of Subsidiary B's assets at December 31, 20X1 of $40,900,000 + carryover basis of transferred assets at December 31, 20X1 of $9,800,000.
**Note 3:** There were no liabilities included in what was transferred from Subsidiary A to Subsidiary B and Subsidiary B did not incur any liabilities in connection with the transfer, so the carrying amount of Subsidiary B's liabilities at both December 31, 20X2 and December 31, 20X1 were unaffected by the transfer.
**Note 4:** Carrying amount of Subsidiary B's equity at December 31, 20X2 of $13,600,000 + equity resulting from the transfer of $10,500,000 of net assets.
**Note 5:** Carrying amount of Subsidiary B's equity at December 31, 20X1 of $12,700,000 + equity resulting from the transfer of $9,800,000 of net assets.

Retrospectively accounting for the transfer from Subsidiary A to Subsidiary B at carryover basis was effectuated by reflecting the transfer as of the beginning of the earliest period presented in Subsidiary B's financial statements (which was January 1, 20X1) given both Subsidiary A and Subsidiary B were under common control for all of 20X1 and 20X2. For purposes of the balance sheet, because

Subsidiary A and Subsidiary B follow the same accounting policies, this was accomplished by adding the carryover bases of the transferred assets as of December 31, 20X2 and 20X1 to the carrying amounts of Subsidiary B's assets as of December 31, 20X2 and 20X1, respectively. Because the transfer is reflected in the balance sheet as if it occurred as of the beginning of the 20X1 fiscal year, there would also be income statement activity related to the transferred assets in Subsidiary B's income statements for its 20X2 and 20X1 fiscal years. For 20X2, this activity is essentially reflected in equity through the increase in the transferred assets from $9.8 million at December 31, 20X1 to $10.5 million at December 31, 20X2. For 20X1, this activity is essentially reflected in equity through the increase in the transferred assets from $8.9 million at January 1, 20X1 to $9.8 million at December 31, 20X1.

#### 3.2.2.1 Transfers between entities with a high degree of common ownership, but that are not under common control

As explained in Scenario 3 of Example 3-1, common control of Company A and Company B does not exist in the following fact pattern:

| | Ownership interests in each company by owner | | |
|---|---|---|---|
| | **Owner X** | **Owner Y** | **Owner Z** |
| Company A | 40% | 40% | 20% |
| Company B | 40% | 40% | 20% |

While none of the owners individually control both Company A and Company B in this scenario, the pool of owners is the same for both companies and each owner's ownership interests in each company are the same. In such situations, we believe that a transfer between Company A and Company B that does not affect the ownership interests of Owner X, Owner Y or Owner Z should be accounted for at carryover basis, similar to a transfer between entities under common control (see Section 3.2.2). The basis for this position starts with a speech given by SEC staff member Donna L. Coallier in 1997 at the Twenty-Fifth American Institute of Certified Public Accountants (AICPA) National Conference on Current SEC Developments, during which she indicated the following:

> When there is a transaction between entities with a high degree of common ownership, but that are not under common control, the staff assesses the transaction to determine whether the transaction lacks substance. FTB [FASB Technical Bulletin] 85-5 provides an example of a similar assessment in an exchange between a parent and a minority shareholder in one of the parent's partially owned subsidiaries. Paragraph 6 of FTB 85-5 states, in part:
>
>> ...if the minority interest does not change and if in substance the only assets of the combined entity after the exchange are those of the partially owned subsidiary prior to the exchange, a change in ownership has not taken place, and the exchange should be accounted for based on the carrying amounts of the partially owned subsidiary's assets and liabilities.
>
> Similarly, in a transfer or exchange between entities with a high degree of common ownership, the staff compares the percentages owned by shareholders in the combined company to the percentages owned in each of the combining companies before the transaction. When the percentages have changed or the owned interests are not in substance the same before and after the transaction, the staff believes a substantive transaction has occurred and has objected to historical cost accounting.

FTB 85-5 addressed several business combination accounting issues and was superseded by Statement 141R. Guidance about accounting for transfers between entities with a high degree of common ownership was not included in Statement 141R, nor has such guidance since been issued by the FASB or SEC staff. Given the lack of authoritative guidance on the issue and given that such transfers lack economic substance, we believe transfers between entities with a high degree of common ownership should be accounted for at carryover basis.

The natural question that arises with respect to accounting for transfers between entities with a high degree of common ownership is what constitutes a high degree of common ownership. Obviously, in Scenario 3 of Example 3-1, there is a high degree of common ownership because each owner has *the same* ownership interest in each entity. The degree to which each owner's ownership interests in each entity may vary beyond them being the same before there is no longer a high degree of common ownership is very small (e.g., one to two percent) and requires careful consideration of all the relevant facts and circumstances. While there may be instances where a one to two percent variation between each owner's ownership interest in each entity would still be considered a high degree of common ownership, there are other instances where that would not be the case. As such, we strongly recommend consultation with a subject matter expert when evaluating ownership structures with even slight variations in each owner's ownership interest in each entity.

**Example 3-3: Determining whether entities have a high degree of common ownership**

Company A transfers certain assets to Company B. The ownership structures for Company A and Company B (both before and after the transfer) are as follows:

| | Ownership interests in each company by owner | | |
|---|---|---|---|
| | Owner X | Owner Y | Owner Z |
| Company A | 40% | 40% | 20% |
| Company B | 34% | 33% | 33% |

While there is common ownership of Company A and Company B, there is not a high degree of common ownership. As such, Company B should not account for the transfer at carryover basis. If the assets transferred to Company B meet the definition of a business, Company B would account for the transfer as a business combination. If the assets transferred to Company B do not meet the definition of a business, Company B would account for the transfer as an asset acquisition.

## 3.3 Not-for-profit entities

Accounting for mergers and acquisitions of not-for-profit entities is covered primarily in ASC 954-805 and 958-805. Key aspects of the mergers and acquisitions guidance provided in these topics include the following:

- The guidance used to determine whether one not-for-profit entity has obtained control over another not-for-profit entity (and should consolidate the other not-for-profit entity) is different from the guidance used by for-profit entities (see ASC 958-805-25-15, 958-810 and 954-810).
- A distinction is made between how a not-for-profit entity accounts for a merger vs. an acquisition. As such, whether a merger or an acquisition occurred is an important determination. ASC 958-805 provides guidance on how to make this determination.
- A not-for-profit entity accounts for a merger using the carryover method. ASC 958-805 provides guidance on how to apply the carryover method.
- A not-for-profit entity accounts for an acquisition using the acquisition method. While similar to the acquisition method provided in ASC 805, there are unique aspects to the acquisition method applied by a not-for-profit entity. For example, under certain circumstances, a not-for-profit entity recognizes a charge in its statement of activities on the acquisition date instead of goodwill. ASC 958-805 provides guidance on the acquisition method to be applied by not-for-profit entities.

As discussed in Chapter 17 and Chapter 18, not-for-profit entities may elect the private-company intangible asset alternative for purposes of their accounting for acquisitions and the private-company goodwill alternatives for purposes of their subsequent accounting for goodwill.

Detailed explanation of the guidance applicable to the accounting for mergers, acquisitions and other transactions involving not-for-profit entities is beyond the scope of this guide. The applicable industry-specific authoritative literature in the Codification should be consulted as necessary.

## 3.4 Joint venturer's acquisition of other joint venturer's interest

As noted in the table in Section 3.1.1, the formation of a joint venture does not fall within the scope of ASC 805. As such, the acquisition method is not applied by any of the investors to the formation of a joint venture. This is because, by definition, no one investor in a joint venture has control over the joint venture. However, consider a situation in which Joint Venturer A and Joint Venturer B each own 50% in Joint Venture (JV). In accordance with the scope of ASC 805, when JV was formed, neither Joint Venturer A nor Joint Venturer B accounted for its formation using the acquisition method because neither controlled JV. Two years after the formation of JV, Joint Venturer A acquires Joint Venturer B's interest in JV. As a result of that acquisition, Joint Venturer A obtains control over JV and the acquisition falls within the scope of ASC 805. Joint Venturer A applies the acquisition method to account for its acquisition of Joint Venturer B's 50% interest in JV. In effect, once Joint Venturer A gains control over JV: (a) JV ceases to be a joint venture and becomes a subsidiary of Joint Venturer A and (b) Joint Venturer A becomes the parent of JV.

**Pending change:** In October 2022, the FASB issued an *Exposure Draft of a Proposed Accounting Standards Update, Business Combinations - Joint Venture Formations (Subtopic 805-60): Recognition and Initial Measurement*, which could affect this guidance. At the publication date for this guide, the project was still in process (see the FASB's project page for its status).

# 4. Identifying business combinations

## 4.1 Determining whether a business was acquired

### 4.1.1 General

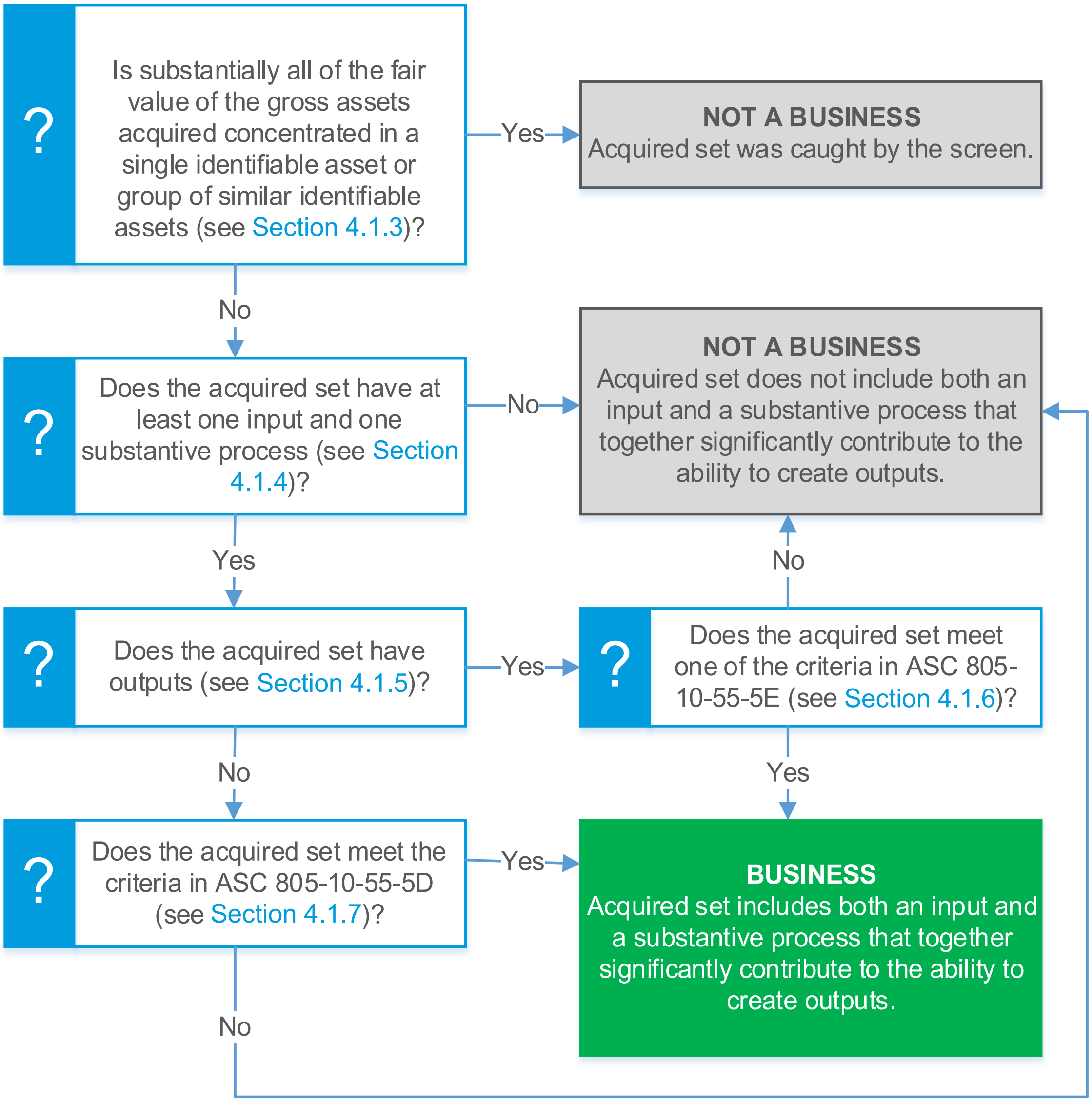
Determining whether what was acquired by the buyer (i.e., the acquired set) is a business is important because only acquisitions that meet the definition of a business combination should be accounted for using the acquisition method. Central to the definition of a business combination (see Section 2.1) is the definition of a business. If what the buyer has purchased does not meet the definition of a business, then it is accounted for as an asset acquisition and not a business combination. There are significant differences between the model used to account for a business combination and the model used to account for an asset acquisition, which are summarized in Section 15.1.

### 4.1.2 Definition of a business and related framework

ASC 805-10-55-3A defines a business as "an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants."

The legal form of an acquisition (an asset deal or a stock deal [see Section 11.4.1.1]) does not determine whether the buyer acquired a business. Determining whether the buyer acquired a business requires considering the nature of the inputs and processes acquired and whether the acquired set includes outputs.

To assist in determining whether an acquired set meets the definition of a business, the FASB provides a detailed framework. The following flowchart illustrates that framework, and each of the sections following the flowchart elaborates on one of the decision points within the flowchart.




Example 6 starting at ASC 805-10-55-51 includes many examples that illustrate the application of this framework to a variety of facts and circumstances. Several of those examples have been included in the remainder of this section.

### *4Q.1.2.1 If the seller did not operate the acquired set as a business, does that mean the acquired set is not a business?*

No. The manner in which the seller used or operated the acquired set has no bearing on whether the acquired set is a business. The perspective taken in evaluating whether an acquired set is a business is one of a market participant. The buyer should consider whether the acquired set is capable of being conducted and managed as a business by a market participant.

### *4Q.1.2.2 If the buyer does not intend to operate the acquired set as a business, can it assume it is not a business?*

No. The manner in which the buyer plans to operate the acquired set has no bearing on whether the acquired set is a business. The perspective taken in evaluating whether an acquired set is a business is one of a market participant. The buyer should consider whether the acquired set is capable of being conducted and managed as a business by a market participant.

#### *4Q.1.2.3 Must the acquisition result in the recognition of goodwill for the acquired set to be considered a business?*

No. The existence of goodwill may be indicative that the acquired set includes the necessary input and substantive process to be a business, but it is not determinative. In addition, an acquired set may be a business even when goodwill does not result from the acquisition. As such, the focus should be on whether the acquired set includes both an input and a substantive process that together significantly contribute to the ability to create outputs instead of whether the acquisition will result in the recognition of goodwill.

#### *4Q.1.2.4 Could the purchase of an individual franchise by the franchisor be considered a business?*

Yes. It is possible that an individual franchise could meet the definition of a business. The components of the franchise being purchased (i.e., the acquired set) should be analyzed to determine whether it gets caught by the screen or includes the necessary elements to conclude it is a business.

### 4.1.3 The screen test

The framework starts with a screen that is applied first to the acquired set. If the screen catches the acquired set, it is not considered a business. The screen catches the acquired set when substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets. For purposes of the screen, gross assets should exclude cash and cash equivalents, deferred tax assets and goodwill resulting from the effects of deferred tax liabilities. Goodwill not resulting from the effects of deferred tax liabilities is included in gross assets. For this purpose, the goodwill being considered is what would be recognized if the acquired set were a business (see Example 4-2).

A single identifiable asset is defined in ASC 805-10-55-5B as follows:

> A single identifiable asset includes any individual asset or group of assets that could be recognized and measured as a single identifiable asset in a business combination. However, for purposes of this evaluation, the following should be considered a single asset:
>
> a. A tangible asset that is attached to and cannot be physically removed and used separately from another tangible asset (or an intangible asset representing the right to use a tangible asset) without incurring significant cost or significant diminution in utility or fair value to either asset (for example, land and building)
>
> b. In-place lease intangibles, including favorable and unfavorable intangible assets or liabilities, and the related leased assets.

Note that this definition of a single identifiable asset is only applicable in the context of applying the screen and does not change existing guidance related to the recognition and measurement of the individual assets.

ASC 805-10-55-5C includes the following guidance for evaluating whether assets are similar:

> A group of similar assets includes multiple assets identified in accordance with paragraph 805-10-55-5B. When evaluating whether assets are similar, an entity should consider the nature of each single identifiable asset and the risks associated with managing and creating outputs from the assets (that is, the risk characteristics). However, the following should not be considered similar assets:
>
> a. A tangible asset and an intangible asset
>
> b. Identifiable intangible assets in different major intangible asset classes (for example, customer-related intangibles, trademarks, and in-process research and development)
>
> c. A financial asset and a nonfinancial asset

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

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

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

All of the examples in this section analyze whether or not the screen catches the acquisition. In particular: (a) Example 4-1 illustrates an acquisition in which the screen catches the acquired set, resulting in the conclusion that the acquired set is not a business and (b) Example 4-6 illustrates application of the screen to a manufacturing facility and equipment and specifically considers whether the manufacturing facility and equipment should be considered a single identifiable asset or a group of similar identifiable assets.

**Example 4-1: Acquisition of homes with in-place leases**

The following example is Scenario 1 of Case A: Acquisition of Real Estate in Example 6—Illustrations of the Definition of a Business from ASC 805-10-55-52 to 55-54:

> ABC acquires, renovates, leases, sells, and manages real estate properties. ABC acquires a portfolio of 10 single-family homes that each have in-place leases. The only elements included in the acquired set are the 10 single-family homes and the 10 in-place leases. Each single-family home includes the land, building, and property improvements. Each home has a different floor plan, square footage, lot, and interior design. No employees or other assets are acquired.
>
> ABC first considers the threshold guidance in paragraphs 805-10-55-5A through 55-5C. ABC concludes that the land, building, property improvements, and in-place leases at each property can be considered a single asset in accordance with paragraph 805-10-55-5B. That is, the building and property improvements are attached to the land and cannot be removed without incurring significant cost. Additionally, the in-place lease is an intangible asset that should be combined with the related real estate and considered a single asset.
>
> ABC also concludes that the 10 single assets (the combined land, building, in-place lease intangible, and property improvements) are similar. Each home has a different floor plan; however, the nature of the assets (all single-family homes) are similar. ABC also concludes that the risks associated with managing and creating outputs are not significantly different. That is, the risks associated with operating the properties and tenant acquisition and management are not significantly different because the types of homes and class of customers are not significantly different. Similarly, the risks associated with operating in the real estate market of the homes acquired are not significantly different. Consequently, ABC concludes that substantially all of the fair value of the gross assets acquired is concentrated in the group of similar identifiable assets; thus, the set is not a business.

**RSM commentary:** In this case, the screen caught the acquired set, which resulted in the conclusion that the acquired set is not a business. Being caught by the screen eliminated the need for ABC to consider the remainder of the framework. Because the acquired set is not a business, it is accounted for as an asset acquisition (see Chapter 15) instead of a business combination.

When considering whether the 10 assets were similar, one key fact was that all of the assets included single-family homes. If one or more of the assets included condominiums or townhomes instead of single-family homes, it is likely that the necessary similarity between the assets would not exist and the acquired set would not get caught by the screen. Another key fact in determining whether the 10 assets were similar was that the class of customers were not significantly different. Consider a situation in which the 10 assets were located in different geographic areas with differing economic characteristics. In this situation, it is likely that the necessary similarity between the assets would not exist and the acquired set would not get caught by the screen. When the assets do not get caught by the screen, the buyer must apply the remainder of the framework to determine whether the acquired set of assets is a business.

Example 4-3 builds off this example and adds an office park to the acquired set, which significantly affects the analysis as to whether the screen catches the acquired set.

**Example 4-2: Quantitative application of the screen**

Buyer and Seller enter into a transaction in which Buyer purchases certain assets and assumes certain liabilities (i.e., the acquired set) with a total fair value of $22,150,000 from the Seller for $22,450,000. The table that follows includes the fair values (which would be the book bases if the acquired set is a business) and tax bases of the assets and liabilities that are included in the acquired set, along with the calculation of the deferred tax liability and goodwill that would be recognized if the acquired set is a business. Lastly, the table also includes the calculation of the gross assets acquired that should be used to determine whether substantially all of the fair value of those assets is concentrated in a single identifiable asset or group of similar identifiable assets.

| | Fair value (Book basis) | Tax basis | Deferred tax liability (Note 1) | Calculation of goodwill (Note 2) | Calculation of gross assets acquired |
|---|---|---|---|---|---|
| Intellectual property (Note 3) | $22,400,000 | $2,900,000 | ($5,850,000) | $22,400,000 | $22,400,000 |
| Equipment | 700,000 | 450,000 | (75,000) | 700,000 | 700,000 |
| Cash (Note 4) | 250,000 | 250,000 | - | 250,000 | Excluded |
| Liabilities (Note 4) | (1,200,000) | (1,200,000) | - | (1,200,000) | Excluded |
| Deferred tax liabilities (Note 4) | | | ($5,925,000) | (5,925,000) | Excluded |
| | $22,150,000 | | | $16,225,000 | |
| Consideration transferred | | | | 22,450,000 | |
| Goodwill (Note 5) | | | | $6,225,000 | 300,000 |
| Total gross assets acquired | | | | | $23,400,000 |

**Note 1:** (Book basis – Tax basis) × 30% tax rate
**Note 2:** The purpose of this column is to calculate the total amount of goodwill for purposes of ultimately determining the amount of goodwill that should be included in the calculation of gross assets acquired.
**Note 3:** The intellectual property represents a single identifiable asset.
**Note 4:** Cash, liabilities and deferred tax liabilities are excluded from what was acquired when determining the fair value of the gross assets acquired for purposes of applying the screen.
**Note 5:** Only the portion of goodwill not attributable to the deferred tax liabilities should be reflected in the goodwill used for purposes of applying the screen. The amount of goodwill that would be recognized if what was acquired is a business is $6,225,000, of which $5,925,000 is attributable to the deferred tax liabilities. As such, $300,000 ($6,225,000 − $5,925,000) of goodwill is used for purposes of determining whether substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets.

The fair value of the intellectual property acquired represents 95.7% of the gross assets acquired ($22,400,000 ÷ $23,400,000). As such, Buyer concludes that substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset (i.e., the screen catches the acquired set), which means the acquired set is not a business and should instead be accounted for as an asset acquisition.

*4Q.1.3.1 How should a Right-of-Use (ROU) asset be considered when applying the screen?*

An ROU asset recognized under ASC 842 is measured based on the amount of the related lease liability adjusted for the fair value of any favorable or unfavorable terms of the lease compared to the market and recorded as a single asset. As a result, entities need to consider ROU assets along with other separately recorded assets when assessing whether the asset group can be considered a single asset when applying the screen.

If the ROU asset represents the right to use an underlying tangible asset, then the ROU asset may be combined with the underlying tangible asset, solely for the purpose of applying the screen. For example, an entity that owns a building with an associated ROU asset related to the ground lease would consider the building and the ROU asset as a single identifiable asset. Similarly, leasehold improvements associated with an ROU asset for an office lease would be combined as a single identifiable asset for the purpose of applying the screen.

If the ROU asset can be removed and used separately from another tangible asset, then it cannot be considered part of the same single identifiable asset. For example, if an acquired group of assets includes an office building and multiple ROU assets for copy machines, the building and the copy machines can be separated and are therefore not considered a single identifiable asset.

ROU assets should also be considered when assessing whether a group of assets are similar. For example, if an entity acquired an ROU asset for multiple apartment buildings, then the entity should consider whether the lease components have significantly different risk characteristics, which could cause them to be considered separately for the purpose of applying the screen.

### 4.1.4 Inputs and processes

An acquired set must have at least one input and one substantive process to be considered a business. Without both an input and substantive process, the acquired set cannot be a business.

ASC 805-10-55-4(a) and 55-4(b) define input and process as follows:

> Input. Any economic resource that creates, or has the ability to contribute to the creation of, outputs when one or more processes are applied to it. Examples include long-lived assets (including intangible assets or rights to use long-lived assets), intellectual property, the ability to obtain access to necessary materials or rights, and employees.
>
> Process. Any system, standard, protocol, convention, or rule that when applied to an input or inputs, creates or has the ability to contribute to the creation of outputs. Examples include strategic management processes, operational processes, and resource management processes. These processes typically are documented, but the intellectual capacity of an organized workforce having the necessary skills and experience following rules and conventions may provide the necessary processes that are capable of being applied to inputs to create outputs. Accounting, billing, payroll, and other administrative systems typically are not processes used to create outputs.

While an acquired set must have at least one input and one substantive process to be considered a business, just having those elements is not enough. For example, while an input may be important to the ability to create or continue producing outputs (e.g., machine and equipment in the production of a widget), if there are other inputs that are critical to the creation or continuation of outputs (e.g., widgets could not be created or continue to be produced without certain intellectual property), then a business may not exist without that other input (see Example 4-6). The analysis of inputs, processes and any additional elements needed for the acquired set to be a business depend on whether the acquired set has outputs.

While employees that form an organized workforce are considered an input and may play a critical role in determining whether the acquired set is a business, it is important to keep in mind that an intangible asset for an assembled workforce is not recognized in the accounting for a business combination (see Section 10.11). However, such an asset may be recognized in an asset acquisition, depending on the facts and circumstances (see Section 15.3.1).

Examples 4-3 to 4-6 analyze the inputs and processes in the acquired set to determine whether it is a business.

#### *4Q.1.4.1 Must the acquired set include employees to be considered a business?*

To be a business, an acquired set must include employees critical to the development of outputs when the set does not include outputs (see Section 4.1.7). When an acquired set includes outputs, whether employees critical to the development of outputs must be included in the acquired set for it to be a business depends on the nature of the inputs and processes in the acquired set (see Section 4.1.6).

#### *4Q.1.4.2 Must the acquired set have liabilities to be a business?*

No. While it is very common for businesses to include liabilities: (a) an acquired set does not have to include liabilities to be considered a business and (b) just because an acquired set has liabilities does not automatically mean it is a business.

#### *4Q.1.4.3 Must the acquired set include all of the inputs and processes necessary to produce outputs?*

No. The framework uses *substantive*, *critical* and *significant* when referring to the inputs and processes in an acquired set that meets the definition of a business. In addition, ASC 805-10-55-5 indicates the following: “A business need not include all the inputs or processes that the seller used in operating that business.” As explained earlier in Question 4Q.1.2.1 and Question 4Q.1.2.2, the buyer should consider whether the acquired set is capable of being conducted and managed as a business by a market participant. In doing so, the buyer should consider how replaceable (or easily acquirable) the missing inputs and processes are from a market participant’s perspective. If it would not be difficult for a market participant to replace or acquire the inputs and processes that are not in the acquired set, then the acquired set may be *capable* of being conducted and managed as a business by the market participant. Conversely, if it would be difficult for a market participant to replace or acquire the inputs and processes that are not in the acquired set, then the acquired set may not be capable of being conducted and managed as a business by the market participant. As illustrated in Example 4-6, while the acquired set included a manufacturing facility and equipment, it did not include certain necessary intellectual property, which resulted in the conclusion that a business was not acquired.

While the determination as to whether a business has been acquired should be made from the perspective of a market participant, considering whether the buyer already has some of the inputs or processes not in the acquired set may help determine how replaceable or easily acquirable the missing inputs and processes are from a market participant’s perspective.

The point to emphasize is that the threshold for concluding that a business was acquired is something less than the acquisition of all of the inputs and processes a standalone business enterprise.

### 4.1.5 Outputs

If the screen is not met and the acquired set includes at least an input and a substantive process, the remaining considerations in the framework depend on whether the acquired set has outputs. ASC 805-10-55-4(c) defines output as follows:

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

In determining whether the acquired set includes outputs, the buyer should consider whether there is a continuation of revenue from the acquired set before and after the transaction. If so, then the acquired set has outputs. If not, then the acquired set does not have outputs. A higher threshold must be reached to conclude the acquired set is a business when the set does not have outputs. A common example of an acquired set that does not include outputs is when the buyer acquires a start-up company that is not yet generating revenues. Other examples of acquisitions in which there may be no outputs include the following:

- Pharma acquires Biotech, which has various research and development projects in process, but does not yet have a marketable product.
- Television Broadcaster acquires a Federal Communications Commission (FCC) license for a television station, the broadcasting equipment and the office building.
- Manufacturer acquires an idled manufacturing facility and the related equipment.

Determining whether an acquired set has outputs requires careful consideration of all the facts and circumstances. Concluding that an acquired set does or does not have outputs determines whether the acquired set must include employees.

Examples 4-3 to 4-6 analyze whether the acquired set includes outputs.

### 4.1.6 Acquired set includes outputs

The threshold for concluding the acquired set is a business is less rigid when the acquired set includes outputs compared to when it does not include outputs (see Section 4.1.7). In situations in which the acquired set includes outputs, ASC 805-10-55-5E indicates that the set has both an input and substantive process that together significantly contribute to the ability to create outputs (i.e., the set is a business) when it meets one of the following criteria:

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

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

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

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

Contractual arrangements that provide for the continuation of revenue should not be included in the analysis of the preceding criteria with respect to whether a substantive process has been acquired.

The existence of outputs in an acquired set (i.e., continuation of revenues before and after the transaction) does not automatically mean that the acquired set includes at least one input and one substantive process that together significantly contribute to the ability to create outputs (i.e., that the acquired set is a business).

Examples 4-3 to 4-5 illustrate the application of the criteria in ASC 805-10-55-5E to determine whether the acquired set is a business.

**Example 4-3: Acquisition of homes and an office park, both with in-place leases (without employees)**

The following example is Scenario 2 of Case A: Acquisition of Real Estate in Example 6—Illustrations of the Definition of a Business from ASC 805-10-55-55 to 55-61 and builds off the facts in Example 4-1:

> Assume the same facts as in Scenario 1 except that ABC also acquires an office park with six 10-story office buildings leased to maximum occupancy of which all have significant fair value. ABC also acquires the vendor contracts for outsourced cleaning, security, and maintenance. Seller's employees that perform leasing (sales, underwriting, and so forth), tenant management, financing, and other strategic management processes are not included in the set. ABC plans to replace the property management and employees with its own internal resources.
>
> ABC concludes that the single-family homes and office park are not similar assets. ABC considers the risks associated with operating the assets, obtaining tenants, and tenant management between the single-family homes and office park to be significantly different because the scale of operations and risks associated with the class of customers are significantly different. Therefore, substantially all of the fair value of the gross assets acquired is not concentrated in a single identifiable asset or group of similar identifiable assets. Thus, ABC must further evaluate whether the set has the minimum requirements to be considered a business.
>
> The set has continuing revenues through the in-place leases and, therefore, has outputs. ABC must consider the criteria in paragraph 805-10-55-5E to determine whether the set includes both an input and a substantive process that together significantly contribute to the ability to create outputs.
>
> ABC concludes that the criteria in paragraph 805-10-55-5E(a) through (b) are not met because the set does not include employees and the processes performed through the cleaning and security contracts (the only processes acquired) will be considered ancillary or minor in the context of all the processes required to create outputs in the real estate industry. That is, while those outsourcing agreements may be considered to provide an organized workforce that performs cleaning and security processes when applied to the building, the processes performed by the cleaning, security, and maintenance personnel are not considered critical in the context of all the processes required to create outputs.
>
> ABC also concludes that the criterion in paragraph 805-10-55-5E(c) is not met because the cleaning and security processes could be easily replaced with little cost, effort, or delay in the ability to continue producing outputs. While the cleaning and security processes are necessary for continued operations of the buildings, these contracts can be replaced quickly with little effect on the ability to continue producing outputs.
>
> ABC concludes that the criterion in paragraph 805-10-55-5E(d) is not met because the cleaning and security contracts are not considered unique or scarce. That is, these types of arrangements are readily accessible in the marketplace.
>
> Because none of the criteria were met, ABC concludes that the set does not include both an input and substantive processes that together significantly contribute to the ability to create outputs and, therefore, is not considered a business.

**RSM commentary:** In this case, the screen did not catch the acquired set, which resulted in ABC having to apply the remainder of the framework to ultimately conclude the acquired set was not a business. The key element missing from the acquired set to conclude that a business was acquired was a substantive process critical to the ability to continue producing outputs. Because the acquired set is not a business, it is accounted for as an asset acquisition (see Chapter 15) instead of a business combination.

Example 4-4 builds off this example and includes employees responsible for key processes in the acquired set, which significantly affects the conclusion as to whether the acquired set includes a business.

**Example 4-4: Acquisition of homes and office park, both with in-place leases (with employees)**

The following example is Scenario 3 of Case A: Acquisition of Real Estate in Example 6—Illustrations of the Definition of a Business from ASC 805-10-55-62 to 55-64 and builds off the facts in Example 4-3:

> Assume the same facts as in Scenario 2, except that the set includes the employees responsible for leasing, tenant management, and managing and supervising all operational processes.
>
> The set has continuing revenues through the in-place leases and, therefore, has outputs. ABC must consider the criteria in paragraph 805-10-55-5E to determine whether the set includes both an input and a substantive process that together significantly contribute to the ability to create outputs.
>
> ABC determines that the criterion in paragraph 805-10-55-5E(a) is met because the set includes an organized workforce that performs processes that when applied to the acquired inputs in the set (the land, building, and in-place leases) are critical to the ability to continue producing outputs. That is, ABC concludes that the leasing, tenant management, and supervision of the operational processes are critical to the creation of outputs. Because it includes both an input and a substantive process, the set is considered a business.

**RSM commentary:** In this case, the screen did not catch the acquired set, which resulted in ABC having to apply the remainder of the framework to ultimately conclude the acquired set was a business. Because there were outputs due to continuing revenues, ABC analyzed the criteria in ASC 805-10-55-5E to determine whether the acquired set was a business. Because inputs were acquired, as well as a process in the form of employees in an organized workforce that was critical to the ability to continue producing outputs, the acquired set met ASC 805-10-55-5E(a) and was determined to be a business. As a business, ABC accounts for the acquisition of the acquired set as a business combination. While the organized workforce was critical in this example to concluding the acquired set is a business, as discussed in Section 10.11, an intangible asset is not recognized for an organized workforce in the accounting for a business combination.

**Example 4-5: Acquisition of brands**

The following example is Case G: Acquisition of Brands in Example 6—Illustrations of the Definition of a Business from ASC 805-10-55-85 to 55-87:

> Company A is a global producer of food and beverages. Company A sells the worldwide rights of Yogurt Brand F, including all related intellectual property, to Company B. Company B also acquires all customer contracts and relationships, finished goods inventory, marketing materials, customer incentive programs, raw material supply contracts, specialized equipment specific to manufacturing Yogurt Brand F, and documented processes and protocols to produce Yogurt Brand F. Company B does not receive employees, manufacturing facilities, all of the manufacturing equipment and processes required to produce the product, and distribution facilities and processes.
>
> Company B first considers the guidance in paragraphs 805-10-55-5A through 55-5C. The gross assets include intellectual property (the trademark, the related trade name, and recipes) associated with Yogurt Brand F (the intellectual property associated with the brand is determined to be a single intangible asset in accordance with the guidance in paragraph 805-20-55-18), customer contracts and related relationships, equipment, finished goods inventory, and the excess of the consideration transferred over the fair value of the net assets acquired. Company B concludes that substantially all of the fair value of the gross assets acquired is not concentrated in a single identifiable asset or

group of similar identifiable assets even though, for purposes of the analysis, the intellectual property is considered to be a single identifiable asset. In addition, because there is significant fair value in both tangible assets and intangible assets, Company B concludes that there is not a group of similar assets that meets this threshold.

The set has outputs through the continuation of revenues, and Company B must consider the criteria in paragraph 805-10-55-5E to determine whether the set includes both inputs and a substantive process that together significantly contribute to the ability to create outputs. The set does not include an organized workforce and, therefore, does not meet the criteria in paragraph 805-10-55-5E(a) through (b). However, the acquired manufacturing processes are unique to Yogurt Brand F, and when those processes are applied to acquired inputs such as the intellectual property, raw material supply contracts, and the equipment, they significantly contribute to the ability to continue producing outputs. As such, the criterion in paragraph 805-10-55-5E(c) is met, and the set includes both inputs and substantive processes. Because the set includes inputs and substantive processes that together significantly contribute to the ability to create outputs, it is considered a business.

**RSM commentary:** In this case, the screen did not catch the acquired set, which resulted in Company B having to apply the remainder of the framework to ultimately conclude the acquired set was a business. Because there were outputs due to continuing revenues, Company B analyzed the criteria in ASC 805-10-55-5E to determine whether the acquired set was a business. Because the acquired manufacturing processes and protocols are unique and significantly contribute to the ability to continue producing outputs when applied to an acquired input (e.g., specialized equipment specific to manufacturing Yogurt Brand F, intellectual property), the set was determined to be a business. The acquisition of a business is accounted for as a business combination.

### 4.1.7 Acquired set does not include outputs

Based on the guidance in ASC 805-10-55-5D, when the acquired set does not have outputs:

> …the set will have both an input and a substantive process that together significantly contribute to the ability to create outputs only if it includes employees that form an organized workforce and an input that the workforce could develop or convert into output. The organized workforce must have the necessary skills, knowledge, or experience to perform an acquired process (or group of processes) that when applied to another acquired input or inputs is critical to the ability to develop or convert that acquired input or inputs into outputs.

For purposes of this guidance, ancillary processes, and those that would be considered to play a minor role in the creation of outputs, are not considered critical processes.

Examples of acquired inputs that an organized workforce of employees could develop or convert into outputs include intellectual property (e.g., technology, In-process research and development (IPR&D), movie script), materials (e.g., raw materials or work-in-process inventory), rights (e.g., mineral interests) and other resources (e.g., real estate).

Example 4-6 illustrates the application of the guidance in ASC 805-10-55-5D to determine whether the acquired set is a business.

**Example 4-6: Acquisition of a manufacturing facility**

The following example is Case E: Acquisition of a Manufacturing Facility in Example 6—Illustrations of the Definition of a Business from ASC 805-10-55-77 to 55-81:

> Widget Co. manufactures complex equipment and has manufacturing facilities throughout the world. Widget Co. decided to idle a facility in a foreign jurisdiction in a reorganization of its manufacturing footprint and furloughed the assembly line employees.
>
> Acquirer enters into an agreement to purchase a manufacturing facility and related equipment from Widget Co. To comply with the local labor laws, Acquirer also must assume the furloughed employees.
>
> The assets acquired include the equipment and facility (land and building) but no intellectual property, inventory, customer relationships, or any other inputs.
>
> Acquirer first considers the guidance in paragraphs 805-10-55-5A through 55-5C. Acquirer concludes that the equipment in the facility can be removed without significant cost or diminution in utility or fair value because the equipment is not attached to the building and can be used in many types of manufacturing facilities. Therefore, the equipment and building are not a single asset. Furthermore, the equipment and facility are not considered similar assets because they are different major classes of tangible assets. Acquirer determines that there is significant fair value in both the equipment and the facility and, thus, concludes that it must further evaluate whether the set has the minimum requirements to be considered a business.
>
> The set is not currently producing outputs because there is no continuation of revenue before and after the transaction; therefore, Acquirer considers the criteria in paragraph 805-10-55-5D and whether the set includes both employees that form an organized workforce and an input that the workforce could develop or convert into output. The set includes employees that have the necessary skills, knowledge, or experience to use the equipment; however, without intellectual property or other inputs that could be converted into outputs using the equipment, the set does not include both an organized workforce and an input that will meet the criteria in paragraph 805-10-55-5D. That is, the equipment itself cannot be developed or converted into an output by those employees. Therefore, the set is not a business.

**RSM commentary:** In this case, the screen did not catch the acquired set, which resulted in Widget Co. having to apply the remainder of the framework to ultimately conclude the acquired set was not a business. There were no outputs (or continuing revenue) given the manufacturing facility had been idled, so Widget Co. analyzed whether the acquired set included employees that form an organized workforce and an input that the workforce could develop or convert into outputs. While the organized workforce was present, there was no input that the workforce could convert into outputs. In addition, while the manufacturing facility and related equipment are important inputs, Widget Co. did not also acquire the intellectual property critical to producing outputs. As a result, the acquired set was not a business.

## 4.2 Other guidance that relies on the definition of a business used in ASC 805

Other guidance that relies on the same definition of a business that is used for purposes of determining whether a business combination has occurred for accounting purposes includes the guidance on determining:

- What constitutes a reporting unit for purposes of goodwill impairment testing in ASC 350
- What constitutes a business for purposes of a scope exception to the guidance on VIEs included in ASC 810-10

- Whether the guidance in ASC 810-10 on how to account for decreases in a parent's ownership interest in a subsidiary (including decreases that result in deconsolidation) is applicable (see Section 16.2)
- Whether the guidance in ASC 610-20 on how to account for the derecognition of nonfinancial and in substance nonfinancial assets is applicable (see Appendix A of our revenue recognition guide)
- Whether a distribution of nonmonetary assets to owners constitutes a spinoff (see ASC 505-60)

An entity must consistently apply the definition of a business in these and other places in U.S. GAAP in which it is used.

## 4.3 Timing of determining whether a business was acquired

The buyer should determine whether or not it has acquired or will acquire a business as early in the acquisition process as possible, perhaps even as early as the due diligence and financial feasibility stage. It is important to make this determination early in the process because whether a business has been acquired has significant accounting *and* valuation implications. As summarized in Section 15.1, there are many significant differences between the accounting for a business combination and the accounting for an asset acquisition. These accounting differences could affect the buyer's compliance with debt covenants. As such, it would be advantageous to the buyer to know of any covenant compliance issues as early in the acquisition process as possible. The earlier the buyer identifies the issues, the earlier it can set to work to try to resolve them. If the buyer waits until the end of the reporting period, or even waits until the acquisition date, its window of opportunity to resolve the covenant compliance issues may have closed.

From a valuation perspective, the buyer may initially believe that the valuation process for an asset acquisition is less time consuming or extensive than that for a business combination. However, this is not the case. In other words, concluding that an asset acquisition has occurred (instead of a business combination) does not negate the need to determine the fair values of the assets acquired and liabilities assumed. It is still necessary to determine these fair values in an asset acquisition because those fair values are used to allocate the purchase price to the individual assets acquired and liabilities assumed (as well as any IPR&D acquired, which is immediately written off in an asset acquisition, unless it has an alternative future use). In addition, the buyer in an asset acquisition may need to estimate the fair value of assets that it would not otherwise recognize if it had concluded that a business had been acquired (e.g., assembled workforce [see Section 10.11 and Section 15.3.1]).

The significant accounting and valuation implications of determining whether a business has been acquired underscore the importance of the buyer making this determination as early in the process as possible. If the buyer waits until the end of the reporting period to make this determination, the accounting for the acquisition itself could be unnecessarily delayed. Once the buyer reaches a conclusion, it should review that conclusion with its external auditor on a timely basis (i.e., before significant effort is undertaken to account for the acquisition). In addition, the buyer should communicate its decision on a timely basis to any valuation specialists engaged to assist in the identification and valuation of the assets acquired and liabilities assumed. Securing the resources needed to help with issues that arise in the accounting for a business combination (e.g., valuation specialists, accounting subject matter experts) will generally be easier if those resources are sought and used outside of the calendar year-end financial reporting season.

# 5. Identifying the buyer

If the business in which a controlling financial interest has been obtained is a VIE, the buyer is always the PB of the VIE as determined under the VIE consolidation model (see Section 2.1).

If the business in which a controlling financial interest has been obtained is not a VIE, the buyer in a business combination is the combining entity that gains control over the business as defined in ASC 810-10-15-8, which is discussed in detail in Section 2.1.

## 5.1 Identifying the buyer when not clear

If, after applying ASC 810-10-15-8, it is not clear which of the combining entities is the buyer in a business combination in which the target is not a VIE, other factors should be taken into consideration. For example, the buyer in a business combination effectuated primarily through the transfer of cash or equity is usually the combining entity that: (a) transfers cash, transfers other assets or incurs liabilities or (b) issues its equity interests. One exception to the latter is a business combination in which the target issues its equity interests. This type of business combination is commonly referred to as a reverse acquisition (see Section 5.2). Other factors used in identifying the buyer in a business combination involving two combining entities, particularly when the business combination is effectuated primarily through exchanging equity interests, include determining which of the combining entities' remaining shareholder groups:

- Possesses the largest portion of the combined entity's voting rights
- Holds the largest voting minority interest, either individually or with an organized group of owners, when such voting interest is the most significant voting interest in the combined entity
- Controls the makeup of the majority of the combined entity's governing body
- Provides a dominant portion of the combined entity's senior management team
- Pays a premium to acquire equity interests of the target
- Dominates in terms of relative size (e.g., has the most assets, revenues or earnings of the combining entities)

Reaching a conclusion about which of the combining entities is the acquirer in a business combination when it is not otherwise clear after applying ASC 810-10-15-8 requires the consideration of all relevant facts and circumstances.

### *5Q.1.1 Are there additional factors to consider in determining who the buyer is in a business combination that involves more than two combining entities?*

Yes. Examples of other factors that should be considered in determining who the buyer is in these scenarios are: (a) the identity of the combining entity that initiated the combination and (b) the relative size of the combining entities.

### *5Q.1.2 If a new entity is formed to achieve a business combination (through its acquisition of a target), should that new entity be considered the buyer?*

It depends on the substance behind forming the new entity. If there was no substance behind forming the new entity (i.e., it was formed only to issue equity interests in connection with its acquisition of a target), then the new entity should not be considered the buyer. In that situation, one of the preexisting combining entities (e.g., the parent entity that formed the new entity) should be identified as the buyer. If there is substance behind forming the new entity, then the new entity could potentially be considered the buyer. We believe the following factors, among others, may indicate that there is substance behind forming the new entity:

- Entity was involved in significant activities prior to the transaction (e.g., raising capital, identifying target acquisitions, negotiating and promoting the transaction)
- Entity survives the transaction
- Entity had a prior ownership interest in the acquiree
- Entity transfers cash or other assets, or incurs liabilities to effectuate the transaction

*5Q.1.3 Can one of the combining entities in a business combination be identified as the buyer for legal purposes and the target for accounting purposes?*

Yes. In some cases, referred to as reverse acquisitions, the combining entity that issues equity securities is considered the buyer for legal purposes, but is considered the target for accounting purposes (see Section 5.2). In other words, in reverse acquisitions, it is the accounting buyer's equity interests that are being acquired by the accounting target.

*5Q.1.4 Does ASC 805 provide any additional factors that should be considered in determining who the buyer is in a combination involving mutual entities?*

No. The same indicators should be used in identifying the buyer in a combination involving mutual entities as are used in identifying the buyer in a more traditional business combination.

## 5.2 Reverse acquisitions

In each business combination, there is a legal buyer (i.e., legal acquirer) and a legal target (i.e., legal acquiree). When an entity issues securities to legally acquire another entity, the entity issuing the securities is the legal buyer and the other entity is the legal target. For accounting purposes, ASC 805 provides guidance that must be used in identifying the buyer in a business combination (see Section 5.1). In most cases, applying this guidance results in identifying the legal buyer as the accounting buyer. However, there are situations in which applying this guidance results in identifying the legal target as the accounting buyer. An example of such a situation is provided in ASC 805-40-05-2:

> As one example of a reverse acquisition, a private operating entity may want to become a public entity but not want to register its equity shares. To become a public entity, the private entity will arrange for a public entity to acquire its equity interests in exchange for the equity interests of the public entity. In this situation, the public entity is the legal acquirer because it issued its equity interests, and the private entity is the legal acquiree because its equity interests were acquired. However, application of the guidance in paragraphs 805-10-55-11 through 55-15 results in identifying:
>
> a. The public entity as the acquiree for accounting purposes (the accounting acquiree)
>
> b. The private entity as the acquirer for accounting purposes (the accounting acquirer).

In summary, a reverse acquisition exists when the buyer for accounting purposes is the target for legal purposes and the target for accounting purposes is the buyer for legal purposes. The basic model in ASC 805 applies to reverse acquisitions in the same manner as it applies to other acquisitions. However, given the unique nature of reverse acquisitions, application of certain aspects of the model take on a slightly different form. For example, the accounting buyer in a reverse acquisition:

- Measures the consideration transferred using the hypothetical amount of equity interests it would have had to issue to keep the accounting target's owners in the same ownership position they are in after the reverse acquisition
- Retroactively adjusts the amount of legal capital in the comparative consolidated financial statements to reflect the legal capital of the accounting target (i.e., the legal capital reflected in the comparative consolidated financial statements must be consistent with that of the legal buyer [which is the accounting target])

- Measures the NCI using the precombination carrying amounts of the accounting buyer's net assets and the NCI's proportionate share in those precombination carrying amounts

Calculating earnings per share for the current and prior period when there is a reverse acquisition takes on additional complexity as well. Extensive discussion on the subject of reverse acquisitions can be found in ASC 805-40, along with a comprehensive example that covers the unique aspects of accounting for a reverse acquisition.

## 6. Determining the acquisition date

The date the buyer obtains control is generally considered the acquisition date for the business combination. In most cases, the acquisition date is the same as the closing date. On the closing date, consideration is legally transferred, assets are legally acquired and liabilities are legally assumed. In some cases, however, the parties to the business combination may agree on an acquisition date (i.e., transfer of control) that is different from the closing date (i.e., transfer of consideration, assets and liabilities). If there is written support for that agreement, then the acquisition date would be based on the date that control transfers and not on the date that consideration, assets and liabilities transfer. Consequently, it is not sufficient to only determine when the closing date occurs for purposes of determining the acquisition date for a business combination. While the closing date is important, it is even more important to understand when control transfers as that is what drives the acquisition date.

In some cases, the buyer may want to designate a *convenience* acquisition date for the business combination that is different from the actual acquisition date. Consider a situation in which the business combination closes on the second day of the month. From a logistical and administrative perspective, designating a *convenience* acquisition date as the last day of the prior month to coincide with the buyer's normal closing process would be much less complex for the buyer. While ASC 805 does not explicitly provide for the buyer designating a *convenience* acquisition date, the practice was acknowledged in paragraph B110 of Statement 141R. As such, we believe it may be appropriate for the buyer to use a *convenience* acquisition date so long as the effects of doing so on the financial statements are immaterial (both quantitatively and qualitatively). In general, we believe a *convenience* acquisition date should be no more than a few days from the actual acquisition date. However, the buyer must still assess the effects of using a *convenience* acquisition date even within a few days of the actual acquisition date. In some facts and circumstances, even a few days between the actual acquisition date and the *convenience* acquisition date could have a material effect on the financial statements. Keep in mind that the need to assess whether the effects of using a *convenience* acquisition date instead of an ASC 805 compliant acquisition date are quantitatively and qualitatively immaterial to the financial statements is no different than the need to assess whether the effects of any other accounting error are quantitatively and qualitatively immaterial to the financial statements.

Identification of the appropriate acquisition date is important because it is the date at which: (a) all amounts involved in the accounting for the business combination are measured by the buyer and (b) the buyer begins consolidating the target for accounting purposes. The acquisition date must be disclosed by the buyer (see Section 14.2.2).

# 7. Initial recognition of assets, liabilities and any noncontrolling interest (NCI)

## 7.1 General

In accounting for business combinations, the two key recognition concepts for the acquired assets and assumed liabilities are: (1) to only recognize assets acquired and liabilities assumed that meet the definitions of assets and liabilities and (2) to distinguish, if necessary, between assets acquired and liabilities assumed in the business combination and those acquired or assumed in a separate transaction or event. In addition to recognizing the identifiable assets acquired and liabilities assumed in a business combination, the buyer must also recognize any NCI in the target that exists after its acquisition. Application of the recognition guidance applicable to a business combination will, in many cases, result in the buyer recognizing an asset or liability that had not previously been recognized by the target.

The guidance discussed in this chapter applies to only the *initial* recognition of most assets acquired and liabilities assumed in a business combination. However, there are exceptions to this initial recognition guidance in which different recognition thresholds are used in determining whether an asset or liability should be recognized in the accounting for a business combination. The table that follows lists those acquired assets and assumed liabilities for which ASC 805 provides exceptions to its initial recognition guidance and indicates where additional discussion is available.

| Assets or liabilities related to: | Additional discussion |
|---|---|
| Leases (after adoption of ASC 842) | Section 10.13 |
| Contingencies | Section 11.2 |
| Indemnification assets | Section 11.3 |
| Income taxes | Section 11.4 |
| Employee benefits | Section 11.5 |
| Customer contracts (after adoption of FASB Accounting Standards Update (ASU) 2021-08) | Section 11.9 |

## 7.2 Definitions of assets and liabilities

The guidance that should be referred to in determining whether an identifiable asset or liability is being acquired or assumed is included in FASB Statement of Financial Accounting Concepts (CON) 8, which provides the following definitions of assets and liabilities:

> E16. An asset is a present right of an entity to an economic benefit.
>
> E37. A liability is a present obligation of an entity to transfer an economic benefit.

Only identifiable assets and liabilities that meet these definitions should be recognized in the accounting for a business combination (except for those subject to the exceptions discussed previously). If the applicable definition is not satisfied, then an asset or liability does not exist, and accordingly, should not be recognized. We recognize that while ASC 805-20-25-2 refers to FASB Concepts Statement No. 6, Elements of Financial Statements, in regard to the definitions of assets and liabilities, this statement was superseded in December 2021 by CON 8. The FASB has proposed changes to amend the reference in ASC 805-20-25-2, however the change has not been finalized as of the date of this publication. We do not believe that the FASB intended to change practices or that any difference in the definitions would have a significant impact on the assets and liabilities recognized in a business combination. Additional discussion on how this general recognition guidance should be applied to specific facts and circumstances is included in several sections within this guide (see Section 10.1).

### 7.3 Part of business combination or separate transaction?

It is important to only include those assets and liabilities in the accounting for the business combination that were actually acquired or assumed in the business combination. In other words, if an asset or liability is effectively acquired or assumed as part of a separate transaction executed concurrently or in the same timeframe as the business combination, care should be exercised to ensure that the asset or liability is not inappropriately included in the accounting for the business combination. Additional guidance on how to identify whether an asset or liability is acquired in a transaction separate and apart from a business combination is provided in Chapter 13.

# 8. Measurement of assets, liabilities and any NCI

## 8.1 Initial measurement

### 8.1.1 General

The overall measurement principle applicable to the accounting for business combinations requires the use of fair value to initially measure: (a) identifiable assets acquired and liabilities assumed and (b) any related NCI in the target. However, for a variety of reasons, there are several exceptions to this overall measurement principle in which certain assets acquired and liabilities assumed are measured at something other than fair value.

The overall measurement principle only applies to the *initial* measurement of assets acquired and liabilities assumed in a business combination for which an exception to fair value is not provided. Accounting for these assets and liabilities subsequent to the accounting for the business combination is, in the vast majority of cases, covered by other authoritative literature. However, there are a limited number of acquired assets and assumed liabilities for which ASC 805 provides subsequent accounting guidance.

The table that follows lists those acquired assets and assumed liabilities for which ASC 805 provides (a) exceptions to its overall measurement principle and (b) subsequent accounting guidance. The table also indicates where additional discussion on these subjects is available.

| Assets or liabilities related to: | Exception to overall measurement principle | Subsequent accounting guidance | Additional discussion |
|---|---|---|---|
| Certain financial assets (after adoption of ASC 326) | X | X | Section 10.3 and Section 10.5 |
| Leases (after adoption of ASC 842) | X | | Section 10.13 |
| Contingencies | X | X | Section 11.2 |
| Indemnification assets | X | X | Section 11.3 |
| Income taxes | X | | Section 11.4 |
| Employee benefits | X | | Section 11.5 |
| Reacquired rights | X | X | Section 11.6 |
| Share-based payment awards | X | | Section 11.7 and Section 13.4 |
| Assets held for sale | X | | Section 11.8 |
| Customer contracts (after adoption of ASU 2021-08) | X | | Section 11.9 |

### 8.1.2 Definition of fair value

For purposes of the fair value measurements required in the accounting for a business combination, the Master Glossary of the Codification defines fair value as “The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.” ASC 820 establishes a framework that should be used in measuring fair value. This framework should be followed by the buyer in measuring the fair value of assets acquired and liabilities assumed in a business combination, as well as any NCI that exists after the business combination.

Various aspects of fair value measurements made in connection with the accounting for a business combination are discussed elsewhere in this guide, including:

- Section 10.2 discusses the highest and best use concept, including application of that concept to land and IPR&D.
- Section 10.3 discusses the fair value of accounts and loans receivable.
- Section 10.5 discusses the fair value of investments in debt securities.
- Section 10.6.4 discusses the fair value of customer contracts and customer relationships.
- Section 10.6.4.1 discusses the fair value of contract assets and contract liabilities (i.e., deferred revenue) prior to the adoption of ASU 2021-08.
- Section 10.7 discusses the fair value of inventory.
- Section 10.14 discusses the fair value of accounts payable and accrued liabilities.
- Section 10.17 discusses the fair value of assumed debt.
- Section 10.19.3 discusses the fair value of an NCI.
- Section 12.3.3 discusses measuring the fair value of an entity's own equity securities.
- Section 12.6.2 discusses the fair value of a buyer's previously held equity interest (PHEI) in a target.
- Section 14.7 discusses the applicability of fair value disclosures to items acquired in a business combination.

## 8.2 Subsequent accounting guidance

ASC 805 provides subsequent accounting guidance for certain assets and liabilities recognized in the accounting for a business combination, including those related to:

- Certain financial assets (after adoption of ASC 326) (see Section 10.3.4 and Section 10.5.3)
- Contingencies (see Section 11.2.4)
- Indemnification assets (see Section 11.3.3)
- Reacquired rights (see Section 11.6.3)
- Contingent consideration (see Section 12.4.4)

In addition, other sections of the Codification provide specific subsequent accounting guidance for certain assets and liabilities recognized in conjunction with a business combination. For example, ASC 350-30-35-17A provides subsequent accounting guidance for research and development (R&D) intangible assets recognized in conjunction with a business combination (see Section 10.12.2). While there is some specific subsequent accounting guidance within the Codification for certain assets and liabilities recognized in conjunction with a business combination, for the vast majority of these assets and liabilities, other guidance in the Codification generally applicable to the asset or liability, regardless of whether it was acquired in a business combination, should be applied. For example, the subsequent accounting for employee replacement share-based payment awards granted by the buyer in a business combination in which the awards are treated as compensation instead of consideration transferred should follow the guidance in ASC 718. In addition, the subsequent accounting for insurance or reinsurance contracts acquired in a business combination should follow the guidance in ASC 944 (see Section 10.18).

## 9. Buyer’s classification or designation of acquired assets and assumed liabilities

There are numerous examples in U.S. GAAP in which an entity must determine the classification for a contract, instrument or agreement, which then dictates its accounting. Similarly, there are also examples in which U.S. GAAP may allow an entity to designate a contract, instrument or agreement in a particular manner, which then has repercussions on its accounting.

An example of a situation in which an entity must classify an instrument prior to determining its accounting treatment involves investments in certain debt securities. ASC 320-10-25 requires investments in debt securities that fall within its scope to be classified as trading, available for sale (AFS) or held to maturity (HTM), as those terms are defined. The accounting for such an investment subsequent to its initial recognition is dependent on its classification.

An example of a situation in which an entity may designate an instrument in a particular manner that then affects how the instrument is accounted for involves derivative instruments. In certain situations and if specified criteria are met, ASC 815-10-05-4 permits an entity to designate a derivative instrument as a hedging instrument. This designation affects the accounting for the derivative instrument and may, in certain situations, affect the accounting for the hedged item.

When a previously classified or designated contract, instrument or agreement is acquired in a business combination, the question arises regarding how the contract, instrument or agreement should be classified or designated by the buyer on the acquisition date for purposes of the post-acquisition-date accounting. Except with respect to the following two types of contracts, instruments or agreements, the buyer should classify the acquired contract, instrument or agreement based on the terms, conditions and other relevant factors (e.g., buyer’s accounting or operating policies) in existence on the acquisition date in accordance with the relevant authoritative literature:

- Those that are leases within the scope of ASC 842 (see Section 10.13)
- Those that are a contract within the scope of ASC 944-10 (see Section 10.18)

In addition to classifying investments in debt securities within the scope of ASC 320-10-25 as trading, HTM or AFS and designating a derivative instrument as a hedging instrument, other examples of contracts, instruments or agreements that the buyer may need to reclassify or redesignate as of the acquisition date include:

- Those involving embedded derivatives within the scope of ASC 815 and whether those embedded derivatives should be separated from the host contract
- Those involving derivatives within the scope of ASC 815 that previously qualified for the normal purchases and normal sales exception and whether: (a) they continue to qualify for that exception after the acquisition and (b) the buyer will elect to apply that exception after the acquisition
- Those within the scope of ASC 825-10 and whether the buyer will elect to account for any or all of those instruments using the fair value option provided for in that subtopic
- Those involving derivatives within the scope of ASC 815 for which hedge accounting was applied and whether the buyer will elect hedge accounting for these or other hedging relationships involving derivatives acquired in the business combination, recognizing that, in general, there are complexities associated with qualifying for and applying hedge accounting with a preexisting derivative that no longer has a zero fair value
- Those customer contracts within the scope of ASC 606-10 that include multiple promises to provide goods or services to the customer and whether the multiple promises to provide goods or services should be bundled together (i.e., as a single performance obligation) or separated (i.e., as separate performance obligations) for accounting purposes

- Those involving an asset or asset group that meets the criteria under ASC 360 to be considered held for sale and whether it should continue to be considered held for sale after the acquisition (see Section 11.8).

# 10. Specific application of general recognition and measurement guidance

## 10.1 Application of general recognition and measurement principles

ASC 805's general recognition and measurement principles are discussed in Section 7.1 and Section 8.1. Application of these overall principles is discussed in the following contexts and sections of this guide:

| Context | Additional discussion |
|---|---|
| Fair value of assets based on highest and best use | Section 10.2 |
| Accounts and loans receivable (both before and after adoption of ASC 326) | Section 10.3 |
| Servicing rights | Section 10.4 |
| Investments in debt securities | Section 10.5 |
| Customer contracts and customer relationships (including deferred revenue) | Section 10.6 and Chapter 17 |
| Inventory | Section 10.7 |
| Intangible assets, in general | Section 10.8 and Section 10.9 |
| Defensive intangible assets | Section 10.10 |
| Assembled workforce | Section 10.11 |
| R&D | Section 10.12 |
| Leases (both before and after adoption of ASC 842) | Section 10.13 |
| Accounts payable and accrued liabilities | Section 10.14 |
| Anticipated restructuring activities involving the target | Section 10.15 |
| AROs | Section 10.16 |
| Assumed debt | Section 10.17 |
| Insurance and reinsurance contracts | Section 10.18 |
| Noncontrolling interest | Section 10.19 |

## 10.2 Application of measurement guidance: Fair value of assets based on highest and best use

When estimating the fair value of an asset to be recognized in the accounting for a business combination, the guidance in ASC 820 should be used. ASC 820 provides guidance on what the definition of fair value means and whether the fair value of a nonfinancial asset should be based on: (a) how the buyer intends to use the asset or (b) how a market participant would use the asset to its highest and best use. Highest and best use is defined in the Master Glossary of the Codification as follows: "The use of a nonfinancial asset by market participants that would maximize the value of the asset or the group of assets and liabilities (for example, a business) within which the asset would be used." The highest and best use of an asset must fall within the parameters of physically possible, legally permissible and financially feasible.

ASC 820 clearly indicates the fair value of a nonfinancial asset should be measured based on its highest and best use and not based on the buyer's intended use of the asset. This is supported by the following comments in ASC 820-10-35-10C on the buyer's intended use of the asset: "Highest and best use is determined from the perspective of market participants, even if the reporting entity intends a different use. However, a reporting entity's current use of a nonfinancial asset is presumed to be its highest and best use unless market or other factors suggest that a different use by market participants would maximize the value of the asset."

While the fair value of an intangible asset should be based on its highest and best use from a market participant's perspective, the buyer's intention may still be to hold the asset for defensive purposes. The accounting issues that arise in connection with defensive intangible assets as well as the definition of defensive intangible assets are provided in Section 10.10.

The best way to understand the concept of highest and best use is to apply that concept to specific fact patterns. Two examples used in ASC 820 to illustrate the highest and best use concept deal with land acquired in a business combination (specifically, ASC 820-10-55-30 to 55-31) (see Example 10-1), and IPR&D acquired in a business combination (specifically, ASC 820-10-55-32) (see Example 10-2).

**Example 10-1: Land acquired in a business combination**

Buyer acquires Target in a business combination. One of Target's assets that is acquired by Buyer is a piece of land on which one of Target's manufacturing facilities is currently located. Buyer understands that this land is currently zoned for commercial use. However, Buyer has learned that owners of adjacent parcels of land, also originally zoned for commercial use, have had their parcels of land rezoned for residential use. In addition, in doing so, these owners are in the process of selling these rezoned adjacent parcels of land and realizing a significant return. Buyer has no intention of demolishing the manufacturing facility on the acquired land or working to rezone the land as residential. However, because of the developments on the adjacent parcels of land, it is reasonable to expect that a market participant may undertake those activities if the price is right.

Based on the guidance in ASC 820-10-35-10C, continued use of the land by Buyer as the location for the manufacturing facility is presumed to be the highest and best use of that land. However, Buyer must also consider whether that presumption can be overcome. In doing so, Buyer considers whether it is reasonable to expect that a market participant would undertake demolition of the manufacturing facility and rezoning of the land for residential use. Buyer concludes that it is reasonable to include the possibility of rezoning the land in the highest-and-best use analysis given that owners of adjacent parcels of land, also originally zoned for commercial use, have had their parcels of land rezoned for residential use and are realizing significant returns on their sale. As such, the fair value of the land under both scenarios (and potentially other scenarios) should be considered by Buyer in determining which of the two (or more) uses of the land represents the highest and best use of the land. In determining which of the two scenarios discussed here represents the highest and best use of the land, Buyer needs to ascertain the fair value of: (a) the land when it is used as part of the manufacturing operation now located on the land (this is the group of assets in which the land would be used), (b) the land on a standalone basis, which would include the costs expected to be incurred to ready the land for use by a residential developer (e.g., demolition of the manufacturing facility), as well as any uncertainty related to Buyer's ability to convert the land to residential property and (c) any other alternatives that a market participant could reasonably be expected to undertake with respect to this land. The highest of these fair values should be considered the highest and best use of the land from the perspective of the market participant.

One key point of this example is that the continued use of an asset in a particular manner may or may not be the highest and best use of that asset. The highest and best use of an asset may be as part of an asset group, in which case the fair value of the asset group should be determined. Another key point of this example is that the highest and best use of an asset is determined from a market participant's perspective, not the perspective of the buyer in the business combination. This is the case even if the buyer has no intention of using the asset in a way in which a market participant would use the asset to realize its highest and best use.

**Example 10-2: IPR&D acquired in a business combination**

Buyer acquires Target in a business combination. As a result, Buyer obtains control of one of Target's IPR&D projects. The acquired IPR&D project is in direct competition with an existing IPR&D project of Buyer. Buyer is further along in its existing IPR&D project, and as a result, has no intention of completing the acquired IPR&D project. Buyer also has no intention of separately selling the acquired IPR&D project for fear that one of its remaining competitors would gain access to it and ultimately use it to compete against any products resulting from Buyer's existing IPR&D project.

The highest and best use of the acquired IPR&D project requires considering what market participants would do with this project. Following are three potential courses of action that market participants could take with respect to an acquired IPR&D project:

1. Continue developing the acquired IPR&D project.
2. Shut down the acquired IPR&D project for the same reason Buyer shuts down the project (i.e., for its defensive value).
3. Shut down the acquired IPR&D project because it is not expected to provide sufficient value in the future, either in terms of returns when completed or in terms of defensive value.

Determining which of these (or other) courses of action that a market participant would take depends on a number of factors, not the least of which are the nature of the acquired IPR&D project and the extent and value of the intelligence captured in the project to date. Buyer also needs to consider what other assets market participants would need to continue developing the acquired IPR&D project (or to otherwise benefit from the acquired IPR&D project) and whether those assets are available to market participants. Once Buyer has determined which courses of action a market participant may take, Buyer then determines the fair value of the acquired IPR&D for each possible course of action. The highest of those fair values typically represents the highest and best use of the acquired IPR&D project.

One key point of this example is that the highest and best use of an asset is determined from a market participant's perspective, not the perspective of the buyer in the business combination. This is the case even if the buyer has no intention of using the asset in a way in which a market participant would use the asset. Another key point of this example is that there may be more than one course of action available to market participants as it relates to the asset being evaluated. When this occurs, each available course of action should be evaluated.

Related to Example 10-2, the AICPA provides robust information on valuing acquired R&D projects in its R&D Accounting and Valuation Guide (AVG). For additional discussion about recognizing assets related to acquired R&D projects, see Section 10.12.

Example 10-1 and Example 10-2 deal with the potential differences that could exist between the buyer's and a market participant's intended use of an asset for purposes of determining the asset's fair value, and only scratch the surface as far as the number of differences that could exist in practice. Consider the number of situations that could arise related to whether contract renewals should be taken into consideration in measuring the fair value of an asset. The buyer in a business combination may have no intention of renewing a particular contract, perhaps because it does not fit with their strategic vision for the company. However, if a market participant would expect to renew the contract, then expectations of future contract renewals should be taken into consideration in determining the fair value of that contract. The only situation in which expected contract renewals by a market participant should not be taken into consideration is estimating the fair value of reacquired rights (see Section 11.6.2).

## 10.3 Accounts and loans receivable

### 10.3.1 General

As discussed in Section 8.1.1, the general rule (to which there are limited exceptions) is that assets and liabilities acquired in a business combination should be measured at their fair value. This general rule covers accounts and loans receivable acquired in a business combination. In other words, there is no exception that allows accounts or loans receivable to be measured at an amount other than fair value (e.g., carrying amount) in the accounting for the business combination. In some cases, the buyer might assert that the fair value of the target's short-term trade accounts receivable is the same as the target's book value, but it is not appropriate to use the target's book value as a surrogate or approximation for fair value unless it is known that the difference between book value and fair value is immaterial. The fair value of the short-term trade accounts receivable must be determined to assess whether the difference is immaterial. If fair value is determined for this purpose, the buyer should strongly consider using that fair value in the accounting for the business combination.

The concept of highest and best use discussed in Section 10.2 does not apply to financial assets because financial assets do not have alternative uses. The fair value of accounts or loans receivable should be based on the price that the buyer would receive if the accounts or loans receivable were sold to market participants in the business of buying accounts or loans receivable. Generally, a present value technique is used to estimate the fair value of accounts or loans receivable, unless quoted prices are available for the same or similar receivable. ASC 820-10-55-6 discusses the general principles of a present value technique, many of which are particularly relevant to estimating the fair value of loans receivable.

Additional considerations related to the measurement of accounts and loans receivable acquired in a business combination depend on whether the buyer has adopted ASC 326. Additional information about ASC 326 is provided in Section 10.3.2. Additional considerations related to the measurement and subsequent accounting for accounts and loans receivable acquired in a business combination are discussed in Section 10.3.3 (when the buyer has not adopted ASC 326) and Section 10.3.4 (when the buyer has adopted ASC 326). Section 10.3.5 discusses the practical issue of acquiring accounts and loans receivable in a business combination resulting in the buyer having mixed bases in the accounts and loans receivable reflected in its consolidated financial statements.

### 10.3.2 ASC 326: General information and effective date

In 2016, the FASB issued ASU 2016-13, which was codified in ASC 326. On its effective date, ASC 326 replaces the impairment guidance included in: (a) ASC 320-10-35 for investments in debt securities, (b) ASC 310-10-35 for accounts and loans receivable and (c) ASC 310-30 for loans receivable, accounts receivable and debt securities with deteriorated credit quality. ASC 326 is discussed in detail in Chapters 4 and 6 of our financial assets guide.

One of the most significant changes under ASC 326 is that for financial assets measured at amortized cost, ASC 326-20 requires the recognition of an allowance for credit losses for losses that are expected to occur over the remaining life of a financial asset, rather than an allowance for credit losses incurred on a financial asset. The approach to accounting for credit losses in ASC 326-20 is commonly referred to as the current expected credit losses model and is discussed in detail in Chapter 6 of our financial assets guide.

ASC 326 became effective for public business entities (PBEs) that are SEC filers, except for entities eligible to be smaller reporting companies (SRCs) (as defined by the SEC), in annual reporting periods beginning after December 15, 2019, and the interim periods therein. For all other entities (e.g., private companies, entities eligible to be SRCs), ASC 326 is effective for annual reporting periods beginning after December 15, 2022, and the interim periods within those fiscal years.

In addition to making changes to the accounting for credit losses in general, the FASB also made changes to how a buyer should account for accounts and loans receivable acquired in a business combination. As such, the accounting for acquired accounts and loans receivable in a business combination depends in part on whether the buyer has adopted ASC 326.

### 10.3.3 Additional considerations related to measuring accounts and loans receivable acquired in a business combination prior to the adoption of ASC 326

Using fair value to measure accounts and loans receivable includes the consideration of potentially not collecting the contractual balances. In addition, the fair value of acquired accounts receivable (with terms greater than one year) and loans receivable that fall within the scope of ASC 310-30 (see Section 10.3.3.1) is based on the present value of the amounts expected to be received as of the acquisition date. Because the fair value of accounts and loans receivable takes into consideration amounts not expected to be collected, it is not necessary (or permissible) prior to the adoption of ASC 326 to recognize separate valuation allowances for these receivables (e.g., allowance for doubtful accounts, allowance for loan losses) when they are acquired in a business combination. It is inappropriate to recognize separate valuation allowances for these receivables when they are measured at their fair values in the accounting for the business combination because to do so would effectively double count the credit or collection risk inherent in those receivables. The subsequent accounting for accounts and loans receivable acquired in a business combination prior to the adoption of ASC 326 is discussed in Section 10.3.3.1.

#### 10.3.3.1 Subsequent accounting for accounts or loans receivable acquired in a business combination prior to the adoption of ASC 326

Prior to the adoption of ASC 326, when the buyer in a business combination acquires accounts receivable (with terms greater than one year) or loans receivable as part of the business combination, the buyer must consider whether those receivables have experienced deterioration in their credit quality since origination. To the extent they have, the buyer must determine whether those receivables fall within the scope of ASC 310-30. Based on ASC 310-30-15-2, receivables within the scope of ASC 310-30 are those (with certain exceptions) "with evidence of deterioration of credit quality since origination acquired by completion of a transfer for which *it is probable, at acquisition, that the investor will be unable to collect all contractually required payments receivable* [emphasis added]." Receivables within the scope of ASC 310-30 are referred to as purchased credit impaired assets (which are also referred to as PCI assets). The subsequent accounting for accounts and loans receivable acquired in a business combination depends on whether they are considered PCI assets.

*Subsequent accounting when accounts receivable (with terms greater than one year) and loans receivable acquired in a business combination are PCI assets*

When accounts receivable (with terms greater than one year) and loans receivable recognized in the accounting for the business combination are considered PCI assets, the guidance in ASC 310-30 should be used to subsequently account for the receivables. Under ASC 310-30, differences between the amount recognized for the acquired financial asset in the accounting for the business combination and the amount of cash flows expected to be collected is recognized in interest income using the interest method over the life of the asset. Conversely, contractual cash flows not expected to be collected are accounted for as a nonaccretable difference. While impairment occurring subsequent to the acquisition is recognized as incurred through an allowance, increases in expected cash flows are accreted into interest income over the asset's remaining life.

*Subsequent accounting when accounts receivable (with terms greater than one year) and loans receivable acquired in a business combination are not PCI assets*

ASC 310-20 requires the difference between the carrying amount assigned to the acquired financial asset and its contractual or principal amount to be recognized in interest income using the interest method over the life of the asset. Contractual cash flows are generally used to apply the interest method when accounting for purchase premiums and discounts in accordance with ASC 310-20.

Our understanding is that it is also acceptable to apply ASC 310-30 by analogy if there is a discount attributable to the financial asset at the acquisition date that is at least partially due to a decline in the debtor's credit quality. This understanding is based on discussions with the staff of the SEC, which were summarized in a letter sent by the chair of the AICPA Depository Institutions Expert Panel to the Office of the Chief Accountant of the SEC in 2009.

### 10.3.4 Additional considerations related to measuring accounts and loans receivable acquired in a business combination after the adoption of ASC 326

The acquisition-date accounting for accounts and loans receivable acquired in a business combination depends on whether those receivables meet the definition of purchased financial assets with credit deterioration (which are also referred to as PCD assets). PCD assets are defined in part in the Master Glossary of the Codification as acquired financial assets "that, as of the date of acquisition, have experienced a *more-than-insignificant deterioration in credit quality* since origination [emphasis added]." For additional information about whether an account or loan receivable should be considered and accounted for as a PCD asset, and how that determination impacts the recognition of credit losses, see Section 6.13 of our financial assets guide.

Given the need to consider the risk of loss no matter how remote, as well as ASC 326-20-30-5 prohibiting discounts that will be accreted into interest income from being offset against expected credit losses, the expectation is that most purchased accounts and loans receivable will require recognition of an allowance for credit losses determined in accordance with ASC 326 on the acquisition date. The accounting for the effects of recognizing that allowance depends on whether the accounts and loans receivable acquired in the business combination are PCD assets:

- *PCD assets*. In the accounting for the business combination, an allowance for credit losses is recognized through an increase to the assets' amortized cost basis (fair value on the acquisition date). As such, the gross amount of acquired PCD assets recognized is the fair value of those assets grossed up by the amount of the allowance for credit losses. The net-of-allowance amount recognized for the PCD assets in the accounting for the business combination is the fair value of those assets.
- *Not PCD assets*. In the accounting for the business combination, the gross amount of non-PCD assets recognized is the fair value of the non-PCD assets. Immediately after the buyer accounts for the business combination, it recognizes an allowance for credit losses on the non-PCD assets through credit loss expense (which is often referred to as recognizing a day-one loss).

To illustrate the implications of an account or loan receivable being considered a PCD asset, consider a situation in which: (a) the buyer acquires a loan receivable with a fair value of $100,000 on the acquisition date and (b) the buyer determines that the allowance for credit losses that should be recognized on the $100,000 loan receivable balance is $2,000. The following table illustrates the accounting for the acquired loan receivable, which depends on whether it is or is not a PCD asset:

| | Acquired loan receivable is a… | |
|---|---|---|
| | Non-PCD asset | PCD asset |
| Gross loan receivable recognized in the accounting for the business combination | $100,000 | $102,000 |
| Allowance for credit losses recognized in the accounting for the business combination | $ - | $2,000 |
| Net loan receivable recognized in the accounting for the business combination | $100,000 | $100,000 |
| Net effect on goodwill recognized in the accounting for the business combination | ($100,000) | ($100,000) |
| Allowance for credit losses recognized on the acquisition date immediately after the accounting for the business combination is complete | $2,000 | $ - |
| Credit loss expense recognized on the acquisition date immediately after the accounting for the business combination is complete (i.e., day-one loss) | $2,000 | $ - |

In the subsequent accounting for accounts and loans receivable acquired in a business combination, both favorable and unfavorable changes in expected cash flows are recognized immediately through credit loss expense rather than recognizing favorable changes as an adjustment to the accretable yield over the life of the instrument, which was the case when applying ASC 310-30 prior to the adoption of ASC 326 (see Section 10.3.3.1).

**Pending change:** The FASB has a project, "Financial Instruments – Credit Losses (Topic 326) – Acquired Financial Assets," on its agenda, which could significantly affect the guidance referred to in this section by expanding the scope of the PCD accounting model to all loans acquired in a business combination and modifying the presentation of expected credit losses for acquired financial assets. At the publication date for this guide, the project was still in process (see the FASB's project page for its status).

### 10.3.5 Mixed bases in accounts and loans receivable after acquisition in a business combination

A financial institution may have both of the following in its loan portfolio: (a) loans originated by it and (b) loans purchased in a business combination. The basis on which the loan loss is determined for loans originated by the financial institution is the original or amortized cost of the loans. In contrast, the basis on which the loan loss is determined for loans purchased by the financial institution in a business combination is generally the fair value of the loans on the related acquisition date. However, under ASC 326, if a discounted cash flow approach is not used to determine expected credit losses for PCD assets, the basis on which the loan loss is determined is the unpaid principal balance.

The mixed basis of the loan portfolio creates significant practical difficulties for the financial institution when it estimates the loan loss allowance for the entire loan portfolio. Similar practical difficulties could arise in other situations involving accounts receivable. For example, when one telecommunications company that serves end users acquires another telecommunications company that serves end users, the accounts receivable of the buyer and those of the target will be measured using different bases in the combined entity's financial statements. This may complicate the buyer's process of estimating and explaining uncollectible amounts for the combined entity in future reporting periods. To provide users of the financial statements with information that will help them understand the mixed basis that may exist in accounts or loans receivable after a business combination: (a) ASC 805 requires the disclosure of certain information for acquired receivables (see Section 14.2.5) and (b) ASC 310-30 requires the disclosure of certain information for PCI assets before the adoption of ASC 326, and ASC 326-20-50 requires the disclosure of certain information for PCD assets after the adoption of ASC 326.

## 10.4 Servicing rights not contractually separated from the related financial assets

Servicing assets are defined in the Master Glossary of the Codification as:

> A contract to service financial assets under which the benefits of servicing are expected to more than adequately compensate the servicer for performing the servicing. A servicing contract is either:
>
> a. Undertaken in conjunction with selling or securitizing the financial assets being serviced
>
> b. Purchased or assumed separately.

Conversely, a servicing liability would result if the benefits of servicing are not expected to adequately compensate the servicer for performing the servicing.

A separate servicing asset or liability is not recognized for servicing rights or obligations acquired in a business combination that have not been contractually separated from the related financial assets also acquired in the business combination. Instead, these inherent servicing rights or obligations are taken into consideration when determining the fair value of the related financial assets that were acquired. As such, recognizing a separate asset or liability for those servicing rights or obligations would effectively result in the fair value of those servicing rights or obligations being double counted.

This treatment of servicing rights is consistent with the SEC staff's views on determining the fair value of a derivative loan commitment, which are captured in SEC Staff Accounting Bulletin (SAB) Topic 5.DD. This SAB topic, which indicates the following, is codified in ASC 815-10-S99-1:

> The staff believes that, consistent with FASB ASC Subtopic 860-50, Transfers and Servicing—Servicing Assets and Liabilities, FN60, and FASB ASC Subtopic 825-10, the expected net future cash flows related to the associated servicing of the loan should be included in the fair value measurement of a derivative loan commitment.... However, as discussed in FASB ASC paragraph 860-50-25-1, a separate and distinct servicing asset or liability is not recognized for accounting purposes until the servicing rights have been contractually separated from the underlying loan by sale or securitization of the loan with servicing retained. [footnote omitted]

## 10.5 Investments in debt securities

### 10.5.1 General

Chapter 3 of our financial assets guide discusses what is and is not a debt security. This discussion should be used by the buyer to identify the investments it acquired in the business combination that should be considered and accounted for as investments in debt securities.

Chapter 9 discusses classification of the investments in debt securities acquired by the buyer in the business combination as trading, HTM and AFS on the acquisition date. These classifications and their accounting implications are described in detail in Section 3.3 of our financial assets guide.

### 10.5.2 Initial measurement of investments in debt securities acquired in a business combination

As discussed in Section 8.1.1, the general rule (to which there are limited exceptions) is that assets and liabilities acquired in a business combination should be measured at their fair value. This general rule covers investments in debt securities. In other words, there is no exception that allows debt securities to be measured at an amount other than fair value (e.g., the target's carrying amount) in the accounting for the business combination.

The concept of highest and best use discussed in Section 10.2 does not apply to financial assets because financial assets do not have alternative uses. As such, the fair value of investments in debt securities should be based on the price that the buyer would receive if the investment were sold to market participants in the business of buying investments in debt securities. Generally, a market approach is used to estimate the fair value of investments in debt securities given that quoted prices are often available for the same or similar investment. When an income approach is used to estimate the fair value of investments in debt securities, the buyer should refer to ASC 820-10-55-6, which discusses the general principles of a present value technique, many of which are particularly relevant when estimating the fair value of investments in debt securities.

Additional considerations related to the measurement of investments in debt securities acquired in a business combination depend on the classification of the investment and whether the buyer has adopted ASC 326. Additional information about ASC 326 is provided in Section 10.3.2. Additional considerations related to the initial measurement for investments in debt securities acquired in a business combination are discussed in Section 10.5.2.1 (when the buyer has not adopted ASC 326) and Section 10.5.2.2 (when the buyer has adopted ASC 326). Section 10.15.3 is about the subsequent accounting for investments in debt securities acquired in a business combination.

#### 10.5.2.1 Additional considerations related to measuring investments in debt securities acquired in a business combination prior to the adoption of ASC 326

Prior to the adoption of ASC 326, acquired debt securities are initially measured at their acquisition-date fair value. No credit losses or valuation allowances are recognized unless or until an individual debt security becomes impaired, and that impairment is deemed to be other than temporary.

#### 10.5.2.2 Additional considerations related to measuring investments in debt securities acquired in a business combination after the adoption of ASC 326

Whether an allowance for credit losses determined in accordance with ASC 326 should be recognized in the acquisition-date accounting for investments in debt securities acquired in a business combination depends on the classification of the investments and whether they meet the definition of purchased financial assets with credit deterioration (which are also referred to as PCD assets) or are beneficial interests that meet the conditions in ASC 325-40-30-1A. PCD assets are defined in part in the Master Glossary of the Codification as acquired financial assets "that, as of the date of acquisition, have experienced a *more-than-insignificant deterioration in credit quality* since origination [emphasis added]."

*Trading*

Given that investments in debt securities acquired in a business combination that the buyer classified as trading on the acquisition date are subsequently accounted for at fair value through earnings, there is no acquisition-date allowance for credit losses. In addition, there are no special acquisition-date considerations related to trading securities that may otherwise meet the definition of a PCD asset.

*HTM and AFS investments in debt securities*

The accounting for investments in debt securities acquired in a business combination that are classified by the buyer as HTM or AFS on the acquisition date depends on whether those investments meet the definition of PCD assets or are beneficial interests that meet the conditions in ASC 325-40-30-1A. Whether HTM investments in debt securities and AFS investments in debt securities should be considered PCD assets is discussed in detail in Section 4.1.7 and Section 6.13, respectively, of our financial assets guide. Beneficial interests that meet the conditions in ASC 325-40-30-1A are discussed in Section 6.14 of our financial assets guide for HTM investments in debt securities, and in Section 4.1.7 for AFS investments in debt securities.

As it relates to investments in HTM debt securities, because ASC 326-20 requires consideration to be given to the risk of loss no matter how remote, the expectation is that most HTM investments in debt securities will require recognition of an allowance for credit losses determined in accordance with ASC 326-20 on the acquisition date. Chapter 6 of our financial assets guide discusses and illustrates in detail the recognition and measurement of an allowance for credit losses under ASC 326-20, including the circumstances under which an allowance for credit losses may not be required (see ASC 326-20-30-10).

The manner in which such an allowance for credit losses is recognized depends on whether the HTM investments in debt securities are PCD assets or are beneficial interests that meet the conditions in ASC 325-40-30-1A, which is discussed later in this section. Conversely, an acquisition-date allowance for expected credit losses should only be recognized on AFS investments in debt securities if the securities are PCD assets or beneficial interests that meet the conditions in ASC 325-40-30-1A. Chapter 4 of our financial assets guide discusses and illustrates the recognition and measurement of an allowance for credit losses under ASC 326-30 in detail.

When an acquisition-date allowance for credit losses is recognized for investments in debt securities the buyer classified as HTM or AFS, the effects of recognizing that allowance on the financial statements depends on whether the investments are PCD assets or beneficial interests that meet the conditions in ASC 325-40-30-1A:

- *PCD assets and beneficial interests that meet the conditions in ASC 325-40-30-1A*. In the accounting for the business combination, an allowance for credit losses is recognized through an increase to the asset's amortized cost basis (fair value on the acquisition date). As such, the gross amount of acquired PCD assets and beneficial interests that meet the conditions in ASC 325-40-30-1A recognized is the fair value of those assets grossed up by the amount of the allowance for credit losses. The net-of-allowance amount recognized for the PCD assets and beneficial interests that meet the conditions in ASC 325-40-30-1A in the accounting for the business combination is the fair value of those investments.
- *Not PCD assets or beneficial interests that meet the conditions in ASC 325-40-30-1A*. In the accounting for the business combination, the gross amount separately recognized for the HTM investments in debt securities is the fair value of those investments. Immediately after the buyer accounts for the business combination, it recognizes an allowance for credit losses on HTM investments in debt securities through credit loss expense (which is often referred to as recognizing a day-one loss). AFS investments in debt securities are recognized and measured at their fair value in the accounting for the business combination without the recognition of an allowance for credit losses, if those securities are not PCD assets or beneficial interests that meet the conditions in ASC 325-40-30-1A.

The acquisition-date business combination accounting for investments in debt securities classified by the buyer as HTM is similar to the acquisition-date business combination accounting for accounts and loans receivable. As illustrated in Section 10.3.4, the different acquisition-date accounting for non-PCD and PCD assets acquired in a business combination does not affect the amount of goodwill recognized in the accounting for the business combination.

**Pending change:** The FASB has a project, "Financial Instruments – Credit Losses (Topic 326) – Acquired Financial Assets," on its agenda, which could significantly affect the guidance referred to in this section by expanding the scope of the PCD accounting model to all loans acquired in a business combination and modifying the presentation of expected credit losses for acquired financial assets. At the publication date for this guide, the project was still in process (see the FASB's project page for its status).

### 10.5.3 Subsequent accounting for investments in debt securities acquired in a business combination

The subsequent accounting for investments in debt securities acquired in a business combination depends on a number of factors, including their classification and whether the buyer has adopted ASC 326. For additional information, refer to our financial assets guide.

## 10.6 Customer contracts and customer relationships

### 10.6.1 General

Section 10.6 discusses the guidance in ASC 805 generally applicable to the recognition and measurement of customer contracts and customer relationships acquired in a business combination. Chapter 17 discusses the guidance that is applicable if an entity elects the private-company intangible asset alternative, which provides alternative guidance with respect to the recognition of intangible assets related to customers. If a private company elects the intangible asset alternative, the guidance in this section dealing with the recognition of a backlog intangible asset, an off-market contract intangible asset and a customer relationship intangible asset is not relevant to the extent those assets are not recognized as a result of applying the alternative.

References to the contractual-legal and separability criteria are made throughout this section in the context of whether one or more intangible assets should be recognized for a customer contract in the accounting for a business combination. These criteria are discussed in more detail in Section 10.8 and Section 10.9.

### 10.6.2 Recognition of assets and liabilities related to customer contracts (including deferred revenue)

The following summarizes the different assets and liabilities that the buyer may recognize related to customer contracts in the accounting for a business combination:

- *Accounts receivable*. When an entity has an unconditional right to consideration from its customer, it recognizes accounts receivable. The buyer's accounting for the target's accounts receivable in the accounting for the business combination is discussed in detail in Section 10.3. For purposes of the private-company intangible asset alternative (see Chapter 17), accounts receivable is not a customer-related intangible (CRI) asset.
- *Contract asset or contract liability (which is often referred to as deferred revenue).* Under ASC 606, a contract liability arises when the customer's performance is greater than that of the entity (i.e., the consideration paid by the customer plus any amount recognized as a receivable is greater than the revenue recognized for the promised goods or services transferred to the customer). Conversely, a contract asset arises under ASC 606 when the entity's performance is greater than that of the customer (i.e., the revenue recognized for the promised goods or services transferred to the customer is more than the consideration paid by the customer or recognized as a receivable). Section 10.6.2.1 provides additional information related to recognizing contract liabilities in the accounting for a business combination.
- *Backlog intangible asset*. The target's order or production backlog is a backlog of purchase and sales orders. From a revenue recognition perspective, the performance obligations included in the purchase and sales orders have not been satisfied. The basis for recognizing an intangible asset for the target's order or production backlog is the contractual-legal criterion. The intangible asset recognized for the target's order or production backlog is measured at fair value. For purposes of the private-company intangible asset alternative (see Chapter 17), a backlog intangible asset is a CRI asset.
- *Off-market contract intangible asset (above market) or liability (below market).* A contract is off market when its terms vary from those that would be offered to a market participant on the acquisition date. The basis for recognizing an off-market contract intangible asset or liability related to a customer contract acquired in a business combination is the contractual-legal criterion. The off-market contract asset or liability recognized in the business combination accounting is measured at its fair value. For purposes of the private-company intangible asset alternative (see Chapter 17), an off-market contract intangible asset is a CRI asset.

- *Customer relationship intangible asset*. If the target has an established practice of entering into contracts with its customers, then the target has customer relationships that arise from a contract. As a result, the contractual-legal criterion has been met for the customer relationships, and accordingly, separate identifiable intangible assets should be recognized for those contractual customer relationships. These separate identifiable intangible assets represent the future contracts the buyer expects to enter into as a result of its current contractual relationships with its customers. If the target is the lessor, an operating lease is an example of a customer contract that may have a related customer relationship that meets the contractual-legal criterion (see Section 10.13). As indicated previously, a backlog of purchase or sales orders from the target's customers represents an identifiable intangible asset because the contractual-legal criterion has been met. In addition, if there is regular interaction between the target and its customers and that interaction gives rise to these purchase or sales orders, then the target has customer relationships related to these orders that meet the contractual-legal criterion. As a result, separate identifiable intangible assets should be recognized for those contractual customer relationships. These separate identifiable intangible assets represent the future purchase or sales orders the buyer expects to enter into as a result of its current contractual relationships (through purchase or sales orders) with its customers. When a contractual customer relationship intangible asset is recognized in the accounting for a business combination, it is measured at its fair value. For purposes of the private-company intangible asset alternative (see Chapter 17), a contractual customer relationship intangible asset is a CRI asset. In some cases, the target may have a history of establishing contracts with its customers, but does not have any open contracts at the acquisition date. This still gives rise to a contractual customer relationship. Noncontractual customer relationships are discussed in Section 10.6.3.

While this is a summary of the different assets and liabilities that the buyer may be required to recognize related to customer contracts in the accounting for a business combination, it is important to note that not all of these assets or liabilities may exist with respect to the customer contracts acquired by the buyer. In other words, the buyer may determine that only one or some (but not all) of these assets or liabilities should be recognized in the accounting for a business combination.

For discussion on accounting for customer lists acquired in a business combination, see Section 10.8.2.

Given the complexities involved in identifying the assets and liabilities related to a customer contract that are acquired in a business combination, and measuring those assets and liabilities at fair value, we strongly recommend that the buyer seek the assistance of a valuation specialist to help with those identification and measurement activities.

#### *10Q.6.2.1 Is it appropriate to combine a receivable related to a customer contract acquired in a business combination with a contract asset or other intangible asset recognized related to that customer contract?*

No. Receivables should always be recognized separate from any other assets related to the customer contract that may be recognized in the accounting for the business combination because receivables are financial assets with specific measurement and subsequent accounting guidance (see Section 10.3). In addition, ASC 606 requires separate recognition of accounts receivable and contract assets recognized for a customer contract (see Chapter 14 in our revenue recognition guide).

#### *10Q.6.2.2 Is it appropriate to combine a customer relationship intangible asset with another intangible asset recognized for the customer contract in the accounting for the business combination?*

Whether or not it is appropriate to combine a customer relationship intangible asset with another intangible asset recognized for the customer contract in the accounting for the business combination depends on whether the timing and manner of derecognition (or amortization) for each asset would be different. For example, when a backlog intangible asset or off-market contract intangible asset is derecognized as the performance obligations in the underlying customer contract or backlog of sales or purchase orders are satisfied, and the customer relationship intangible asset is amortized over a period that extends well beyond the term of the acquired customer contract, it would likely not be appropriate to combine the backlog intangible asset or off-market contract intangible asset with the related customer relationship intangible asset.

*10Q.6.2.3 Should an off-market contract intangible asset or a backlog intangible asset be recognized even if the underlying customer contract or backlog of sales or purchase orders cannot be transferred to another party?*

Yes. Because the off-market contract intangible asset and backlog intangible asset satisfy the contractual-legal criterion for recognition purposes, they do not need to be separable.

*10Q.6.2.4 What is the effect of the target's order or production backlog being cancelable?*

Because the contractual-legal criterion is met, an order or production backlog is still considered an identifiable intangible asset even if the purchase or sales orders may be canceled by the customer. However, the fact that the order or production backlog is cancelable would likely affect the fair value estimate of the backlog intangible asset recognized in the accounting for the business combination.

#### 10.6.2.1 Contract liabilities acquired in a business combination (prior to adoption of ASU 2021-08)

Prior to ASC 606, deferred revenue was recognized in the accounting for a business combination based on the fair value of the underlying legal obligation. When ASC 606 was added to the Codification as a result of the issuance of ASU 2014-09, there were no conforming amendments made to ASC 805 related to recognizing and measuring customer contracts acquired in a business combination. With the implementation of ASC 606, one question raised was whether a contract liability (i.e., deferred revenue) should be recognized based on the underlying legal obligation, as was generally done prior to ASC 606, or the underlying performance obligation, as that concept is used in ASC 606. This question and other related questions were addressed in October 2021 by the FASB with the issuance of ASU 2021-08. See Section 11.9 for the applicable accounting guidance subsequent to the adoption of ASU 2021-08.

Prior to the adoption of ASU 2021-08, the buyer would recognize contract liabilities related to customer contracts within the scope of ASC 606 at fair value because there was no recognition and measurement exception for these liabilities under ASC 805. We are aware there was diversity in practice prior to the adoption of ASU 2021-08 that resulted in the recognition of contract liabilities based on the fair value of either: (a) the legal obligation (using the definition of a liability in paragraph E37 of CON 8) or (b) the performance obligation (using the definition in ASC 606-10-25-14).

### 10.6.3 Recognition of noncontractual customer relationships

The basis for recognizing contractual customer relationships is the contractual-legal criterion. By its very nature, this basis does not exist for a noncontractual customer relationship. Instead, noncontractual customer relationships must be evaluated to determine whether they satisfy the separability criterion. Recall that to be separable, an intangible asset acquired by the buyer must be capable of being separated from the target either on its own or when combined with a related contract, identifiable asset or liability. One type of support that may exist to corroborate the separability of a noncontractual customer relationship includes exchange transactions for the same or similar customer relationships. An example of a noncontractual customer relationship that meets the separability criterion is provided in ASC 805-20-55-27. This example involves relationships with depositors at a financial institution, which are frequently involved in exchange transactions along with the related deposits.

To the extent a noncontractual customer relationship is not recognized as a separately identifiable intangible asset, its value is effectively included in goodwill. For example, the value of a target's walk-up customer base should not be considered a separately identifiable intangible asset, which results in the related value of that walk-up customer base effectively being included in goodwill.

As discussed previously in Section 10.6.2, in some cases, the target may have a history of establishing contracts with its customers, but does not have any open contracts at the acquisition date. This still gives rise to a contractual customer relationship. In other words, the nonexistence of a customer contract at the acquisition date does not automatically result in the customer relationship needing to be analyzed as a noncontractual customer relationship for purposes of determining whether an identifiable intangible asset exists.

### 10.6.4 Fair value measurement

After a buyer determines whether it is appropriate to recognize one or more assets or liabilities related to a customer contract acquired in a business combination, the buyer next determines the fair value of each of those assets or liabilities to be recognized.

While there may be situations in which there is an active market price for certain assets and liabilities related to customer contracts (e.g., certain commodities contracts), in most cases, there will not be an active market price for those assets or liabilities. The lack of an active market price results in the buyer needing to use a valuation technique to determine the fair value of the assets and liabilities related to a customer contract. The nature of the customer contract can add complexity to identifying the appropriate valuation technique and applying that valuation technique properly.

The fair value of the assets and liabilities related to a customer contract should reflect the perspective of a market participant. Consider a situation in which the buyer acquires a target that is the primary provider of a product, and because of that, a market participant would have much higher production and fulfillment costs than the target. Assume the target has a contract to sell a significant amount of this product to a customer at market terms and expects to enter into future contracts for this product with the customer. In addition, assume the following: (a) there is no receivable outstanding with the customer on the acquisition date, (b) the buyer appropriately concludes a contract asset or contract liability should not be recognized for the acquired customer contract and (c) the buyer appropriately concludes that it should recognize a backlog intangible asset and a customer relationship intangible asset related to the acquired customer contract. All other things being equal, the market participant having higher production and fulfillment costs would typically result in a lower fair value measurement for the target's backlog intangible asset and customer relationship intangible asset. If the buyer does not appropriately take the different cost structure of the market participant into consideration when estimating the fair value of the target's backlog intangible asset and customer relationship intangible asset in this situation, the assets would be overvalued by the buyer, which would result in understating goodwill.

From a valuation perspective, it is important to make sure there is no double counting when measuring the fair value of the assets and liabilities related to a customer contract acquired in a business combination. For example, when the buyer recognizes a backlog intangible asset and a customer relationship intangible asset, it should ensure it is not double counting the value of the backlog (i.e., the cash flows from the existing contract) by including it in the measurement of both intangible assets.

The fair value of any assets or liabilities related to a customer contract are not affected by the buyer's subsequent accounting for the contract under ASC 606.

Given the complexities involved in identifying the assets and liabilities related to a customer contract that are acquired in a business combination, and measuring those assets and liabilities at fair value, we strongly recommend that the buyer seek the assistance of a valuation specialist to help with those identification and measurement activities.

#### 10.6.4.1 Measuring the fair value of contract assets and contract liabilities (prior to adoption of ASU 2021-08)

Given that there was no exception in ASC 805 with respect to recognizing and measuring contract assets and contract liabilities for customer contracts within the scope of ASC 606 prior to the adoption of ASU 2021-08, the buyer must determine the fair value of those assets and liabilities. Depending on the facts and circumstances, the approach used to estimate the fair value of a contract liability may take into consideration the costs to fulfill the remaining legal or performance obligation, a normal operating margin and the time value of money. As required by ASC 820, these inputs must reflect a market participant's perspective, not the buyer's perspective. So, for example, the operating margin should reflect what would be used by a market participant and not the operating margin of the buyer.

The carrying amount of a contract asset or contract liability recognized and accounted for under ASC 606 by the target prior to the acquisition should not be used as a surrogate for the fair value of the contract asset or contract liability recognized by the buyer in the accounting for the business combination because: (a) the contract assets and contract liabilities recognized by the buyer in the accounting for a business combination must meet the corresponding definition of an asset or liability in CON 8 and (b) ASC 606 does not result in recognizing contract assets and contract liabilities at their fair value, which is the measurement basis required in ASC 805. In fact, there will be many situations in which the buyer recognizes a relatively small contract liability under ASC 805 even though the target has a relatively large contract liability on its balance sheet under ASC 606 as of the acquisition date. Consider the following example.

**Example 10-3: Recognition of a contract liability for a customer contract acquired in a business combination**

Target enters into a contract with Customer on July 1, 20X1. Under the contract, Target licenses a trademark (i.e., symbolic intellectual property (IP)) to Customer for a five-year period in return for an upfront nonrefundable fee of $10 million. Customer pays Target on July 2, 20X1. While there are no other fees, goods or services included in the contract, Customer expects Target to undertake normal course business activities to maintain the trademark. On January 1, 20X2, Buyer acquires Target, including the contract with Customer.

*Target's accounting prior to being acquired by Buyer*

Assume Target appropriately concludes (based on the guidance in ASC 606 and its analysis of additional facts and circumstances) that the contract with Customer has one performance obligation that is satisfied ratably over the five-year license period. As such, when Target receives the payment from Customer on July 2, 20X1, it recognizes a contract liability in the amount of $10 million. During the six months remaining in 20X1, Target recognizes $1 million in revenue related to the contract with Customer ($10 million ÷ 5-year license term × ½ year). At December 31, 20X1, the remaining balance in the contract liability for the contract with Customer is $9 million.

*Buyer's accounting on the acquisition date*

Buyer analyzes the contract with Customer and concludes the following with respect to the assets and liabilities related to that contract that it should recognize in the accounting for the business combination:

- A receivable is not recognized given that all of the contract consideration was paid prior to the acquisition.
- A contract liability should be recognized for the remaining legal obligation present in the contract with Customer. While there is diversity in practice regarding whether the fair value of a contract liability is based on the legal obligation or the performance obligation, as previously discussed in Section 10.6.2.1, in this example Buyer determined the fair value based on the legal obligation.
- A backlog intangible asset is not recognized because there are no open orders under the contract.

- The contract is at-market, which means neither an off-market contract intangible asset or liability should be recognized.
- Whether a customer relationship intangible asset should be recognized in this example has been ignored for ease of illustration.

Based on this analysis, Buyer recognizes a contract liability for the fair value of the remaining legal obligation related to licensing the symbolic IP to Customer for the remaining 4.5 years in the contract. Buyer (and Target) maintain the trademark through their normal business activities. In other words, there are no incremental activities Buyer (or Target) undertakes with respect to maintaining the trademark specifically for Customer's use over the license period. In determining the fair value of the remaining legal obligation, Buyer considers what it would have to pay to transfer the remaining legal obligation to a market participant. Based on the definition of fair value in ASC 820, and the lack of incremental activities a market participant would have to perform over the remaining license period to satisfy the remaining legal obligation, Buyer concludes the fair value of the remaining legal obligation is only $54,000, which it also concludes is de minimis in its facts and circumstances.

Assume Buyer recognizes a contract liability for $54,000 despite it being de minimis. Doing so has the effect of increasing the amount of goodwill (or decreasing the amount of a gain from a bargain purchase) otherwise recognized in the accounting for the business combination.

*Buyer's accounting after the acquisition date (see Section 10.6.5)*

Assume Buyer appropriately concludes (based on the guidance in ASC 606 and its analysis of additional facts and circumstances) that the contract with Customer has one performance obligation that is satisfied ratably over the remaining license period of 4.5 years (or 54 months). As such, in 20X2, Buyer recognizes revenue of $12,000 ($54,000 contract liability ÷ 54 months × 12 months) and reduces the contract liability by $12,000.

### 10.6.5 Post-acquisition accounting for assets and liabilities related to customer contracts recognized in the accounting for a business combination

#### 10.6.5.1 Derecognition of assets and liabilities related to customer contracts other than customer relationship intangible assets

A contract asset is derecognized when the buyer has an unconditional right to consideration from its customer. In other words, the contract asset is derecognized when the buyer recognizes accounts receivable from the customer.

We believe the following assets and liabilities related to a customer contract that are recognized in the accounting for a business combination subsequently should be accounted for based on the guidance in ASC 606:

- A contract liability
- An off-market contract intangible asset or liability
- A backlog intangible asset

In other words, these assets or liabilities are derecognized (e.g., amortized) as or when the related underlying remaining performance obligation is satisfied. As such, the buyer must apply ASC 606 to determine whether the remaining performance obligation in the customer contract is satisfied over time or at a point in time. While the manner in which the remaining performance obligation is satisfied (i.e., over time or at a point in time) as determined by the buyer after the acquisition date is likely to be the same manner in which the performance obligation was being satisfied as determined by the target prior to the acquisition date, that may not always be the case. Determining how and when a performance obligation is satisfied is addressed in detail in Chapter 9 of our revenue recognition guide.

Once the buyer has determined whether a remaining performance obligation is satisfied over time or at a point in time, it derecognizes a contract liability, off-market contract intangible asset or liability or a backlog intangible asset related to the remaining performance obligation in the same manner. For example, if there is a contract liability related to a remaining performance obligation that is satisfied over time it is derecognized over time as the remaining performance obligation is satisfied, with the offset increasing revenue. For another example, if there is a backlog intangible asset related to a remaining performance obligation that is satisfied at a point in time, that contract backlog asset is derecognized at the point in time the remaining performance obligation is satisfied, with the offset reducing revenue.

To the extent a remaining performance obligation is satisfied over time, the buyer must also identify the measure of progress toward complete satisfaction of the remaining performance obligation. If a cost-to-cost measure is used for this purpose, it should be based on the costs incurred by the buyer to satisfy the remaining performance obligation after the acquisition date and an estimate of the total expected costs to be incurred by the buyer in satisfying the remaining performance obligation after the acquisition date.

**Example 10-4: Construction contract acquired in a business combination (prior to adoption of ASU 2021-08)**

[**Note:** The following example illustrates the journal entries that may result from the acquisition of a target that has a construction contract with a customer in the scope of ASC 606. These journal entries are illustrative of one approach that could be taken to journalize the activity under the contract. Depending on a company's internal accounting system (i.e., subaccounts used to journalize activity on construction contracts), other journal entries or use of different accounts may be warranted.]

Buyer acquired Target on January 1, 20X1. Buyer has not elected the private-company intangible asset alternative (see Chapter 17). Both Buyer and Target are construction contractors. As of January 1, 20X1, Target only had one open contract with a customer. Both Buyer and Target appropriately concluded based on all of the relevant facts and circumstances that the contract includes a single performance obligation under ASC 606. Buyer also appropriately concludes (based on its analysis of the facts and circumstances) that a contract asset, backlog intangible asset and off-market contract intangible asset should be recognized on the acquisition date related to Target's open customer contract. For ease of illustration, this example does not consider whether Buyer should recognize a customer relationship intangible asset for this customer. Buyer completes the construction contract with Target's customer on June 30, 20X1.

Key information related to Target's customer contract as of the acquisition date and for the quarters ending March 31, 20X1 and June 30, 20X1, includes:

| | As of January 1, 20X1 (acquisition date) | Quarter ending March 31, 20X1 | Quarter ending June 30, 20X1 |
|---|---|---|---|
| Amounts not yet billed to the customer | $1,000,000 | $200,000 | $0 |
| Amounts billed to the customer | Note 1 | $800,000 | $200,000 |
| Estimate of the costs to complete the contract from a market participant's perspective (Note 3) | $450,000 | Note 3 | Note 3 |
| Estimate of the costs to complete the contract from an entity-specific perspective (Note 3) | $400,000 | $100,000 | $0 |
| Costs incurred under the contract | Note 1 | $300,000 | $100,000 |
| Estimate of the total costs to complete the contract subsequent to the acquisition date from an entity-specific perspective (Note 3) | $400,000 | $400,000 | $400,000 |
| Estimate of the contract asset's fair value (Note 2) | $150,000 | Note 2 | Note 2 |
| Estimate of the backlog intangible asset (Note 2) | $130,000 | Note 2 | Note 2 |
| Estimate of the above-market intangible asset's fair value (Note 2) | $80,000 | Note 2 | Note 2 |

**Note 1:** The postacquisition-date accounting should only take into consideration the amounts to be billed and the costs to be incurred *after* the acquisition date as well as any accounts receivable, contract asset or contract liability, backlog intangible asset and off-market intangible asset recognized on the acquisition date.

**Note 2:** The fair values of the contract asset, backlog intangible asset and off-market contract intangible asset are hypothetical for illustration purposes and cannot be recomputed based on the limited information available. In addition, such fair values only need to be determined as of the acquisition date so that an asset or liability can be recognized appropriately in the accounting for the business combination. The subsequent accounting for the asset or liability recognized in the accounting for the business combination depends on whether the single performance obligation in the contract is satisfied over time or at a point in time.

**Note 3:** The estimate of costs to complete from a market participant's perspective is taken into consideration in estimating the fair value of the contract asset or contract liability, backlog intangible asset and off-market contract intangible asset or liability. As such, that estimate only needs to be made at the acquisition date. The estimate of the costs to complete the contract from an entity-specific perspective is taken into consideration in the postacquisition-date accounting for the contract. As such, that estimate needs to be reassessed as of every reporting date after the acquisition date.

After its acquisition of Target, Buyer must determine whether the single remaining performance obligation in Target's customer contract is satisfied over time or at a point in time. Buyer makes this determination by considering the same factors it considers in determining whether any of the performance obligations in its own construction contracts are satisfied over time or at a point in time. The facts and circumstances considered in the context of the guidance in ASC 606 determine whether a performance obligation is satisfied over time or at a point in time. Buyer appropriately concludes that the remaining performance obligation in Target's customer contract is satisfied over time.

*Recognition of the contract asset, the backlog intangible asset and the off-market contract intangible asset on January 1, 20X1 (the acquisition date):*

| | Debit | Credit |
|---|---|---|
| Contract asset | $150,000 | |
| Backlog intangible asset | 130,000 | |
| Off-market contract intangible asset | 80,000 | |
| Goodwill (Note 1) | | $360,000 |

**Note 1:** For purposes of this example, assume that Buyer would have recognized goodwill in its accounting for the business combination (absent considering the customer contract) in excess of $360,000. The entry to record goodwill recognized in a business combination includes many other components. This credit to goodwill is only shown to illustrate the fact that recognizing the assets related to the customer contract effectively reduces the amount of goodwill ultimately recognized in the accounting for the business combination.

*Recognition of activity occurring in quarter ending March 31, 20X1:*

| | Debit | Credit |
|---|---|---|
| Cost of sales (Note 1) | $300,000 | |
| Accounts payable (Note 5) | | $300,000 |
| | | |
| Revenue (Note 2) | $157,500 | |
| Backlog intangible asset (Note 2) | | 97,500 |
| Off-market contract intangible asset (Note 2) | | 60,000 |
| | | |
| Accounts receivable (Notes 4 and 5) | $800,000 | |
| Contract asset (Note 3) | | $150,000 |
| Contract liability (Note 3) | | 12,500 |
| Revenue (Note 3) | | 637,500 |

**Note 1:** We have assumed the $300,000 of contract costs do not satisfy the criteria to capitalize fulfillment costs in ASC 340-40. Careful consideration of all the facts and circumstances would be required to arrive at this conclusion in an actual fact pattern.

**Note 2:** The off-market contract intangible asset and backlog intangible asset are derecognized (or amortized) as a reduction of revenue based on the measure of progress toward complete satisfaction of the remaining performance obligation. Buyer uses a cost-to-cost method as the measure of progress toward complete satisfaction of the performance obligation in the customer contract. As of March 31, 20X1, the remaining performance obligation is 75% satisfied ($300,000 of costs incurred during the quarter ÷ $400,000 of total costs expected to be incurred after the acquisition date). The amount of the backlog intangible asset derecognized (or amortized) in the quarter ending March 31, 20X1 is $97,500 (75% × $130,000 backlog intangible asset recognized in the accounting for the business combination). The amount of the off-market contract intangible asset derecognized (or amortized) in the quarter ending March 31, 20X1 is $60,000 (75% × $80,000 off-market contract intangible asset recognized in the accounting for the business combination).

**Note 3:** The receivable of $800,000 recognized as of March 31, 20X1 represents the customer's performance since the acquisition date. Buyer's performance for the quarter ending March 31, 20X1 is $637,500 ([$1,000,000 total billings after the acquisition date – $150,000 contract asset recognized in the accounting for the business combination] × 75%). Since the acquisition date, the customer's performance exceeds Buyer's performance by $162,500 ($800,000 – $637,500), which is used first to reduce the contract asset recognized in the accounting for the business combination ($150,000) to zero, with the $12,500 remainder recognized as a contract liability ($162,500 – $150,000).

**Note 4:** Buyer recognizes accounts receivable for the customer billings because they represent an unconditional right to consideration from the customer. If this was not the case, accounts receivable would not have been recognized.
**Note 5:** The entries to reflect payment of cash for the accounts payable and receipt of cash for the accounts receivable have not been included in this example.

*Recognition of activity occurring in quarter ending June 30, 20X1 (prior to closing out the contract):*

| | Debit | Credit |
|---|---|---|
| Cost of sales (Note 1) | $100,000 | |
| Accounts payable (Note 5) | | $100,000 |
| | | |
| Revenue (Note 2) | $52,500 | |
| Backlog intangible asset (Note 2) | | $32,500 |
| Off-market contract intangible asset (Note 2) | | 20,000 |
| | | |
| Accounts receivable (Notes 4 and 5) | $200,000 | |
| Contract liability (Note 3) | 12,500 | |
| Revenue (Note 3) | | $212,500 |

**Note 1:** We have assumed the $100,000 of contract costs do not satisfy the criteria to capitalize fulfillment costs in ASC 340-40. Careful consideration of all the facts and circumstances would be required to arrive at this conclusion in an actual fact pattern.
**Note 2:** The off-market contract intangible asset and backlog intangible asset are derecognized (or amortized) as a reduction of revenue based on the measure of progress toward complete satisfaction of the remaining performance obligation. Buyer uses a cost-to-cost method as the measure of progress toward complete satisfaction of the performance obligation in the customer contract. As of June 30, 20X1, the remaining performance obligation is 100% satisfied. As such, Buyer derecognizes the $32,500 remaining balance for the backlog intangible asset and the $20,000 remaining balance for the off-market contract intangible asset in the quarter ending June 30, 20X1.
**Note 3:** Because the remaining performance obligation was 75% satisfied at March 31, 20X1 and 100% satisfied as of June 30, 20X1, 25% of the remaining performance obligation was satisfied in the quarter ending June 30, 20X1. As such, $212,500 should be recognized as revenue in the quarter ending June 30, 20X1 ([$1,000,000 total billings after the acquisition date – $150,000 contract asset recognized in the accounting for the business combination] × 25%). In addition, because the remaining performance obligation was completed as of June 30, 20X1, the contract liability of $12,500 recognized at March 31, 20X1 should be derecognized.
**Note 4:** Buyer recognizes accounts receivable for the customer billings because they represent an unconditional right to consideration from the customer. If this was not the case, accounts receivable would not have been recognized.
**Note 5:** The entries to reflect payment of cash for the accounts payable and receipt of cash for the accounts receivable have not been included in this example.

*Overall effects:*

The following table shows the total amount of revenue and cost of sales recognized over the term of the contract that remains after the acquisition date:

| | Quarter ending March 31, 20X1 | Quarter ending June 30, 20X1 | Total since acquisition date |
|---|---|---|---|
| Revenue | $480,000 ($637,500 – $157,500) | $160,000 ($212,500 – $52,500) | $640,000 |
| Cost of sales | $300,000 | $100,000 | $400,000 |

In addition, the total amount of revenue recognized on the customer contract after the acquisition date ($640,000) is the total billings to the customer after the acquisition date ($1 million) less the contract asset of $150,000, the backlog intangible asset of $130,000 and the off-market contract intangible asset of $80,000 recognized for the customer contract in the accounting for the business combination.

#### 10.6.5.2 Amortization of customer relationship intangible assets

After its initial recognition in the accounting for a business combination, a customer relationship intangible asset must be amortized (unless it is considered to be indefinite-lived, which is extremely rare). The buyer must determine the appropriate method and useful life to use in amortizing the asset.

The useful life of an asset is defined in the Master Glossary of the Codification as follows: “The period over which an asset is expected to contribute directly or indirectly to future cash flows.” ASC 350-30-35-3 lists the factors that should be considered in establishing the useful life of an intangible asset. Of those factors, the one that is most relevant with respect to determining the useful life of a contractual customer relationship intangible asset requires the consideration of various economic factors, such as:

- Whether the customer’s demand for the buyer’s products or services is projected to increase or decrease
- Whether the buyer’s competition is expected to take actions that will affect the customer’s demand (e.g., introduce a new competing product, discontinue a competing product)

In addition, the buyer should make sure the assumptions it is making with respect to establishing the useful life and amortization method are consistent with the assumptions it used in estimating the fair value of the customer relationship intangible asset. For example, if the valuation approach used to estimate the fair value of the customer relationship intangible asset ascribed proportionately more value to the customer relationship intangible asset earlier in its life, the amortization method should generally result in proportionately more of the asset being amortized (i.e., proportionately more amortization expense) earlier in the asset’s life. We understand that the SEC staff has and will question inconsistencies between the assumptions used to measure the fair value of a customer relationship intangible asset, and the method and useful life used to amortize that asset.

While not specifically provided for in U.S. GAAP, we believe it may be helpful for the buyer to consider the following reasonableness checks (i.e., rules of thumb) we have seen utilized in practice when: (a) the customer relationship intangible asset’s fair value was determined using a projected cash flow approach and (b) the buyer is considering use of the straight-line amortization method:

| Reasonableness check related to using straight-line amortization method | Example |
|---|---|
| In general, the useful life should not be longer than 70% of the period over which cash flows were projected. | If cash flows were projected over 20 years to determine the fair value of a customer relationship intangible asset, its useful life should generally not be more than 14 years. |
| In general, the useful life should not be longer than the period in the projected cash flows over which 95% of the asset's projected cash flows are generated (referred to as the 95% test). | If the projected cash flows for a customer relationship intangible asset are $1 million, and $950,000 of that amount is generated in the first 15 years of a 20-year cash-flow projection, the useful life should generally not be more than 15 years. |
| In general, in a high-tech industry or industry subject to significant obsolescence, the useful life should not extend past the last year in which the annual projected cash flows are 5% or more of the total projected cash flows (referred to as the 5% test). | If the annual projected cash flows for a customer relationship intangible asset are 6.1% and 4.5% of total projected cash flows in years 3 and 4 of the cash flow projection, respectively, the useful life should generally not be more than 3 years. |

With respect to the 95% test and the 5% test, we believe the following:

- The 5% test is likely to be most meaningful when: (a) the customer relationship intangible asset is in an industry with a high level of technological innovation and obsolescence and (b) discounted projected cash flows are used to perform the test.
- The 95% test is likely to be most meaningful when: (a) the customer relationship intangible asset is in an industry with lower levels of technological innovation and obsolescence and (b) undiscounted projected cash flows are used to perform the test.

These reasonableness checks are only used when the buyer is considering the use of a straight-line amortization method. It is worth noting that it may be appropriate to use a longer life than that indicated by the reasonableness checks when a method other than straight-line amortization is used (e.g., an accelerated amortization method that tracks with the projected cash flows). It is also worth noting that the longer the useful life of a customer relationship intangible asset, the greater the likelihood that the buyer should use something other than the straight-line amortization method.

### 10.6.6 Buyer is a customer of the target

Consider a situation in which the buyer in a business combination was a customer of the target it is acquiring. In this situation, a customer relationship intangible asset should not be recognized by the buyer in the accounting for the business combination. As discussed in Section 7.2, the initial basis for recognizing intangible assets in the accounting for a business combination is the definition of an asset included in paragraph E16 of CON 8. An element of that definition requires an asset to provide "a present right of an entity to an economic benefit." A customer relationship between the buyer and the target does not provide any economic benefit (e.g., cash flows) outside of the consolidated entity. Because the definition of an asset is not met, a customer relationship intangible asset for the preexisting customer relationship between the target and the buyer should not be recognized in the accounting for the business combination.

### 10.6.7 Costs to obtain or fulfill a customer contract

As discussed in Chapter 13 of our revenue recognition guide, an entity may have capitalized certain costs within the scope of ASC 340-40 that arose in conjunction with performing under customer contracts. The two categories of costs addressed in ASC 340-40 include costs to obtain a contract and costs to fulfill a contract. If the target recognized an asset on its balance sheet for these capitalized costs prior to being acquired, we believe these costs should not be recognized by the buyer in the accounting for the business combination because they do not meet the definition of an asset to the acquirer. However, consideration should be given to whether these costs impact the valuation of the other assets addressed in Section 10.6.2, such as the backlog or customer relationship intangible assets.

## 10.7 Inventory

Inventory acquired in a business combination should be measured at its fair value, which is the price that would be received to sell it in an orderly transaction between market participants on the acquisition date. Buyers should not assume that the fair value of acquired inventory is equal to its carrying amount prior to the business combination.

ASC 805 does not provide specific guidance on measuring the fair value of inventory. The guidance commonly referred to for this purpose is paragraph 37c of Statement 141 (the predecessor to Statement 141R [see Section 1.2]), which provided the following guidance on estimating the fair value of different categories of inventory (and is hereafter referred to as the Statement 141 inventory valuation guidance):

- **Finished goods**: "Estimated selling prices less the sum of (a) costs of disposal and (b) a reasonable profit allowance for the selling effort of the acquiring entity."
- **Work in process**: "Estimated selling prices of finished goods less the sum of (a) costs to complete, (b) costs of disposal, and (c) a reasonable profit allowance for the completing and selling effort of the acquiring entity based on profit for similar finished goods."
- **Raw materials**: "Current replacement costs."

When applying the Statement 141 inventory valuation guidance, the reasonable profit allowance for finished goods inventory should have been less than the reasonable profit allowance for work-in-process inventory because the profit allowance for work-in-process inventory included the profit related to the effort to complete inventory production, as well as the effort to sell the inventory. Also, the reasonable profit allowance used in estimating the fair value of finished goods inventory acquired in a business combination should have been less than the profit earned on the same products manufactured by the buyer to be sold in the ordinary course of its business because the estimated fair value of the acquired finished goods inventory should have only included the profit related to the selling effort, whereas the profit earned on products manufactured by the buyer would have also included profit related to the manufacturing effort. In addition, when applying the Statement 141 inventory valuation guidance to work-in-process inventory, costs to complete should have included all inventoriable costs.

The Statement 141 inventory valuation guidance was not carried over into Statement 141R. As a result, this guidance is not included in ASC 805. However, based on discussions held by the FASB's Valuation Resource Group, we believe application of the Statement 141 inventory valuation guidance for finished goods and work-in-process inventories generally are consistent with the definition of fair value in ASC 820. There are, however, certain differences that may be significant, such as using market participant assumptions (instead of entity-specific assumptions) for purposes of estimating the costs to complete work-in-process inventory, the costs of disposal and reasonable profit allowances for both finished goods and work-in-process inventories. In addition, for raw materials, fair value must be measured based on the price that would be received to sell the raw materials in an orderly transaction between market participants at the acquisition date, which may be consistent in many (but not all) cases with current replacement costs as discussed in the Statement 141 inventory valuation guidance.

**Pending change:** In September 2022, the AICPA issued a Working Draft of its Business Combinations AVG, portions of which address issues to consider when estimating the fair value of inventory in a business combination. In comparison to the Statement 141 inventory valuation guidance, the approach included in the Business Combinations AVG introduces additional assumptions and complexity into the process of valuing inventory. While the Business Combinations AVG is still in draft form as of the date this guide was published, we understand that the valuation guidance is considered to be reflective of best practices already being employed by valuation specialists in certain situations.

The AICPA's task force recognizes that the valuation methodology outlined in the Working Draft of its Business Combinations AVG is very detailed and that other methodologies may be applied to estimate the fair value of inventory. In addition, there may be situations in which it is not possible, necessary or practical to perform certain steps described in the methodology outlined in the draft guide. This may occur, for example, due to materiality considerations or non-relevance of a particular step (e.g., inventory holding costs may not be relevant when inventory turns over quickly).

Keep in mind that given the inherent complexities that can often arise in estimating the fair value of certain types of inventories, hiring a valuation specialist may be warranted even when the buyer plans to use the Statement 141 inventory valuation guidance.

## 10.8 Identification of intangible assets that are separate from goodwill

### 10.8.1 General

Unless the private-company intangible asset alternative has been elected (see Chapter 17), all identifiable assets acquired in a business combination must be recognized separately from goodwill. Ensuring that all identifiable assets are recognized separately from goodwill is not only important to the accounting for the business combination, but also to the postacquisition accounting because goodwill is not amortized (unless the private-company goodwill amortization alternative has been elected [see Section 18.3]), while finite-lived intangible assets are amortized.

Section 10.8 discusses the guidance in ASC 805 generally applicable to the identification of intangible assets separate from goodwill. Even if a private company elects the intangible asset alternative, the guidance in this section continues to be relevant for purposes of identifying intangible assets other than those affected by the private-company intangible asset alternative.

An intangible asset is separately identifiable if it meets either the separability or the contractual-legal criterion.

To meet the separability criterion, an intangible asset acquired by the buyer must be capable of being separated from the target either on its own or combined with a related contract, identifiable asset or liability. The separation can occur as the result of a sale, transfer, license, lease or other exchange.

To meet the contractual-legal criterion, an intangible asset acquired by the buyer must arise from a contractual right or a legal right. An intangible asset arising from a contractual or legal right satisfies the contractual-legal criterion even if: (a) the contractual or legal right cannot be separated from the target or (b) the contractual or legal right is nontransferable.

*10Q.8.1.1 How does the buyer's intention with respect to selling, transferring, licensing, leasing or otherwise exchanging the intangible asset affect the determination as to whether that asset is separable?*

The buyer's intention with respect to the intangible asset does not factor into the determination as to whether the intangible asset is separable. In other words, if an intangible asset could be sold on its own or along with a related contract, identifiable asset or liability, the buyer is not permitted to disregard the recognition of that intangible asset just because the buyer does not intend to sell, transfer, license, lease or otherwise exchange the intangible asset. This approach reflects the fact that management's intent is not part of the definition of an asset.

*10Q.8.1.2 What type of support demonstrates that an intangible asset is actually separable?*

If there is evidence of exchange transactions for the same or similar type of asset, then the separability criterion has been met. This is true regardless of the frequency with which such exchanges occur or whether the buyer was involved with those transactions. However, exchange transactions are not necessarily the only support that could be used as the basis for meeting the separability criterion.

*10Q.8.1.3 Why is an asset that can only be sold along with a related contract, asset or liability considered separable?*

An intangible asset may be so closely related to another asset or liability that it is typically (or only) sold as a package with that other asset or liability. For example, a depositor relationship intangible asset is typically (or only) sold as a package with the deposit liabilities giving rise to the depositor relationship. If an intangible asset was not recognized for the depositor relationship intangible asset previously acquired and the deposit liabilities were later sold, a gain would likely result from that sale.

*10Q.8.1.4 If an intangible asset is recognized for a license that gives the target the right to own and operate a particular type of facility (e.g., license to own and operate a nuclear power plant), when the buyer recognizes the intangible asset for that license may it recognize one asset for the combined fair values of the facility and the license?*

Based on the guidance in ASC 805-20-55-2(b), one asset may be recognized for the combined fair values of the facility and the license provided that the useful lives of both are similar.

*10Q.8.1.5 If the buyer concludes on the date of acquisition that an identifiable intangible asset does not exist for a particular item, but shortly after that date there is a change in circumstances and an identifiable intangible asset does exist for that item, should the buyer reclassify the fair value of the identifiable intangible asset out of goodwill?*

No. Changes in circumstances occurring after the acquisition date should not result in reclassification of an amount from goodwill. However, when new or better information about the circumstances that existed on the acquisition date is obtained after the initial accounting for a business combination, such new or better information may (depending on the facts and circumstances) serve as the basis for recording a measurement period adjustment (see Section 12.7).

### 10.8.2 Analysis of various situations to determine whether intangible assets exist

The following table provides several illustrative situations and the rationale for whether Buyer will recognize an identifiable intangible asset upon accounting for its acquisition of Target.

| Situation | Does an identifiable intangible asset exist? |
|---|---|
| Target holds a license to own and operate a nuclear power plant, and in fact, has a nuclear power plant in operation. Target may not sell or otherwise transfer the license independent of the power plant. | Yes. When Buyer acquires Target, an identifiable intangible asset related to the license exists because the contractual-legal criterion is met. The license grants a legal right and the intangible asset arises from that right. This is the case even though Buyer cannot sell or otherwise transfer the license separate from the power plant. |

| Situation | Does an identifiable intangible asset exist? |
|---|---|
| Target owns a technology patent and has licensed the right to use that patent to third parties in exchange for ongoing consideration. | Yes. When Buyer acquires Target, an identifiable intangible asset exists for the patent because the contractual-legal criterion is met. The patent represents a legal right and an intangible asset arises from that right.<br><br>In addition, as discussed in detail in Section 10.6, if the terms of the licenses are favorable compared to market, then off-market intangible assets are recognized for those licenses because the contractual-legal criterion is met (see Note 1). The licenses represent contractual rights and intangible assets arise from those rights. If the terms of the licenses are unfavorable compared to market, then off-market liabilities are recognized. To the extent off-market intangible assets for the licenses should be recognized, they should typically be recognized separate from the intangible asset for the patent because the amortization periods and methods would likely be different. |
| Target has a substantial customer list. There are no restrictions on Target's ability to sell or otherwise enter into an exchange transaction involving the transfer of information about its customers. | Yes (see Note 1). When Buyer acquires Target, an identifiable intangible asset exists because the separability criterion is met. Even if Buyer has no intention of selling the customer list, the fact that the customer list could be sold on its own satisfies the separability criterion. The ability to sell is supported by the fact that customer lists, in general, are often sold via license agreements. Neither of the following is required to support the ability to sell the customer list: (a) Target to have licensed its customer list in the past nor (b) Buyer to have intentions to license the customer list in the future. |
| Target has a substantial customer list. The agreements it has with its customers prohibit Target from selling or otherwise entering into an exchange transaction involving the transfer of information about its customers. | No. When Buyer acquires Target, an identifiable intangible asset for the customer list does not exist because neither the separability nor contractual-legal criterion is met. The separability criterion is not met as it relates to the customer list because Target is prohibited from selling information about its customers. The contractual-legal criterion is not met as it relates to the customer list because there is no contractual or legal right directly associated with the customer list. |

| Situation | Does an identifiable intangible asset exist? |
|---|---|
| Target purchased a substantial customer list in the prior year from an unrelated third party. The terms of the purchase provide Target with exclusive rights to the customer list (i.e., the unrelated third party is prohibited from selling that customer list to any other parties). In addition, the terms of the purchase prohibit Target from selling or otherwise entering into an exchange transaction involving the transfer of information about the customers on the list. When Target purchased this customer list, it recognized an intangible asset. | Yes (see Note 1). When Buyer acquires Target, an identifiable intangible asset for the customer list exists because the contractual-legal criterion is met. The purchase agreement with the unrelated third party from which Target bought the customer list is a contract and the intangible asset arises from that contract. This is the case even though Target cannot sell or otherwise enter into an exchange transaction involving the transfer of information about the customers on this list. |
| Target has a registered trademark along with documented unpatented technical expertise that is necessary for the production of the trademarked products. | Yes. When Buyer acquires Target, two identifiable intangible assets exist. In the case of the trademark, the contractual-legal criterion is met. The trademark represents a legal right and the intangible asset arises from that right.<br><br>In the case of the documented unpatented technical expertise, the separability criterion is met. While an intangible asset for this technical expertise would likely not be sold by itself (i.e., without the related trademark), the separability criterion is still met because the intangible asset for the technical expertise could be sold when combined with a related contract or asset (i.e., the intangible asset for the trademark). Presumably, there are exchange transactions involving trademarks and the documented unpatented technical expertise that is integral to those trademarks for purposes of supporting the fact that the separability criterion has been met.<br><br>It is highly likely that a conclusion would be reached in this fact pattern to recognize one intangible asset for the registered trademark and a second intangible asset for the documented unpatented technical expertise instead of recognizing one combined asset for both. This is due to the technical expertise likely being considered a finite-lived intangible asset (which is amortized over its useful life), whereas the registered trademark could potentially be considered: (a) an indefinite-lived intangible asset (which is tested periodically for impairment instead of being amortized) or (b) a finite-lived intangible asset with a different useful life than the technical expertise intangible asset. For additional |

| Situation | Does an identifiable intangible asset exist? |
|---|---|
| | discussion of this situation, see ASC 805-20-55-5(b). |

**Note 1**: Chapter 17 provides the guidance that should be applied to determine whether intangible assets related to customers should be recognized when the private-company intangible asset alternative has been elected.

For discussion of the accounting for customer contract and customer relationship intangible assets, see Section 10.6 and Chapter 17.

## 10.9 Intangible assets

Various other sections in this guide discuss several specific types of intangible assets that should be recognized in the accounting for a business combination. ASC 805-20-55-11 to 55-45 list and discuss several other types of intangible assets that meet either the separability or contractual-legal criterion, and therefore, should be recognized as identifiable intangible assets in the accounting for a business combination. This section discusses the guidance in ASC 805 generally applicable to the recognition of these other types of intangible assets that may be acquired in a business combination.

Chapter 17 discusses the guidance that is applicable if an entity elects the private-company intangible asset alternative, which provides alternative guidance with respect to the recognition of intangible assets related to customers and noncompete agreements (NCAs). Even if a private company elects the intangible asset alternative, the guidance in this section continues to be relevant for purposes of recognizing intangible assets other than those related to customers and NCAs.

The table that follows includes: (a) the potential identifiable intangible assets listed and discussed in ASC 805-20-55-11 to 55-45 and other paragraphs of ASC 805-20, (b) the criterion that supports recognition of the intangible asset (as appropriate) and (c) the paragraphs in ASC 805-20 that provide specific discussion on the potential identifiable intangible asset. This list is not all-inclusive as there are many other possible intangible assets that could be acquired in a business combination.

| Potential identifiable intangible asset acquired by the buyer | Does an identifiable intangible asset exist? | Which criterion typically supports identifiability of the asset? | Relevant paragraphs in ASC 805-20 |
|---|---|---|---|
| Trademarks, trade names, service marks, collective marks and certification marks that are legally protected (see Section 10.8.2) | Yes | Contractual-legal | 55-16 to 55-18 |
| Trademarks, trade names, service marks, collective marks and certification marks that are not legally protected, but that are separable | Yes | Separability | 55-16 to 55-18 |
| Trade dress (unique color, shape, package design) | Yes | Contractual-legal | 55-14 |
| Newspaper mastheads | Yes | Contractual-legal | 55-14 |
| Registered Internet domain names | Yes | Contractual-legal | 55-19 |
| Noncompetition agreements | Yes (Note 1) | Contractual-legal | 55-14 |
| Customer lists or databases that are separable (see Section 10.8.2) | Yes (Note 1) | Separability | 55-4, 55-21 |

| Potential identifiable intangible asset acquired by the buyer | Does an identifiable intangible asset exist? | Which criterion typically supports identifiability of the asset? | Relevant paragraphs in ASC 805-20 |
|---|---|---|---|
| Order or production backlog (see Section 10.6.2) | Yes (Note 1) | Contractual-legal | 55-22 |
| Customer contracts and contractual customer relationships (see Section 10.6.2) | Yes (Note 1) | Contractual-legal | 55-23 to 55-25, 55-52 to 55-57 |
| Noncontractual customer relationships that are separable (see Section 10.6.3) | Yes (Note 1) | Separability | 55-27, 55-55 |
| Prospective contracts with potential new customers | No (Note 1) | Neither | 55-7 |
| Plays, operas and ballets under copyright | Yes | Contractual-legal | 55-29 and 55-30 |
| Books, magazines, newspapers and other literary works under copyright | Yes | Contractual-legal | 55-29 and 55-30 |
| Musical works such as compositions, song lyrics and advertising jingles under copyright | Yes | Contractual-legal | 55-29 and 55-30 |
| Pictures and photographs under copyright | Yes | Contractual-legal | 55-29 and 55-30 |
| Video and audiovisual material under copyright, including motion pictures or films, music videos, television programs and podcasts | Yes | Contractual-legal | 55-29 and 55-30 |
| Licensing, royalty and standstill agreements | Yes | Contractual-legal | 55-31 |
| Advertising, construction, management, service or supply contracts | Yes | Contractual-legal | 55-31 |
| Lease agreements (see Section 10.13) | Note 2 | Note 2 | 55-31 |
| Construction permits | Yes | Contractual-legal | 55-31 |
| Franchise agreements | Yes | Contractual-legal | 55-31 |
| Operating and broadcast rights | Yes | Contractual-legal | 55-31 |
| Servicing contracts for financial assets, such as mortgage or credit card servicing contracts, that are contractually separate from the financial assets to which they relate as a result of meeting one of the two criteria in ASC 805-20-55-33 | Yes | Contractual-legal | 55-33 to 55-35 |
| Servicing contracts for financial assets, such as mortgage or credit card servicing contracts, that are not contractually separate from the financial assets to which they relate (see Section 10.4) | No | Neither | 55-35 |
| Employment contracts | Yes | Contractual-legal | 55-36 |

| Potential identifiable intangible asset acquired by the buyer | Does an identifiable intangible asset exist? | Which criterion typically supports identifiability of the asset? | Relevant paragraphs in ASC 805-20 |
|---|---|---|---|
| Use rights, such as drilling, water, air, timber cutting and route authorities | Yes | Contractual-legal | 55-37 |
| Patented technology (see Section 10.8.2) | Yes | Contractual-legal | 55-38 |
| Computer software and mask works under patent or copyright | Yes | Contractual-legal | 55-40 and 55-41 |
| Unpatented technology that is separable | Yes | Separability | 55-38 |
| Unpatented technical expertise or know-how that is separable (see Section 10.8.2) | Yes | Separability | 55-5 |
| Databases under copyright | Yes | Contractual-legal | 55-42 |
| Databases, including title plants, that are not under copyright, but that are separable | Yes | Separability | 55-42 and 55-43 |
| Trade secrets, such as secret formulas, processes and recipes, that are legally protected | Yes | Contractual-legal | 55-44 and 55-45 |
| Trade secrets, such as secret formulas, processes and recipes, that are not legally protected, but that are separable | Yes | Separability | 55-44 and 55-45 |
| IPR&D that is separable (see Section 10.12) | Yes | Separability | 30-6 |
| Assembled workforce (see Section 10.11) | No | Neither | 55-6 |

**Note 1**: Chapter 17 provides the guidance that should be applied to determine whether intangible assets related to customers and NCAs should be recognized when the private-company intangible asset alternative has been elected.

**Note 2:** Whether an identifiable intangible exists with respect to a lease acquired in a business combination depends on whether: (a) the buyer has adopted ASC 842 and (b) the buyer is the lessee or lessor. The accounting for leases acquired in a business combination is discussed in detail in Section 10.13.

Recognition of intangible assets in conjunction with the accounting for insurance or reinsurance contracts acquired in a business combination is discussed in Section 10.18.

*10Q.9.1 What is the effect of one of the identifiable intangible assets in the list having characteristics of assets other than those of intangible assets?*

When an asset has characteristics of both an intangible asset and an asset other than an intangible asset, the accounting for that asset should be based on its substance. For example, mineral rights have characteristics of tangible assets and should be accounted for as such.

*10Q.9.2 If the target has a group of complementary identifiable intangible assets, such as: (a) a trademark, trade name and formulas or (b) a copyright and any related assignments or license agreements, may those individual assets be accounted for as a single asset?*

If the estimated useful lives of the individual identifiable intangible assets within the group of complementary identifiable intangible assets are similar, the group may be accounted for as a single asset.

*10Q.9.3 Could some of the items in this list result in a liability being recognized instead of an identifiable intangible asset?*

Yes. For example, a liability could arise from an off-market customer contract (see Section 10.6), an employment contract and a licensing agreement.

## 10.10 Defensive intangible assets

The Master Glossary of the Codification defines a defensive intangible asset as “An acquired intangible asset in a situation in which an entity does not intend to actively use the asset but intends to hold (lock up) the asset to prevent others from obtaining access to the asset.” For example, a buyer might gain control over its competitor’s trade name as a result of buying its competitor. If the buyer does not intend to use its former competitor’s trade name (i.e., the buyer intends to transition its former competitor’s business to its own trade name) and does not plan on allowing any other entity to obtain access to the trade name (e.g., by selling or licensing it), then the trade name would be considered a defensive intangible asset.

Guidance applied to non-R&D defensive intangible assets acquired in a business combination or otherwise includes the following:

- A transition period (i.e., a short period of time after acquisition during which the asset will be used) does not disqualify an intangible asset from being considered a defensive intangible asset. With respect to the trade name example cited earlier, the fact that the former competitor’s trade name will be used until the buyer transitions to its own trade name does not disqualify the former competitor’s trade name from being considered a defensive intangible asset.
- The designation of an acquired intangible asset as a defensive intangible asset may change over time if the entity’s intentions with respect to that asset change. With respect to the trade name example cited earlier, the buyer may decide at a later point in time to reintroduce its former competitor’s brand name. The possibility of this happening after the acquisition date does not disqualify the trade name from being considered a defensive intangible asset on the acquisition date.
- A defensive intangible asset is its own unit of account (i.e., defensive intangible assets are separately identifiable, and therefore, their value should not be included in the carrying amount of another intangible asset [recognized or unrecognized]).
- The fair value of a defensive intangible asset would not be zero because there is inherent value in holding a defensive intangible asset.
- The useful life of a defensive intangible asset is the period over which its value is expected to diminish.
- Only in rare circumstances would it be appropriate to conclude that a defensive intangible asset is indefinite-lived.
- Once recognized, it would be inappropriate to conclude that a defensive intangible asset is immediately abandoned (and therefore, that it should be immediately written off).

The guidance otherwise applicable to R&D intangible assets should be applied to R&D defensive intangible assets (see Section 10.12).

## 10.11 Assembled workforce

ASC 805-20-55-6 defines an assembled workforce as “...an existing collection of employees that permits the acquirer to continue to operate an acquired business from the acquisition date.” An assembled workforce does not represent an identifiable intangible asset acquired in a business combination because it does not meet either the separability criterion or the contractual-legal criterion. Consider the acquisition of a large fast-food chain. Clearly, the large fast-food chain has an assembled workforce. However, there is no employment contract between the entire collection of employees that make up the assembled workforce and the employer. As such, the contractual-legal criterion is not met. With respect to the separability criterion, neither the large fast-food chain nor its acquirer would be able to sell, transfer, license, rent or otherwise exchange the assembled workforce without disrupting the business. In other words, the assembled workforce can really only be sold or transferred as part of the sale of the business as a whole. As such, the separability criterion is not met.

The end result of not recognizing an intangible asset for an assembled workforce acquired in a business combination is that any value associated with that assembled workforce is effectively included in any goodwill that is recognized in the accounting for the business combination, or serves to reduce any gain from a bargain purchase recognized in the accounting for the business combination. In contrast, it may be appropriate in an asset acquisition (i.e., an acquisition of net assets that does not meet the definition of a business) to recognize an intangible asset for an assembled workforce. For discussion on accounting for an assembled workforce in an asset acquisition, see Section 15.3.1. For discussion on the definition of a business (which is used to determine whether an acquired set should be accounted for as a business combination or asset acquisition), see Section 4.1.

## 10.12 Research & Development (R&D)

### 10.12.1 Initial recognition of R&D assets acquired in a business combination

IPR&D acquired in a business combination satisfies the definition of an asset (see Section 7.2). This is the case even if the IPR&D: (a) has no alternative future use and (b) is not likely to provide future economic benefits. Alternative future use is a concept that is used to determine the accounting for IPR&D acquired in a transaction other than a business combination (see Section 15.3.3).

The fact that it does not have to be likely that the IPR&D acquired in a business combination will provide future economic benefits raises a question when considered in conjunction with the definition of an asset. The definition of an asset is used to determine the assets that should be recognized by the buyer in a business combination (see Section 7.2). The asset definition relied upon for this purpose is found in paragraph E16 of CON 8, which indicates: “An asset is a present right of an entity to an economic benefit..” The FASB concluded that the nature of IPR&D does, in fact, represent a present right to an economic benefit as that phrase is used in CON 8. The fact that the benefits are not certain does not lead to a conclusion that there are no benefits associated with the IPR&D. The FASB’s rationale for recognizing IPR&D acquired in a business combination as an asset is based on the fact that the business combination represents an observable exchange transaction involving the IPR&D. The future economic benefits expected from the IPR&D are an integral part of that exchange transaction’s value proposition. In addition, the fact that a buyer may experience difficulty in determining the fair value of IPR&D acquired in a business combination does not affect the decision to recognize R&D assets.

The difficulties of measuring the fair value of IPR&D have been dealt with in practice for some time. The AICPA provides helpful information to address these difficulties in its R&D Accounting and Valuation Guide.

For an example that illustrates the perspective that should be used in measuring acquired IPR&D at fair value, see Example 10-2.

### 10.12.2 Subsequent accounting for R&D assets acquired, and accounted for, in a business combination

The subsequent accounting for R&D assets acquired in, and recognized in the accounting for, a business combination depends on the nature of those assets.

#### 10.12.2.1 Acquired intangible R&D assets

Until the related IPR&D efforts are completed or abandoned, the related intangible asset is treated as an indefinite-lived intangible asset. As an indefinite-lived intangible asset, the intangible R&D asset is not amortized, but is tested for impairment annually, or more often, as required by the guidance that applies to the impairment testing of indefinite-lived intangible assets.

Upon completion of the IPR&D efforts, the related intangible asset is amortized over its estimated useful life. However, if the IPR&D efforts are abandoned, the related intangible asset may need to be written off in its entirety. For purposes of determining whether an intangible R&D asset has been abandoned, the temporary stoppage of the related IPR&D efforts does not equate to the abandonment of those R&D efforts. ASC 360-10-35-47 to 35-48 provides guidance on how to account for the abandonment of assets. This guidance should be consulted upon the abandonment of R&D efforts acquired in a business combination.

#### 10.12.2.2 Acquired R&D assets related to computer software to be sold, leased or otherwise marketed

Based on the guidance discussed earlier in Section 10.12.1, intangible assets should be recognized in the accounting for a business combination when R&D assets related to computer software to be sold, leased or otherwise marketed (referred to in this section as software-related R&D intangible assets) are acquired. These assets should be recognized at their acquisition-date fair value. Once recognized, the accounting for the software-related intangible asset depends on whether technological feasibility of the software has been established. As noted in ASC 985-20-25-2, "...technological feasibility of a computer software product is established when the entity has completed all planning, designing, coding, and testing activities that are necessary to establish that the product can be produced to meet its design specifications including functions, features, and technical performance requirements."

When technological feasibility has been established, the software-related R&D intangible asset is accounted for as any other intangible asset related to computer software to be sold, leased or otherwise marketed that has reached technological feasibility. In other words, it is accounted for in accordance with ASC 985-20.

When technological feasibility has not been established, then the software-related R&D intangible asset is accounted for as any other IPR&D intangible asset recognized in the accounting for a business combination. That is, until the related IPR&D efforts are completed or abandoned, the software-related R&D intangible asset is treated as an indefinite-lived intangible asset. For this purpose, the IPR&D efforts are considered complete upon reaching technological feasibility. As an indefinite-lived intangible asset, the software-related R&D intangible asset is not amortized, but is tested at least annually for impairment. Upon completion of the IPR&D efforts (i.e., reaching technological feasibility), the software-related R&D intangible asset should be reflected as capitalized software costs. That asset should be accounted for in accordance with ASC 985-20 and any qualifying costs incurred after reaching technological feasibility should be capitalized as part of that asset.

**Pending change:** The FASB has a project, "Accounting for and Disclosure of Software Costs," on its agenda which could significantly affect this guidance. At the publication date for this guide, the project was still in process (see the FASB's project page for its status).

#### 10.12.2.3 Acquired tangible R&D assets

If acquired R&D assets include tangible assets such as property and equipment constructed for R&D activities, then those tangible R&D assets should be accounted for using the authoritative literature applicable to property and equipment. As such, these assets should be depreciated over their estimated useful lives and tested for impairment under the same circumstances as other tangible assets, such as property, plant and equipment.

### 10.12.3 Accounting for R&D costs incurred after the business combination

Costs incurred by an entity in conjunction with its own R&D efforts should be expensed as incurred even if expended for the direct benefit of an R&D intangible asset recognized previously in the accounting for a business combination. As a result, any value provided by these postacquisition R&D costs does not serve to increase the related R&D intangible asset.

## 10.13 Leases

### 10.13.1 General

In February 2016, the FASB issued ASU 2016-02 which addresses the accounting for leases and was codified in ASC 842. On its effective date, ASC 842 replaced the legacy U.S. GAAP for leases in ASC 840.

The most significant change under ASC 842 was the recognition of ROU assets and lease liabilities by lessees for all leases, other than those that meet the definition of short-term leases for which a lessee may elect an accounting policy under which ROU assets and lease liabilities are not recognized. This change resulted in lessees recognizing ROU assets and lease liabilities for most leases accounted for as operating leases under legacy U.S. GAAP.

With the changes it made to accounting for leases in general, the FASB also made changes to how the target's leases should be accounted for in a business combination. The remainder of this section addresses how the target's leases should be accounted for in a business combination after the adoption of ASC 842.

### 10.13.2 Initial consideration when the target is the lessee

When the target is the lessee, the buyer must decide whether to elect an accounting policy by class of underlying asset (which would be applicable to all acquisitions) to not recognize ROU assets and lease liabilities for acquired leases with a remaining lease term of 12 months or less. If the buyer elects the short-term acquired lease accounting policy, it would also not recognize an asset or liability for short-term leases with terms that are favorable or unfavorable compared to market (see Section 10.13.4). The subsequent accounting for short-term operating leases when this policy has been elected is discussed in detail in Section 7.1.1 of our lessee guide.

### 10.13.3 Classifying the acquired leases

For a contract, instrument or agreement acquired in a business combination that is or includes a lease, the buyer should retain the target's lease classification as of the acquisition date, provided it was determined appropriately by the target. The only exception is if the acquired lease is modified in conjunction with the business combination and the modification is not accounted for as a separate contract in accordance with ASC 842-10-25-8, in which case the classification of the lease should be reassessed on the acquisition date. If the acquired lease is modified in conjunction with the business combination and the modification is accounted for as a separate contract, the classification of the lease prior to the modification is retained and the classification of any lease in the separate contract (which was created by the modification) is determined on the acquisition date. For additional information about when a lessee should account for modifications made to a lease as a separate contract, see Section 7.2.5.1 of our lessee guide. For guidance about when a lessor should account for modifications made to a lease as a separate contract, see ASC 842-10-25-8 to 25-10 and 25-15 to 25-18.

If the target's financial statements were not audited, a high level of scrutiny should be placed on the target's preacquisition classification of the lease.

Changes to the lease that are considered modifications for accounting purposes are those that change the lease's scope or consideration. As such, a change to remove the seller's or target's name and add the buyer's name as the new lessee or lessor is not considered a modification for accounting purposes.

It is important to note that a buyer in a business combination does not reassess classification of an acquired lease solely because its assessment of factors affecting the lease term or the likelihood of exercising a purchase option are different from the target's assessments. For example, consider a situation in which a lessee enters into a lease with a noncancellable term of four years and a renewal option for one additional year. On the commencement date, the lessee concludes it is reasonably certain to exercise the renewal option. As a result, the lessee concludes the lease term is five years (see Section 5.3.2 of our lessee guide). Based on this lease term and other relevant facts and circumstances, the lessee concludes the lease should be classified as a finance lease. In the following year, there is no reason for the lessee to reassess the lease term or classification (see Section 5.3.5 of our lessee guide), and one year after entering into the lease, the lessee is acquired in a business combination. The buyer in the business combination determines the acquired lease's remaining lease term for purposes of recognizing and measuring it in the business combination accounting (see Section 10.13.6). In doing so, the buyer concludes it is not reasonably certain to exercise the renewal option. As a result, the buyer concludes the remaining lease term is three years. The buyer's reassessment of the lease term on the acquisition date does not trigger the need for it to reassess the acquired lease's classification on the acquisition date. In other words, the lease continues to be classified as a finance lease on the acquisition date regardless of the buyer's reassessment of the lease term. Assume another year passes, and the buyer's facts and circumstances change such that it concludes it is reasonably certain to exercise the renewal option, which means the remaining lease term is three years (or one year longer than what the lease term would have been absent the change in facts and circumstances since the acquisition date). In this situation, the reassessment of the lease term does trigger the need for a reassessment of the lease classification (see Section 6.7 of our lessee guide). The effects of any change in the lease term would be accounted for outside the business combination, similar to the accounting for a change in the lease term for a lease that was not acquired in a business combination.

**10.13.4 Determining whether an acquired operating lease is favorable or unfavorable**

Whether the target is the lessee or the lessor in operating leases acquired by the buyer in the business combination, a comparison should be performed between the terms of those leases and the market terms of the same or similar leases on the acquisition date. The purpose of this comparison is to determine whether the terms of the acquired leases are: (a) favorable compared to market (i.e., below market if the target is the lessee or above market if the target is the lessor), (b) unfavorable compared to market (above market if the target is the lessee or below market if the target is the lessor) or (c) neither favorable nor unfavorable compared to market. The accounting implications of these potential outcomes depend on whether the target is the lessee (see Section 10.13.6) or lessor (see Section 10.13.7).

**10.13.5 Determining whether an identifiable intangible asset arises from the acquired lease**

The buyer should determine whether the acquired lease gives rise to any identifiable intangible assets.

Whether favorable lease terms should give rise to an intangible asset depends on whether the target is the lessee (see Section 10.13.6) or lessor (see Section 10.13.7).

ASC 805-20-25-13 provides the following examples in which the acquisition of a lease could give rise to the buyer recognizing a separately identifiable intangible asset : "... a lease of gates at an airport or of retail space in a prime shopping area might provide entry into a market or other future economic benefits that qualify as identifiable intangible assets, such as a customer relationship" (see Section 10.6.2). To determine whether another identifiable intangible asset arises from an acquired lease, the buyer should consider whether a market participant would be willing to pay a price for the lease even if the lease were at market terms. For example, a market participant would likely be willing to pay a price for an at-market lease of retail space in a prime shopping area when it has not been able to obtain retail space in that area. If that is the case, the buyer would recognize an intangible asset related to the lease provided the definition of an identifiable intangible asset is met.

### 10.13.6 Recognition and measurement for lessees

For acquired leases with a remaining lease term of more than 12 months, and for those short-term leases for which the buyer has not elected the accounting policy discussed in Section 10.13.2, the buyer must recognize ROU assets and lease liabilities. Unlike most other assets and liabilities acquired in a business combination, the lease liability and ROU asset are not recognized at their fair values on the acquisition date. Instead, the buyer applies the guidance in ASC 842 to determine the remaining lease term and the remaining lease payments (see Section 5.3 and Section 5.5 of our lessee guide, respectively) as if the commencement date for the lease is the acquisition date. The buyer uses that information to initially measure a lease liability at the present value of the remaining lease payments. The discount rate used for this purpose is one of the following, as appropriate:

- If known, the rate implicit in the lease.
- If the rate implicit in the lease is not known, the buyer's incremental borrowing rate as of the acquisition date.
- If the buyer is not a PBE and has made the election to use the risk-free rate as the discount rate for all of its leases within a class of underlying asset, the risk-free rate as of the acquisition date.

Each of these rates are discussed further in Section 5.2 of our lessee guide. To the extent an acquired lease has variable payments based on other than an index or rate, those payments should be subsequently recognized in the same manner as they would have been if the lease had not been acquired.

The initial measurement of the ROU asset in the accounting for the business combination is the amount of the lease liability adjusted for the fair value of any favorable or unfavorable terms compared to market (see Section 10.13.4).

Because the buyer is assuming the acquisition date is the commencement date for the lease, no prepaid or accrued rent should be recognized by a lessee in the accounting for the business combination.

The amounts recognized for the lease liability and ROU asset in the accounting for the business combination do not vary based on the classification of the lease. However, because the lease liability and ROU asset are subsequently accounted for under ASC 842, the accounting for a lease after the acquisition date does depend on the classification of the lease (which is discussed in detail in Section 7.2 of our lessee guide).

While the method used to amortize the ROU asset depends on the classification of the lease (see Section 7.2.2.2 and Section 7.2.3.2 of our lessee guide), the amortization period for that asset does not. The amortization period for the ROU asset acquired in a business combination should be the remaining useful life of the underlying asset if either: (a) ownership of the underlying asset transfers to the buyer or (b) the buyer is reasonably certain to exercise a purchase option for the underlying asset. Otherwise, the amortization period for the ROU asset should be the remaining lease term.

The target's leasehold improvements should be recognized by the buyer on the acquisition date and measured at their fair value. In any of the following circumstances, the amortization period for leasehold improvements acquired in a business combination should be their remaining useful life: (a) ownership of the underlying asset transfers to the lessee, (b) the lessee is reasonably certain to exercise a purchase option for the underlying asset or (c) the remaining useful life of the leasehold improvements is shorter than the remaining lease term as of the acquisition date. Otherwise, when the leasehold improvements' useful life is longer than the remaining lease term as of the acquisition date, the amortization period for those leasehold improvements should be the remaining lease term.

**Example 10-5: Accounting for an operating lease acquired in a business combination in which the target is the lessee**

Lessee and Lessor entered into a lease on January 1, 20X6. The terms of the lease and other facts pertinent to the accounting for the lease include the following:

- Lessor makes the asset available to Lessee for its use on January 1, 20X6.
- Lessee has the right to use the asset for a noncancellable term of five years. There are no extension, termination or purchase options.
- Fixed lease payments in year one of the lease are $39,000 and increase by $2,500 per year over the noncancellable term.
- Lease payments are made annually in arrears.
- Lessee paid a $5,000 bonus to its employee in connection with entering into the lease.
- Lessor paid a $10,000 lease incentive to Lessee on January 1, 20X6.
- Lessee's incremental borrowing rate is 7% (the rate implicit in the lease is not readily determinable).
- The useful life of the asset is more than five years.

Based on its application of ASC 842, Lessee concludes the lease should be classified as an operating lease. There are no modifications to the lease after January 1, 20X6. Lessee has no other leases.

On January 1, 20X8, Lessee is acquired by Acquirer in a business combination. The carrying amount of the lease liability and ROU asset right before the acquisition are $121,735 and $111,235, respectively. In the accounting for the business combination, Acquirer determines that the fair value of the favorable terms of the lease is $55,000. Acquirer does not identify any identifiable intangible assets or liabilities related to the lease that should be recognized in the accounting for the business combination. In addition, Acquirer's incremental borrowing rate at the acquisition date is 6% (the rate implicit in the lease is not readily determinable), and the useful life of the asset as of the acquisition date is more than three years.

*Accounting for the lease on the acquisition date*

Acquirer continues to classify the lease as an operating lease on the acquisition date.

Based on the remaining annual lease payments in arrears of $44,000 for 20X8, $46,500 for 20X9 and $49,000 for 20Y0, a remaining lease term of three years and Acquirer's incremental borrowing rate of 6%, the lease liability that should be recognized by Acquirer in the accounting for the business combination is $124,035. The ROU asset that should be recognized by Acquirer in the accounting for the business combination is $179,035, calculated by starting with the lease liability on the acquisition date ($124,035) and increasing it by the fair value of the favorable terms of the lease ($55,000). The acquisition date accounting for the lease is unaffected by the previously incurred initial direct costs or previously received lease incentives. The difference between the amounts recognized for the lease liability and the ROU asset essentially affects the amount of goodwill (or gain from a bargain purchase) recognized in the broader accounting for the business combination.

Example 7-8 in our lessee guide illustrates the subsequent accounting for the lease after the acquisition date.

#### 10.13.7 Recognition and measurement for lessors

Unlike most other assets and liabilities acquired in a business combination (which are recognized at fair value), for an acquired lease in which the target is the lessor, the buyer should recognize and measure assets and liabilities in accordance with ASC 842-10 and ASC 842-30.

##### 10.13.7.1 Additional discussion related to acquired operating leases in which the target is the lessor

When the target is the lessor in operating leases acquired by the buyer in the business combination, the favorability or unfavorability of the leases (see Section 10.13.4) should result in the following when accounting for the business combination:

- *Favorable:* Recognition of an intangible asset
- *Unfavorable:* Recognition of a liability
- *Neither favorable nor unfavorable (at market):* No recognition of an incremental intangible asset or liability

In addition, the asset that is the subject of the operating lease should be recognized at its acquisition-date fair value separate and apart from any asset or liability recognized due to the favorable or unfavorable terms of the lease. The fact that the asset is the subject of an operating lease should have no effect on the measurement of that asset itself because the fair value of the operating lease is considered separately as discussed in Section 10.13.4 and the preceding bullet points.

##### 10.13.7.2 Additional discussion related to acquired sales-type or direct-financing leases in which the target is the lessor

A net investment in the lease should be recognized by the buyer for acquired leases in which the target is the lessor and the leases are classified as either sales-type or direct-financing leases. ASC 805-20-30-25 indicates that the net investment in the lease should be the sum of the following:

a. The lease receivable at the present value, discounted using the rate implicit in the lease, of the following, as if the acquired lease were a new lease at the acquisition date:
   1. The remaining lease payments
   2. The amount the lessor expects to derive from the underlying asset following the end of the lease term that is guaranteed by the lessee or any other third party unrelated to the lessor.

b. The unguaranteed residual asset as the difference between the fair value of the underlying asset at the acquisition date and the carrying amount of the lease receivable, as determined in accordance with (a), at that date.

In addition, ASC 805-20-30-25 indicates the following: (a) the sum of these two components should equal the acquisition-date fair value of the underlying asset and (b) when determining the acquisition-date fair value of the underlying asset, the buyer should take into consideration the lease's terms and conditions as of the acquisition date.

## 10.14 Accounts payable and accrued liabilities

As discussed in Section 8.1.1, the general rule (to which there are limited exceptions) is that assets and liabilities acquired in a business combination should be measured at their fair value. This general rule applies to accounts payable and accrued liabilities. In other words, there is no exception that allows accounts payable and accrued liabilities to be measured at an amount other than fair value (e.g., carrying amount). In some cases, the buyer might assert that the fair values of the target's accounts payable and accrued liabilities are the same as their book values. It is not appropriate to use the target's book value as a surrogate or approximation for fair value unless it is known that the difference between book value and fair value is immaterial. The fair value of the accounts payable or accrued liability must be determined to assess whether the difference is immaterial. If fair value is determined for this purpose, the buyer should strongly consider using that fair value in the accounting for the business combination.

When estimating the fair value of accounts payable and accrued liabilities, the buyer must estimate the price it would have to pay to transfer the liability to a market participant. As such, payment timing, nonperformance risk and the profit required by market participants to take on the liability should be reflected in the fair value estimate. It is not appropriate to assume that the price to transfer the accounts payable or accrued liabilities is the same as the price to settle those liabilities or the same as the carrying amount of those liabilities. How the buyer should estimate the amount at which it would be able to transfer one of its liabilities can be challenging given the lack of market information on transfer prices for entity-specific liabilities. Oftentimes, there is little market information available because contractual or other legal restrictions prevent the transfer of such liabilities.

When faced with the challenge of determining the fair value of a liability, the buyer should consider whether it would be beneficial to consult a valuation specialist for assistance.

*10Q.14.1 Should accrued bonuses for a preexisting bonus plan of the acquired company be recorded by the acquirer?*

Yes. If the acquired company has previously recognized a bonus liability due to a present obligation to pay the employees for their past services, the acquirer should recognize the obligation as an assumed liability. We believe the portion of the bonus that relates to precombination services should be recorded as a liability as part of the business combination, even if the recipients must remain employed to obtain the bonus earned as of the acquisition date for service performed prior to the acquisition. However, the amount should be adjusted for known or expected forfeitures and should not include amounts earned after the acquisition date. This accounting does not apply to bonus plans created by the acquirer contemporaneously with (or in consideration of) the business combination.

## 10.15 Anticipated restructuring activities involving the target

The definition of a liability is used to determine the liabilities that should be recognized by the buyer in a business combination (see Section 7.2). The liability definition relied upon for this purpose is that found in paragraph E37 of CON 8: “A liability is a present obligation of an entity to transfer an economic benefit.”

In applying the definition of a liability to restructuring costs *expected* to be incurred as a result of a business combination, the FASB concluded that a present obligation of the buyer does not exist at the acquisition date. A mere plan to engage in restructuring activities or other exit activities, or even a commitment to such a plan, does not create an obligation of the buyer or the combined entity. In this situation, an obligation for restructuring or other exit activities involving the target could not arise until after the acquisition date when the buyer actually takes control of the target’s operations. In essence, what the buyer plans to do with the target after the acquisition does not affect the buyer’s accounting for the acquisition.

In determining whether and when an obligation exists for restructuring or other exit activities, the guidance in ASC 420 should be followed. For this purpose, ASC 420 also relies on the definition of a liability in paragraph E37 of CON 8, except when one-time termination benefits are involved. Except for those one-time termination benefits, a liability of the buyer does not exist at the acquisition date under ASC 420 for the costs associated with anticipated restructuring or other exit activities involving the target for the same reasons as discussed in the previous paragraph. For one-time termination benefits (as defined in the Master Glossary of the Codification) that are part of a plan in which restructuring or other exit activities involving the target are expected to occur, ASC 420 establishes separate liability recognition criteria. If the buyer is going to offer these one-time termination benefits to employees of the target as part of a restructuring plan, the criteria in ASC 420 that must be met by the buyer prior to recognizing a liability are as follows:

- Provide a clear and sufficient explanation of those benefits such that the employees who may be subject to termination appreciate the nature of the benefits they would receive if terminated under the plan
- Indicate that significant changes to, or withdrawal of, the plan will not occur
- Communicate the plan to employees

It is extremely difficult to envision a situation in which all these criteria would be met by the buyer as of the acquisition date. As such, an obligation for one-time termination benefits provided under a restructuring or other exit plan would typically not arise until after the acquisition date when the buyer actually takes control of the target's operations.

It is also important to note that to the extent the target has ongoing restructuring activities on the acquisition date or announces restructuring activities between the date the business combination is announced and the date it is closed, consideration should be given to whether those activities were undertaken by the target on behalf of, or at the request of, the buyer. If so, it may be necessary to account for those restructuring activities separate from the business combination (see Section 13.6).

## 10.16 Asset Retirement Obligations (AROs)

The target acquired by the buyer in a business combination may have tangible long-lived assets for which there are related AROs. For example, consider a situation in which the target has a manufacturing facility with underground storage tanks and there is a state law that requires the owner to remove those tanks 20 years after their initial installation and restore the location of the tanks to its original condition. In this example, the obligation to remove the tanks and restore their location is an ARO. Guidance on the accounting for AROs in general is included in ASC 410-20.

In situations in which the buyer acquires a tangible long-lived asset and a related ARO in a business combination, the buyer recognizes both an asset and a liability in its accounting for the business combination, and both are measured at their fair value on the acquisition date. The fair value of the tangible long-lived asset should be measured exclusive of the effects of the ARO, which would result in a higher amount than if the fair value of the asset was measured inclusive of the effects of the ARO. Including the effects of the ARO in the fair value measurement of the asset would result in inappropriately double counting those effects in the buyer's accounting for the business combination—once in the fair value of the asset (as a reduction) and once in the fair value of the ARO liability. The fair value of the ARO liability will likely be different from the carrying amount of the ARO liability recorded by the target prior to the acquisition.

## 10.17 Assumed debt

Debt assumed by the buyer in a business combination is measured at its fair value. It is not appropriate to assume that the price to transfer the liability is the same as the price to settle the liability or the same as the target's carrying amount of the liability. In other words, there is no exception in ASC 805 that permits debt assumed in a business combination to be measured at the target's carryover basis on the acquisition date. In some cases, the buyer might assert that the fair value of the assumed debt is the same as the target's carryover basis for the debt right before the acquisition occurred. This assertion is not valid from an accounting perspective until it is proven, which requires estimating the fair value of the assumed debt.

Estimating the amount at which the buyer would be able to transfer debt to a market participant in an orderly transaction presents unique challenges given the lack of market information on transfer prices for entity-specific liabilities. Oftentimes, there is little market information available because contractual or other legal restrictions prevent the transfer of such liabilities. Guidance on measuring the fair value of liabilities is included in ASC 820-10-35. When faced with the challenge of determining the fair value of assumed debt, the buyer should consider whether it would be beneficial to consult a valuation specialist for assistance.

*10Q.17.1 If the buyer in a business combination assumes the target's debt, should the target's unamortized debt issuance costs be recognized in the buyer's accounting for the business combination?*

No. Debt issuance costs do not meet the definition of an asset in CON 8 and are only deferred as a contra-liability when incurred because of an accounting convention designed to treat such costs in a manner similar to how interest costs are treated. As such, the buyer should not recognize a contra-liability related to the target's preexisting debt issuance costs in the accounting for the business combination.

*10Q.17.2 If a target issues standalone financial statements subsequent to being acquired, how is the amount of debt included in those standalone financial statements affected by the business combination?*

How the amount of debt shown in the target's standalone financial statements subsequent to being acquired is affected depends on whether the target elects pushdown accounting (see Appendix C).

When the target elects pushdown accounting, the fair value of the debt recognized by the buyer in the accounting for the business combination is pushed down to the target's standalone financial statements.

When the target does not elect pushdown accounting, the fair value of the debt is not pushed down to the target's financial statements. Instead, the target retains the carrying amount of the debt, which includes any contra-liability for debt issuance costs. However, the buyer and target should understand whether the buyer's acquisition of the target (including its debt) could trigger changes to the terms of the debt (e.g., through a change-in-control provision) that would need to be evaluated under ASC 470-50 to determine whether the changes should be accounted for as a debt modification or extinguishment in the target's standalone financial statements. Any preexisting debt issuance costs would only be derecognized in the target's standalone financial statements to the extent extinguishment accounting results from the application of ASC 470-50.

## 10.18 Insurance and reinsurance contracts

ASC 944-805 indicates the following with respect to insurance and reinsurance contracts within the scope of ASC 944-10 that are acquired in a business combination:

- Such contracts should be considered new contracts and recognized at fair value for measurement and accounting purposes.
- The buyer's classification of each contract as either an insurance or reinsurance contract or a deposit contract should be based on the terms, conditions and other relevant factors in existence at the inception of the contract. However, if a modification to the contract occurred after inception, but before the acquisition date, and it affected the contract's classification, then the contract should be classified based on the terms, conditions and other relevant facts in existence when the contract was modified. If the target classified each contract appropriately at contract inception or at the modification date (as applicable), the buyer is essentially carrying forward the target's classification of each such contract.
- How such contracts should be recognized and measured as two different components in the accounting for the business combination.
- Which model should be used to account for contracts that are not insurance or reinsurance contracts, such as a contingent commission arrangement or claim reserve guarantee.
- How the intangible asset (or liability) recognized as a result of applying this guidance should be subsequently measured.

ASC 944-805 provides subsequent accounting guidance for certain long-duration insurance and reinsurance contracts acquired in a business combination. This guidance was amended by ASU 2018-12 to:

- Address the applicability of premium deficiency testing on the present value of future profits related to insurance and reinsurance contracts acquired in a business combination (see ASC 944-805-35-3 and to update the related disclosure requirements accordingly (see ASC 944-805-50-3)
- Incorporate in certain implementation guidance and illustrations related to demutualizations the effects of changes made to simplify the amortization of deferred acquisition costs (see ASC 944-805-55-3 and 55-6 to 55-13)

As a result of ASU 2020-11, the effective date of ASU 2018-12 was deferred such that, for PBEs that are SEC filers, except for entities eligible to be SRCs (as defined by the SEC), the amendments to ASC 944-805 are effective for fiscal years beginning after December 15, 2022, and interim periods within those fiscal years. For all other entities, the amendments to ASC 944-805 are now effective for fiscal years beginning after December 15, 2024, and interim periods within fiscal years beginning after December 15, 2025. Additionally, ASU 2020-11 changed the early application transition date to allow entities to adopt as of the beginning of the prior period presented or as of the beginning of the earliest period presented.

## 10.19 Recognition and measurement of an NCI

### 10.19.1 General

NCI is defined in the Master Glossary of the Codification as "The portion of equity (net assets) in a subsidiary not attributable, directly or indirectly, to a parent. A noncontrolling interest is sometimes called a minority interest." For example, Company A acquires a 70% interest in the common stock of Company B. Company A did not previously own any of Company B's common stock. After Company A's acquisition of a 70% interest in the common stock of Company B (which is accounted for as a business combination), there remains a 30% NCI in Company B in Company A's consolidated financial statements.

The FASB's guidance on accounting for business combinations and NCIs reflects the FASB's view that a consolidated entity represents a single economic unit. When accounting for a business combination, the net assets acquired are recorded as if there was an acquisition of 100% of the target. This is the case regardless of whether 51% or 100% (or any percent in between) of the target is acquired by the buyer. In addition, the net assets acquired are measured predominantly at fair value in accordance with ASC 805. As such, in cases in which less than 100% of the target is acquired by the buyer, the buyer must also recognize the fair value of the NCI. This approach results in the buyer recognizing both its and the NCI's share of goodwill (i.e., the buyer recognizes 100% of goodwill).

Section 10.19 provides guidance on the issues that must be addressed by the buyer when recognizing an NCI in the accounting for a business combination, including: (a) identification of the NCI in a target, (b) considerations involved in estimating the fair value of an NCI in a target, (c) presentation of the NCI in the balance sheet and (d) disclosures about the NCI.

### 10.19.2 Identification of the NCI in a target

NCI is defined in the Master Glossary of the Codification as "The portion of equity (net assets) in a subsidiary not attributable, directly or indirectly, to a parent." In addition, ASC 810-10-45-15 indicates the following: "The ownership interests in the subsidiary that are held by owners other than the parent is a noncontrolling interest. The noncontrolling interest in a subsidiary is part of the equity of the consolidated group."

The subsidiary's ownership interests could consist of one or more financial instruments (or embedded features). When determining the financial instruments (or embedded features) that represent the NCI in the target (which becomes a subsidiary of the buyer [or parent] after the acquisition) for purposes of the consolidated financial statements, it is helpful to consider the following two questions:

1. What are the financial instruments (or embedded features) that are classified as equity by the target in its standalone financial statements?
2. For the instruments (or embedded features) identified in the first question, which portion are not directly or indirectly attributable to the buyer?

Financial instruments such as mandatorily redeemable stock that require liability classification under ASC 480 are not an ownership interest, and therefore, would not be an NCI.

ASC 810-10-45-16A(b) also refers to the following financial instrument (or embedded feature) as an NCI in a target for purposes of the consolidated financial statements:

> A financial instrument (or an embedded feature) issued by a parent or a subsidiary for which the payoff to the counterparty is based, in whole or in part, on the stock of a consolidated subsidiary, that is considered indexed to the entity's own stock in the consolidated financial statements of the parent and that is classified as equity.

Such instruments may include put options allowing the NCI shareholders to put their interests to the buyer (i.e., controlling interest holder), call options allowing the buyer to acquire the NCI or forward contracts requiring the buyer to acquire the NCI at some later date. Whether these instruments should be included in the NCI depends in part on whether they should be classified as equity.

The financial instruments (or embedded features) that are issued by the buyer and do not meet the requirements to be classified as equity, as well as instruments of the target not classified as equity in its standalone financial statements, should not be taken into consideration when identifying the NCI in the target. For example, freestanding written put options issued by the target on its common stock that can be physically settled or net cash settled by the holder should not be considered when identifying the NCI because those instruments should be reflected as a liability by the target.

The preceding discussion illustrates the importance placed on the classification of the target's, or in some cases, the buyer's financial instruments (or embedded features) as a liability or equity for purposes of identifying the NCI.

Identifying the NCI can be straightforward in some situations. For example, Buyer acquires a 70% interest in the common stock of Target. As a result, Buyer becomes the parent of Target and Target becomes a subsidiary of Buyer. Buyer did not previously own any of Target's common stock. The only financial instrument (or embedded feature) classified as equity by Target is its common stock. Buyer concludes that: (a) it should account for its acquisition as a business combination in accordance with ASC 805 and (b) the NCI in Target is represented by a 30% interest in the common stock of Target. On the acquisition date, the NCI in the consolidated financial statements should be measured based on the fair value of the 30% interest in the common stock of Target. Going forward, the NCI in the consolidated financial statements would essentially reflect the equity attributable to that 30% NCI.

In other situations, identifying the NCI can be quite complex. The types of financial instruments (or embedded features) that might be considered an NCI (depending on the facts and circumstances) are discussed earlier in this section (and in ASC 810-10-45-16A). Most of those financial instruments (or embedded features) are issued by the target. However, as noted earlier, certain financial instruments (or embedded features) issued by the buyer might also be considered an NCI (depending on the facts and circumstances). When determining whether these financial instruments (or embedded features) should be included in the NCI, consideration should first be given to the definition of a freestanding financial instrument within ASC 480 to determine the appropriate unit of account. This determination is a critical step in appropriately applying the guidance and determining if a financial instrument (or embedded feature) must be classified as a liability rather than included in the NCI. Determining whether a financial instrument is a freestanding financial instrument is discussed in Section 1.2 and Section 5.2.1 of our debt and equity guide.

To determine whether equity-linked instruments (i.e., freestanding instruments such as options that are linked to equity but are not in the form of shares) should be classified as equity and included in the NCI, it is generally necessary to consider ASC 480, as well as: (a) ASC 815-10 to determine if the instrument is a derivative and (b) ASC 815-40 to determine if the instrument is indexed to the issuer's own stock and meets all of the conditions for equity classification. This analysis is addressed in Chapter 5 of our debt and equity guide. In addition, if there are any embedded features within any freestanding financial instruments that are not derivatives in their entirety, those features should be evaluated in accordance with ASC 815-15 to determine if separate recognition as a derivative is required. (This analysis is illustrated in Section 4.3 of our debt and equity guide for features embedded in preferred and similar stock.) The guidance that begins at ASC 480-10-55-53 is also important to consider for fixed price forward contracts to purchase an NCI, as well as circumstances that involve a put and call option on the NCI that are exercisable on the same date and at the same fixed price. Only after considering the decision points in ASC 480 and 815 that are relevant to a particular set of facts and circumstances is it appropriate to reach a conclusion on the classification of a financial instrument (or embedded feature) that is being evaluated to determine whether it should be included in the NCI.

### 10.19.3 Considerations involved in estimating the fair value of an NCI

#### 10.19.3.1 General

Any NCI in the target at the acquisition date should be measured and recorded at its acquisition-date fair value. If there is an active market price for the shares not held by the buyer (i.e., the shares held by the NCI shareholders), then that active market price (without adjustment) multiplied by the number of shares held by the NCI shareholders represents the fair value of the NCI. This is supported by the guidance in ASC 820-10-35-41, which states the following: "A quoted price in an active market provides the most reliable evidence of fair value and shall be used without adjustment to measure fair value whenever available, except as specified in paragraph 820-10-35-41C." (ASC 820-10-35-41C does not address measurement issues specific to an NCI.) Adjusting the active market price for discounts (such as a discount for lack of control (DLOC) or discount for lack of marketability (DLOM)) is not appropriate when there is an active market price for the shares held by the NCI shareholders because any necessary discounts are presumed to be reflected in the active market price.

In some situations, it may not be clear whether the market that produces a quoted price is an active market. ASC 820-10-35-54C to 35-54H provide guidance on this subject.

When there is no active market price for the shares held by the NCI shareholders, the fair value of the NCI is estimated using one or more valuation techniques (e.g., market and [or] income approaches). When using a valuation technique to estimate the fair value of the NCI, the following questions often arise:

- Can the consideration transferred by the buyer for its controlling interest be used to extrapolate the fair value of the NCI? (see Section 10.19.3.2)
- If part of the NCI in the target is purchased by a party other than the buyer at the same time the buyer purchases its controlling interest, can the amount paid by the other party be used to calculate the fair value of the entire NCI? (see Section 10.19.3.3)
- What factors should be considered in determining whether any discounts (e.g., DLOC, DLOM) are necessary in estimating the fair value of the NCI? (see Section 10.19.3.4)

Each of these questions is explored further in this section. While the questions and related discussion are focused on estimating the fair value of an NCI when there is no active market price for the shares held by the NCI shareholders, they are also applicable to measuring the fair value of any PHEI the buyer had in the target prior to acquiring a controlling interest when there is also no active market price for that PHEI (see Section 12.6.2) (except as discussed in Section 12.5 with respect to measuring the fair value of the buyer's PHEI in a target when no consideration was transferred in the business combination). For example, if Company A held a 10% interest in Company B at the time it purchased an additional 70% interest in Company B, the fair value of both Company A's 10% PHEI in Company B and the 20% NCI in Company B would need to be estimated for purposes of accounting for the business combination. If there is not an active market price for Company B's shares, the questions and related discussion in the remainder of Section 10.19.3 are applicable to estimating the fair value of both Company A's 10% PHEI in Company B and the 20% NCI in Company B.

**Example 10-6: Fair value of NCI**

Buyer acquires a 60% interest (120,000 shares) in Target for $7.2 million. As such, Buyer is paying $60 per share for its ownership interest in Target. The only ownership interests in Target consist of common stock that is traded on the New York Stock Exchange (NYSE). Buyer did not own any interest in Target prior to acquiring its 60% interest. As a result of acquiring the 60% interest, Buyer controls Target, which results in Buyer accounting for the acquisition of the 60% interest in Target as a business combination. The NCI in Target (40% of the common stock of Target) is equivalent to 80,000 shares. The price of Target's stock on the NYSE on the acquisition date is $55 per share.

The difference between the per-share price of Target's stock on the NYSE on the acquisition date ($55) and the per-share price paid by Buyer ($60) likely represents a DLOC. The fair value of the NCI is $4.4 million (80,000 shares × $55 per share) in this situation.

### 10.19.3.2 Extrapolation of an NCI's fair value using the consideration transferred by a buyer for its controlling interest

Consider the fact pattern in which Company A pays $70 million for a 70% interest in Company B. Extrapolating the fair value of the NCI in this fact pattern would result in valuing the 30% NCI at $30 million. In general, use of an extrapolation approach by itself to determine the fair value of noncontrolling shares is inappropriate because additional analysis is typically needed to consider the following:

- *Whether the economic rights of controlling shares differ from the economic rights of noncontrolling shares*. For example, controlling shares may have priorities or preferences with respect to dividends, distributions or liquidation, including the right to repayment of invested capital plus a return prior to any repayment of invested capital related to noncontrolling shares. When the controlling shares include these priorities or preferences, the amount paid for those shares reflects the value of those priorities or preferences. To extrapolate the fair value of the noncontrolling shares using the amount paid for the controlling shares, adjustments will be needed to factor out the incremental value provided by the priorities or preferences. Differences in the economic rights of controlling and noncontrolling shares have the potential to create a significant difference in the fair values of those shares. To understand the economic rights of controlling and noncontrolling shares, it is often necessary to review agreements in addition to the purchase agreement, such as shareholders' agreements or other operating agreements.
- *Whether the controlling shareholders were willing to pay more (i.e., a control premium) on a per-unit basis to obtain a controlling interest.* Discounts for lack of control or lack of marketability may be required to remove the effects of a control premium when estimating the fair value of noncontrolling shares by using the amount paid to obtain a controlling interest (see Section 10.19.3.4).

The fact that the per-share values of the controlling interest and NCI may differ due to a control premium or an NCI discount is supported by ASC 805-20-30-8, which indicates the following:

> The fair values of the acquirer's interest in the acquiree and the noncontrolling interest on a per-share basis might differ. The main difference is likely to be the inclusion of a control premium in the per-share fair value of the acquirer's interest in the acquiree or, conversely, the inclusion of a discount for lack of control (also referred to as a noncontrolling interest discount) in the per-share fair value of the noncontrolling interest if market participants would take into account such a premium or discount when pricing the noncontrolling interest.

#### 10.19.3.3 Concurrent purchases of part of an NCI

A buyer should not assume that the amount paid per unit for part of an NCI purchased concurrent with its purchase of the controlling interest is representative of the fair value of the entire NCI. Consider the fact pattern presented earlier involving Company A and Company B in which there was a 30% NCI in Company B. If at the same time Company A bought its 70% interest in Company B for $70 million, Company C bought a 10% interest in Company B for $10 million, would the concurrent transaction with Company C support a fair value estimate of $30 million for the 30% NCI? We believe the answer to that question requires an in-depth analysis of all of the facts and circumstances, including the following:

- *Is Company C an independent third party?* In determining whether Company C is an independent third party, consideration should be given to other relationships, involvement and arrangements that Company C may have with Company A or Company B because they may influence the price paid in that concurrent transaction. If Company C is not an independent third party, the price it paid per unit may not be representative of the fair value of the entire NCI.
- *Were the shares purchased by Company C in the same class of stock as the shares held by the other NCI shareholders?* If the shares purchased by Company C are in a different class of stock than the shares held by the other NCI shareholders, the value of the interest purchased by Company C is inherently different from the value of the NCI.
- *Was the amount paid by Company C significant to Company C or the total transaction?* If the amount paid by Company C is insignificant to Company C or the total transaction, the price paid per unit by Company C may not be representative of the per-unit fair value of the entire NCI.
- *Was the transaction with Company C orderly?* A consideration when answering this question includes whether the transaction was exposed to the market for a period of time before it occurred. If that was not the case, the price paid per unit by Company C may not be representative of the per-unit fair value of the entire NCI.

Company A must answer all of these questions in the affirmative to conclude that the price paid by Company C for its purchase of a 10% NCI in Company B concurrent with Company A's purchase of the controlling interest in Company B should be used to extrapolate the fair value of the entire NCI in Company B. To the extent one or more of these questions is answered in the negative, adjustments may be needed to the amount paid by Company C on a per-unit basis to arrive at the per-unit fair value of the NCI as a whole.

#### 10.19.3.4 Discounts

When there is not an active market price for the NCI, it is common practice to start with the amount paid by the buyer for its controlling interest and apply any necessary discounts to that amount to arrive at the fair value of the NCI. When this approach is taken, determining the fair value of the NCI can be difficult, because assessing the necessity and extent of those discounts requires many complex considerations and exercising significant judgment. Given the judgment and complexity involved, consultation with valuation specialists is often necessary to determine the necessity and extent of any discounts that must be applied to the amount paid by the buyer for the controlling interest to arrive at the fair value of the NCI.

Determining the fair value of an NCI by starting with the fair value of the controlling interest requires the buyer to evaluate the following overall considerations, which may give rise to the need for a discount:

- *Was the amount paid by the buyer for the controlling interest affected by bidding wars or the desire to keep other buyers away?* If so, premiums paid in connection with these circumstances need to be removed from the amount paid by the buyer for its controlling interest for purposes of estimating the fair value of the NCI.
- *Did the buyer of the controlling interest pay for any entity-specific synergies?* Entity-specific synergies are those that a market participant does not benefit from. The effects of entity-specific synergies on the amount paid by the buyer for the controlling interest should be removed from that amount when using it as the starting point for estimating the fair value of the NCI.
- *Are the shares underlying the NCI in a different class of stock than the shares purchased by the buyer to obtain the controlling interest?* If so, there is an inherent difference between the fair value of one share of the controlling interest and one share of the NCI. That difference must be quantified using an allocation method to arrive at the starting point for estimating the fair value of the NCI.
- *Did the buyer obtain control of the target in a step acquisition (see Section 12.6)?* If so, the buyer may have obtained control as a result of purchasing less than 51% (i.e., a less-than-controlling interest) in the target in the current transaction. For example, assume a buyer obtains control of a target in which it had a 40% PHEI when it purchased an additional 20% interest in the target. While the buyer purchased a less-than-controlling interest in the transaction that resulted in it obtaining control of the target, the value of that less-than-controlling interest still includes the value of the buyer obtaining control overall. As such, the buyer must still consider whether a discount is necessary when using the amount paid by the buyer for the less-than-controlling interest to determine the fair value of the NCI.
- *Was there consistent consideration of discounts in the valuation of the NCI compared to other valuations performed in connection with the business combination?* A buyer should make sure it is consistently considering the need for discounts across all the valuations being performed in connection with the business combination. For example, if an ASC 718 valuation is being performed to appropriately account for replacement share-based payment awards (see Section 11.7 and Section 13.4), the discounts applied in the ASC 718 valuation should be consistent with the discounts applied in determining the fair value of the NCI.

After discounting or adjusting the amount paid by the buyer for its controlling interest based on the preceding considerations, if necessary, the buyer must then consider whether any additional discounts are required. One of the most common reasons for an additional discount is the inclusion of a control premium in the per-share fair value of the buyer's interest in the target, or conversely, the inclusion of a DLOC (also referred to as an NCI discount) in the per-share fair value of the NCI. Such premiums and discounts should only be considered and applied if market participants would take them into account when pricing the NCI. Another discount that may be taken into account by market participants when pricing the NCI based on the amount paid by the buyer for its controlling interest is a DLOM. To properly evaluate the cash flow, risk and marketability of a noncontrolling position, both quantitative and qualitative analyses must be performed to determine the unique characteristics of the equity interest being valued. Certain factors should be assessed to determine whether the interests of all investors in a transaction are aligned and whether a DLOC or DLOM is necessary and appropriate.

The necessity and extent of any DLOC or DLOM is influenced by whether the buyer is considered a financial buyer or strategic buyer. Financial buyers are typically looking to earn a return on their investment in a target by enhancing the target's cash flows and exiting the investment at a profit. Conversely, strategic buyers are typically looking to augment their existing business and operations, primarily by taking advantage of synergies that will result from adding the target to those operations. In general, a higher DLOC is typically present when a strategic buyer acquires a controlling interest (compared to a financial buyer) because a strategic buyer is more likely to take actions that will affect the distribution of the target's cash flows.

A private equity group (PEG) can be either a financial or strategic buyer. The PEG's individual characteristics need to be evaluated to conclude one way or the other. It should not be assumed that a PEG is a financial buyer or a strategic buyer. A PEG that buys a controlling interest in a target is likely a strategic buyer if the target complements the PEG's existing investments, either within the fund that made the investment or within the PEG's other funds. In contrast, a PEG that buys a controlling interest in a target is more likely to be a financial buyer if that purchase is the PEG's initial investment in an industry that is not represented within its entire portfolio.

The remainder of this section discusses factors that should be considered when determining the necessity and extent of any DLOC or DLOM when valuing an NCI by starting with the amount paid by the buyer for a controlling interest. All the factors discussed should be considered in reaching a conclusion about the necessity and extent of any DLOC or DLOM. No one factor is necessarily more significant or conclusive than the other factors discussed. In addition, the need for a DLOC or a DLOM should be assessed separately and independently because determining the fair value of an NCI may require both discounts, only one discount or neither discount.

### *DLOC*

When estimating the fair value of an NCI by starting with the amount paid by the buyer for a controlling interest, the following factors should be considered by the buyer when assessing the necessity and extent of any DLOC:

- *Discretionary cash flows*. In general, the greater the level of discretionary cash flows under the buyer's influence, the greater the possibility for disproportionate differences in the controlling and noncontrolling cash flows. The nature of the discretionary cash flows over which the buyer has influence typically depends on whether the buyer is a strategic or financial buyer:
  - *Strategic buyer.* Discretionary actions taken by a strategic buyer may affect the target's operations in any number of ways, including, but not limited to, maximizing market participant synergies, changing operations, changing management and selecting vendors or business partners (e.g., directing business to other entities in the strategic buyer's portfolio, rewarding vendors that have been favorable to the strategic buyer in the past). While these actions will affect the target's cash flows, the focus for purposes of the DLOC analysis should be on whether these discretionary actions maximize returns to the target as a whole, and as a result, proportionately benefit all of the target's shareholders. When this is not the case (i.e., the discretionary cash flows disproportionately benefit the strategic buyer), the extent of any necessary DLOC would increase.
  - *Financial buyer.* With the exception of management fees, a financial buyer is expected to manage the target's cash flows to an efficient level, which would minimize the amount of discretionary cash flows. With respect to management fees, a key consideration is whether the management fees represent the market value of the services provided by the financial buyer. When the management fees exceed the market value of the services provided by the financial buyer, the excess of the fees over the market value of the services provided represents a disproportionate equity distribution to the financial buyer as the controlling shareholder, which would increase the extent of any necessary DLOC.
- *Discretionary and nonoperating assets*. The consideration of discretionary and nonoperating assets is typically only relevant for a strategic buyer because a financial buyer is expected to manage the target's cash flows to an efficient level, which would minimize the existence of such

assets. To the extent discretionary and nonoperating assets exist, they would result in an increase to any necessary DLOC.

- *Drag-along rights*. With drag-along rights, the buyer (as the controlling shareholder) can require the NCI shareholders to sell their investments at the same time as the buyer sells its investment. In considering the impact of drag-along rights on control, the buyer has the ability to control disproportionate to its ownership. As a result, the NCI shareholders subject to drag-along rights lack control over the price and time at which a sale may occur, which increases any DLOC. However, if the NCI shareholders have discretion to sell their shares prior to being compelled to do so in connection with the drag-along rights, the increase in any DLOC due to drag-along rights is reduced.
- *Tag-along rights*. With tag-along rights, the NCI shareholders have the right to sell their investments at the same time as the buyer (as the controlling shareholder). Unlike drag-along rights, the presence of tag-along rights affords the NCI shareholders control over when and (to an extent) at what price they can sell their interests. Further, the buyer's ability to sell common stock is restricted as a result of tag-along rights. As a result, tag-along rights have the effect of decreasing any necessary DLOC.
- *Holding period.* In general, a shorter expected holding period decreases any necessary DLOC, while a longer expected holding period increases any necessary DLOC. For example, a strategic buyer with a shorter holding period may not have the time required to introduce and receive controlling benefits, resulting in a decrease to any necessary DLOC.

In evaluating the necessity and extent of any DLOC, it is important to remember that, beyond quantitative analysis, the buyer's specific qualitative characteristics still require evaluation.

### *DLOM*

A controlling interest in an entity is generally considered marketable and an NCI that is not publicly traded is generally considered nonmarketable. As a result, when the amount paid by the buyer for the controlling interest on a per-unit basis is used to estimate the NCI's fair value, a DLOM may be necessary. The necessity and extent of a DLOM is affected by the following considerations:

- *Drag-along rights and tag-along rights.* The presence of drag-along or tag-along rights decreases any necessary DLOM because the NCI shareholders have the obligation or right, respectively, to sell their NCI with the buyer (as the controlling interest), which increases the marketability of the NCI.
- *Holding period.* In general, a shorter expected holding period decreases any necessary DLOM, while a longer expected holding period increases any necessary DLOM. A strategic buyer typically plans for an indefinite holding period, which may lead to an increase in any necessary DLOM. A financial buyer should consider whether there are different principal markets for the buyer's controlling interest and the NCI when evaluating the effects of the expected holding period on the necessity and extent of any DLOM. When the principal market for the buyer's controlling interest and the NCI is the same, there is typically no effect on, or a decrease in, any necessary DLOM. Conversely, if there are different principal markets for the buyer's controlling interest and the NCI, there is typically an increase in any necessary DLOM. To determine the extent of this increase, the buyer should consider the time necessary for an NCI to sell in a secondary market.

Similar to the evaluation of the DLOC, it is important to remember that, beyond quantitative analysis, the buyer's specific qualitative characteristics still require evaluation to determine the necessity and extent of any DLOM.

#### 10.19.3.5 Additional resources

The discussion in this section about determining the fair value of an NCI is a summary of the more detailed discussion included in our white paper, Noncontrolling interests in business combinations, which also includes numerous examples. While a summary, it still makes readily apparent the fact that estimating the fair value of an NCI when there is not an active market price for the shares held by the NCI shareholders requires careful and thorough consideration of all the facts and circumstances. Because of the complexities involved, we recommend that an entity consider engaging a valuation specialist to assist in estimating the fair value of the NCI.

In addition, in 2019, the AICPA issued its Portfolio Company AVG. While its scope does not explicitly address estimating the fair value of an NCI in a private company, many of the general concepts discussed in the guide are relevant in that situation. For example, Chapter 9 of the guide discusses the concepts of control and marketability in the context of estimating the fair value of investments made by venture capital and private equity funds and other investment companies.

### 10.19.4 Presentation of an NCI in the balance sheet

Within the consolidated balance sheet, the NCI in a target should be: (a) clearly identified and labeled and (b) presented separately within equity (i.e., not combined with the buyer's [i.e., parent's] equity). However, public companies must also consider the guidance in SEC Accounting Series Release (ASR) 268 and ASC 480-10-S99-3A (which includes the "SEC Staff Announcement: Classification and Measurement of Redeemable Securities") (collectively referred to as the public company redeemable securities guidance). While technically this guidance only applies to SEC registrants, we believe it is preferable for private companies to apply it also. The public company redeemable securities guidance applies to a redeemable NCI in a target unless the redemption feature is considered a freestanding financial instrument, and therefore, is within the scope of ASC 480. Depending on the facts and circumstances, application of the public company redeemable securities guidance may result in classifying a redeemable NCI outside of permanent equity (i.e., in temporary equity) in the consolidated financial statements. Sometimes this is referred to as mezzanine equity. Temporary or mezzanine equity is a caption that is presented on the balance sheet between liabilities and equity, rather than shown as part of total liabilities or total equity.

Whether the public company redeemable securities guidance is applicable to an instrument depends primarily on the circumstances under which the instrument is redeemable (i.e., is it redeemable at the option of the holder or is the event that would result in redemption solely within the control of the issuer). The complexity involved in analyzing all of the factors included in the public company redeemable security guidance is strongly influenced by the complexity of the redeemable NCI itself and the relevant facts and circumstances. Analyzing the circumstances requires having a sound understanding of the terms of the redeemable NCI, as well as the public company redeemable securities guidance. Additionally, it should be noted that if the public company redeemable securities guidance is applicable, it not only affects the presentation of the NCI in the balance sheet, but also its ongoing measurement. The public company redeemable securities guidance is discussed and illustrated in detail in Section 4.2.3 of our debt and equity guide.

### 10.19.5 Disclosures about the NCI

Specific information about the NCI, including how its fair value was determined, must be disclosed by the buyer in its financial statements (see Section 14.2.5). Additional disclosure requirements apply if the buyer (i.e., parent) is an SEC registrant and there is a redeemable NCI. These additional disclosures should also be provided by a private company that follows the public company redeemable securities guidance.

# 11. Exceptions to the general recognition and measurement guidance

## 11.1 Exceptions to overall recognition and measurement principles

ASC 805's overall recognition and measurement principles are discussed in Section 7.1 and Section 8.1. ASC 805 provides several exceptions to these overall principles, which are listed in the table that follows along with the sections that provide additional discussion on these exceptions:

| Assets or liabilities related to: | Exception to overall recognition principle | Exception to overall measurement principle | Additional discussion |
|---|---|---|---|
| Certain financial assets (after adoption of ASC 326) | | X | Section 10.3 and Section 10.5 |
| Leases (after adoption of ASC 842) | X | X | Section 10.13 |
| Contingencies | X | X | Section 11.2 |
| Indemnification assets | X | X | Section 11.3 |
| Income taxes | X | X | Section 11.4 |
| Employee benefits | X | X | Section 11.5 |
| Reacquired rights | | X | Section 11.6 |
| Share-based payment awards | | X | Section 11.7 and Section 13.4 |
| Assets held for sale | | X | Section 11.8 |
| Contract assets and liabilities (after adoption of ASU 2021-08) | X | X | Section 11.9 |

## 11.2 Preacquisition contingencies

### 11.2.1 General

With limited exceptions, the general contingency guidance provided in ASC 805 applies to all contingencies acquired in a business combination that would otherwise be within the scope of the general gain and loss contingency guidance in ASC 450 (e.g., the guidance applicable to litigation contingencies and assurance-type warranties). The limited exceptions include those contingencies for which ASC 805 provides specific accounting guidance (e.g., indemnification assets, contingent consideration).

It should be noted that one of the challenges related to contingencies acquired in a business combination is ensuring that all of the acquired contingencies are considered by the buyer in the accounting for the business combination. The buyer should take the appropriate steps to ensure that it has considered the accounting implications for all of the acquired contingencies. For example, the buyer should review all agreements entered into in conjunction with the acquisition and have discussions with legal counsel to determine whether all acquired contingencies have been considered in the accounting for the business combination.

### *11Q.2.1.1 Does the accounting for a warranty obligation acquired in a business combination depend on whether it is an assurance-type or service-type warranty?*

The accounting for a warranty obligation acquired in a business combination depends on whether it represents an assurance-type or service-type warranty in the customer contract under ASC 606.

As discussed in more detail in Section 6.5 of our revenue recognition guide, ASC 606 distinguishes between assurance-type warranties and service-type warranties for purposes of identifying performance obligations in a customer contract. An assurance-type warranty only provides assurance that the product complies with agreed-upon specifications. This type of warranty is not a performance obligation under ASC 606, and should instead be accounted for under ASC 460. A service-type warranty provides a service (e.g., maintenance) in addition to the assurance-type warranty. This type of warranty is accounted for as a performance obligation under ASC 606.

When the buyer in a business combination acquires warranties, it should understand whether the warranties are performance obligations under ASC 606. If the warranties are performance obligations, prior to the adoption of ASU 2021-08, a contract liability should be recognized for the warranties and measured at fair value. Section 10.6.2.1 discusses the recognition of contract liabilities prior to the adoption of ASU 2021-08. If the warranties are performance obligations and the entity has adopted ASU 2021-08, we believe the contract liability should be recognized and measured based on the guidance in ASC 606 (except when one of the practical expedients provided in ASC 805-20-30-29 has been elected). Section 11.9.2 discusses the recognition and measurement of contract assets and liabilities after the adoption of ASU 2021-08. Once the liability is recognized (whether at fair value or based on the guidance in ASC 606), the buyer then derecognizes the contract liability based on the guidance in ASC 606. For example, if the buyer applies ASC 606 to the warranty performance obligation and concludes it is satisfied over time, the contract liability recognized in the accounting for the business combination is derecognized over time with the offset to revenue.

When the acquired warranties are not performance obligations, they are preacquisition contingencies. The accounting for preacquisition contingencies acquired in a business combination is addressed in the remainder of this section.

### 11.2.2 Initial accounting

A preacquisition contingency is recognized at its acquisition-date fair value provided that fair value can be determined. For purposes of determining fair value, the guidance in ASC 820 is used. All of the relevant facts and circumstances related to the item being measured should be taken into consideration in the context of this fair value measurement guidance to assess whether the item's fair value can be determined. While it may not be possible to determine the fair value of some preacquisition contingencies, an entity should often be able to determine the fair value of an assurance-type warranty. It is also worth noting that when assessing whether the fair value of a litigation contingency can be determined, the estimated settlement amount for that contingency may not necessarily be the same as the fair value of the contingency.

If the acquisition-date fair value of the preacquisition contingency cannot be determined, then the general contingency guidance in ASC 805 should be used. Using this guidance results in the recognition of an asset or liability for a preacquisition contingency acquired in a business combination if it is probable at the acquisition date that such an asset or liability exists and if its amount is reasonably estimable. For purposes of assessing whether the probable and reasonably estimable thresholds have been met, the applicable definitions and guidance in ASC 450 are used.

A contingent asset or contingent liability is not recognized for a preacquisition contingency in the accounting for the business combination if: (a) its fair value cannot be determined and (b) the probable and reasonably estimable criteria in ASC 805 are not met. Instead, the contingency is disclosed and accounted for subsequent to the acquisition date in accordance with other applicable U.S. GAAP, including the general gain and loss contingency guidance in ASC 450.

The buyer has until the end of the measurement period to assess whether the fair value of the contingency can be determined, or if not, whether the probable and reasonably estimable criteria in ASC 805 are met. However, regardless of whether the fair value or the reasonably estimable amount is used to measure a contingent asset or contingent liability recognized in the accounting for a business combination, both measurements must reflect the facts and circumstances as they existed on the acquisition date. In other words, both are acquisition-date measurements and should not take into consideration facts and circumstances arising after the acquisition date.

### 11.2.3 Measurement period accounting

When an adjustment is made to a contingent asset or liability recognized in the accounting for a business combination, the buyer must determine whether that adjustment should be accounted for as a measurement period adjustment. Section 12.7 explains measurement period adjustments along with the related accounting treatment. If the adjustment is not a measurement period adjustment or an error, Section 11.2.4 discusses how to account for the adjustment.

### 11.2.4 Subsequent accounting

The subsequent accounting guidance for contingent assets and contingent liabilities recognized in the accounting for a business combination: (a) depends on their nature and (b) must be systematic and rational. In essence, the buyer must adopt an accounting policy related to its subsequent accounting for contingent assets and contingent liabilities recognized in the accounting for a business combination, and that accounting policy should refer to other relevant U.S. GAAP as appropriate and should be consistently applied to similar contingent assets and contingent liabilities.

#### *11Q.2.4.1 What accounting policies could the buyer use with respect to the subsequent accounting for contingent liabilities initially recognized at fair value in the accounting for a business combination?*

We understand that the following two accounting policies may be common in practice:

- *Analogy to the subsequent accounting guidance for guarantees in ASC 460*. We understand this accounting policy may be commonly used in practice to subsequently account for assurance-type warranty obligations initially recognized at fair value in the accounting for a business combination. This accounting policy is supported by paragraph B20 in the basis for conclusions of FASB Staff Position (FSP) Financial Accounting Standard (FAS) 141R-1, in which the FASB indicated that a method similar to that used to subsequently account for guarantee liabilities initially recognized at fair value can be a systematic and rational basis to subsequently account for assurance-type warranty obligations initially measured at fair value in the accounting for a business combination. Depending on the facts and circumstances, this accounting policy may also be appropriate for other contingent liabilities initially recognized at fair value in the accounting for a business combination.
- *Analogy to the subsequent accounting guidance for AROs in ASC 410-20*. We understand this accounting policy may be commonly used in practice for contingent liabilities (other than assurance-type warranty obligations) recognized at fair value in the accounting for the business combination because it considers accretion of the liability and changes in the expected cash flows to satisfy the contingent obligation.

#### *11Q.2.4.2 When a contingent liability is initially recognized at fair value in the accounting for a business combination, may the subsequent accounting policy for that liability be based on ASC 450?*

No. Applying a subsequent accounting policy based on ASC 450 to a contingent liability initially recognized at fair value in the accounting for a business combination would likely result in the recognition of a gain or loss immediately after completing the business combination accounting, which would negate the requirement to initially recognize the contingent liability at fair value when the fair value can be determined. In other words, there is no point to requiring the initial recognition of a contingent liability at fair value (when fair value can be determined) in the accounting for a business combination if immediately after the business combination accounting a significant adjustment to the contingent liability would be recorded based on ASC 450.

*11Q.2.4.3 When a contingent liability is initially recognized at fair value in the accounting for a business combination, may the buyer subsequently account for the contingent liability at fair value?*

In general, a contingent liability initially recognized at fair value in the accounting for a business combination should not be subsequently accounted for at fair value unless there is other applicable U.S. GAAP that requires such subsequent accounting. The subsequent accounting guidance in ASC 805 applicable to contingent consideration assets and liabilities (which results in those assets and liabilities being subsequently accounted for at fair value [see Section 12.4.4.2]) is not applicable to the contingent liabilities discussed in this section that are initially recognized at fair value.

*11Q.2.4.4 When a contingent liability is initially recognized at its reasonably estimable amount in the accounting for a business combination, should the buyer subsequently account for that contingent liability using the guidance in ASC 450?*

Yes. Given that ASC 450 is the basis for the guidance in ASC 805 to recognize a contingent liability that is probable of occurring at its reasonably estimable amount when its fair value cannot be determined, we believe ASC 450 should be the basis used to subsequently account for that liability.

### 11.2.5 Income tax effects

The income tax effects of contingencies are discussed in Section 11.4.2 and Section 11.4.4.

### 11.2.6 Disclosures

Specific information about preacquisition contingencies involved in a business combination must be disclosed by the buyer in its financial statements. For additional discussion about these disclosures, see Section 14.2.5.

**Example 11-1: Litigation contingency**

Buyer acquires Target on December 10, 20X1, which is the acquisition date. Buyer has a calendar year end and must submit its annual financial statements to its lender by March 31 of the following year. As of the acquisition date, Target has litigation outstanding against it. Buyer assumes this litigation in the acquisition. Target's previous owners (i.e., the sellers) did not provide Buyer with an indemnification related to this outstanding litigation, and there is no consideration contingent on resolution of the litigation. Consider the following two scenarios:

*Scenario A*

Buyer is not able to determine the fair value of the related contingent liability. As such, Buyer must now determine whether it is probable that a liability has been incurred related to this litigation at the acquisition date and whether the amount of that liability is reasonably estimable in accordance with ASC 805. Buyer concludes it is probable that a liability has been incurred at the acquisition date and that the amount of that liability is reasonably estimable. Based on the information it is able to gather prior to issuing its financial statements for the year ending December 31, 20X1, Buyer initially determines the reasonably estimable amount of this liability to be $750,000 and recognizes a liability using this provisional amount. In addition, Buyer makes the appropriate disclosures in its December 31, 20X1 financial statements about the incomplete accounting for this liability and the business combination in general. On May 31, 20X2, Buyer completes its assessment of the reasonably estimable amount of this liability as of the acquisition date and concludes that a better estimate for the liability as of the acquisition date is $950,000.

*Scenario B*

Buyer is able to determine the fair value of the related contingent liability. Based on the information it is able to gather prior to issuing its financial statements for the year ending December 31, 20X1, Buyer initially determines that the fair value of this liability is $1 million and recognizes a liability using this provisional amount. In addition, Buyer makes the appropriate disclosures in its December 31, 20X1 financial statements about the incomplete accounting for this liability and the business combination in general. On May 31, 20X2, Buyer completes its fair value estimate for this liability and concludes that a better fair value estimate for the liability as of the acquisition date is $1.1 million.

In November 20X2, the plaintiff in the litigation begins to experience severe financial difficulties. Because of those difficulties, Buyer is able to enter into a tentative settlement agreement with the plaintiff in the amount of $400,000 on November 30, 20X2. Final settlement is not expected to occur until early 20X3.

The acquisition-date and subsequent accounting under Scenario A and Scenario B is summarized in the table that follows:

<table>
<tr><th></th><th>Scenario A (Probable and reasonably estimable)</th><th>Scenario B (Fair value)</th></tr>
<tr><td>Acquisition-date accounting in financial statements for year ending December 31, 20X1 given to the lender on March 31, 20X2</td><td>Buyer recognizes a provisional liability of $750,000 in the accounting for the business combination.</td><td>Buyer recognizes a provisional liability of $1 million in the accounting for the business combination.</td></tr>
<tr><td rowspan="2">Accounting for the adjustment determined on May 31, 20X2</td><td>Buyer recognizes a measurement period adjustment on May 31, 20X2, to reflect its final assessment of the best reasonably estimable amount for the contingent liability as of the acquisition date. The measurement period adjustment increases the liability to $950,000 and either:</td><td>Buyer recognizes a measurement period adjustment on May 31, 20X2, to reflect its final estimate of the acquisition-date fair value of the contingent liability. The measurement period adjustment increases the liability to $1.1 million and either:</td></tr>
<tr><td colspan="2">(a) increases the amount of goodwill recognized in the accounting for the business combination or (b) decreases the amount of the gain from a bargain purchase recognized in the accounting for the business combination. The measurement period adjustment is reflected in the reporting period in which the adjustment is determined (which is the month ending May 31, 20X2) and is not retrospectively reflected back to the acquisition date.</td></tr>
</table>

| | Scenario A (Probable and reasonably estimable) | Scenario B (Fair value) |
|---|---|---|
| Accounting for the effects of the tentative settlement agreement | The tentative settlement agreement does not give rise to a measurement period adjustment because the information giving rise to the tentative settlement amount was not about the facts and circumstances in existence at the acquisition date. As such, the accounting for the business combination is unaffected by this development. The buyer's systematic and rational subsequent accounting policy for contingent liabilities recognized in the accounting for a business combination should result in an adjustment to the contingent liability upon entering into the tentative settlement agreement and the effects of that adjustment (e.g., $550,000 in Scenario A, $700,000 in Scenario B) should be reflected in income. | |

## 11.3 Indemnification assets

### 11.3.1 Initial recognition and measurement

In some cases, the seller of the target may contractually indemnify the buyer for the outcome of a contingency. The accounting for this type of indemnification asset depends on whether the indemnified item is recognized in the accounting for the business combination and if so, the basis used to measure the indemnified item. For example, consider the situation in which the seller in a business combination contractually indemnifies the buyer for the unfavorable resolution of the target's open litigation at the acquisition date. In this example, the buyer's accounting for the indemnification asset depends on the buyer's accounting for the litigation (i.e., the indemnified item) (see Section 11.2).

The basic recognition principle for an indemnification asset is that if the indemnified item is recognized in the accounting for the business combination, then the indemnification asset is also recognized. If the indemnified item is not recognized in the accounting for the business combination, then the indemnification asset is also not recognized.

The basic initial measurement principle for an indemnification asset is that the basis used to measure the indemnification asset should be consistent with the basis used to measure the indemnified item. As a result, if the indemnified item is measured at its acquisition-date fair value, then the corresponding indemnification asset is measured at its acquisition-date fair value. If the indemnified item is measured using a basis other than its acquisition-date fair value (e.g., a contingent liability for litigation might have been measured at its reasonably estimable amount), then the measurement of the corresponding indemnification asset uses that same basis and assumptions that are consistent with those used to measure the indemnified item. The need to consider the collectibility of the indemnification asset and any contractual limitations of the indemnification are discussed in Section 11.3.4.

### 11.3.2 Measurement period adjustments

Depending on the facts and circumstances, an indemnification asset may be subject to a measurement period adjustment after it is initially recognized in the accounting for the business combination (see Section 12.7). A measurement period adjustment that changes the amount recorded for the indemnified item would likely give rise to a measurement period adjustment that changes the amount recorded for the corresponding indemnification asset. These measurement period adjustments should be reflected in the accounting for the business combination. To the extent the measurement period adjustments are for the same amount, goodwill would generally not be affected.

### 11.3.3 Subsequent measurement

The subsequent measurement of an indemnification asset follows the subsequent measurement of the indemnified item. In other words, the same basis that is used to measure the indemnified asset or liability is used to measure the indemnification asset. The need to consider the collectibility of the indemnification asset and any contractual limitations of the indemnification are discussed in Section 11.3.4.

If both the indemnified asset or liability and the indemnification asset are remeasured at the end of a subsequent reporting period, the change in each should be presented in the income statement in accordance with the applicable U.S. GAAP. In many cases, this will result in the change in the indemnified asset or liability and the change in the indemnification asset offsetting each other in the same line item of the income statement (i.e., the changes are effectively reflected on a net basis in the income statement). In other situations, though, it may be necessary to reflect the change in the indemnified asset or liability in one line item on the income statement and the change in the indemnification asset on a different line item (i.e., the changes would be recorded gross in the income statement). One such situation is when the indemnified liability relates to an uncertain tax position. Any change in the indemnified liability would likely be reported in the income tax line item in accordance with ASC 740 and the corresponding change in the indemnification asset would be reported as an expense or gain based on other applicable U.S. GAAP. In addition, as discussed in ASC 805-20-35-4B, special considerations are involved in the subsequent accounting for an indemnification asset that arises in a government-assisted acquisition of a financial institution.

Consider a situation in which the buyer recognizes both an indemnified liability and an indemnification asset for $1 million in the accounting for the business combination. In addition, in a subsequent reporting period, the buyer determines that both the indemnified liability and the indemnification asset need to be reduced by $300,000 (which is not a measurement period adjustment). Whether the $300,000 change in the indemnified liability and the $300,000 change in the indemnification asset are effectively reflected on a gross or net basis in the income statement depends on the nature of the indemnified liability. If the indemnified liability represents a litigation contingency, then the $300,000 decrease in the contingent liability and the $300,000 decrease in the indemnification asset would most likely be recorded in the same line item on the income statement within operating income (e.g., operating expenses). If the indemnified liability represents an uncertain tax position, then the $300,000 decrease in the income tax liability would likely be recorded in the income tax line item (as discussed earlier) and the $300,000 decrease in the indemnification asset would likely be recorded in a line item on the income statement within operating income.

### 11.3.4 Collectibility and contractual limitations

The initial and subsequent measurement of an indemnification asset is subject to an assessment of its collectibility and contractual limitations. If the indemnification asset is measured at its fair value, both of these issues should inherently be reflected in the fair value estimate of the indemnification asset, and a valuation allowance for the indemnification asset should not be necessary. If the indemnification asset is measured using a basis other than fair value, then the buyer should ensure that the net indemnification asset recognized incorporates both the buyer's assessment of the collectibility of the indemnification asset and any contractual limitations present in the indemnification. Assessing the collectibility of an indemnification asset measured at other than fair value may result in recognition of a valuation allowance.

### 11.3.5 Derecognition

An indemnification asset is derecognized only upon the occurrence of one of the following three events: (1) the buyer collects the asset, (2) the buyer sells the asset or (3) the buyer otherwise loses the right to the asset.

#### 11.3.6 Disclosures

Specific information about indemnification assets recognized in the accounting for a business combination must be disclosed by the buyer in its financial statements (see Section 14.2.5).

## 11.4 Income taxes

### 11.4.1 General

ASC 805-740 provides guidance on how to account for the income tax effects of a business combination. The recognition and measurement principles used to account for the income tax effects of a business combination differ, in the following ways, from the general recognition and measurement principles in ASC 805:

- From a recognition perspective, deferred tax assets and liabilities are recognized in accordance with ASC 740 instead of being recognized based solely on whether those assets and liabilities meet the technical definitions of assets and liabilities included in CON 8 (which is the general recognition principle in ASC 805). While ASC 740 follows an asset and liability approach to accounting for income taxes, it does not rely on those definitions for purposes of identifying the deferred tax assets and liabilities that should be recognized by an entity. However, for all practical purposes, there should be very few cases in which the assets and liabilities recognized as a result of applying the recognition guidance in ASC 740 differ from those that would be recognized as a result of using the definitions in CON 8.
- From a measurement perspective, the amounts recognized for deferred tax assets and liabilities are determined in accordance with ASC 740, which uses undiscounted amounts to measure deferred tax assets and liabilities (except for those related to leveraged leases after the effective date of ASC 842) and uncertain tax positions. In addition, ASC 740 measures tax positions that meet its more-likely-than-not threshold at the largest amount of tax benefit that is more than 50% likely of being realized upon ultimate settlement with a taxing authority. The measurement approaches used in ASC 740 are fundamentally different from the fair value measurement principle used in ASC 805.

The effects of a business combination on the buyer's accounting for income taxes depends on whether the acquisition was treated as a taxable or nontaxable transaction. The difference between the two types of transactions is discussed in detail in Section 11.4.1.1. Following is a list of additional income-tax-related accounting topics that are discussed in detail in the remainder of Section 11.4:

- Acquired temporary differences and loss or credit carryforwards, including deferred tax asset valuation allowances (acquisition-date accounting issue) (see Section 11.4.2)
- Change in buyer's preexisting valuation allowance (acquisition-date accounting issue) (see Section 11.4.3)
- Tax treatment of contingent consideration (acquisition-date and subsequent accounting issues) (see Section 11.4.4)
- Difference between tax-deductible goodwill and goodwill for book purposes (acquisition-date accounting issue) (see Section 11.4.5)
- Tax treatment of transaction costs (acquisition-date accounting issue) (see Section 11.4.6)
- Change in valuation allowance or uncertain tax positions that were recorded in the acquisition-date accounting (subsequent accounting issue) (see Section 11.4.7)

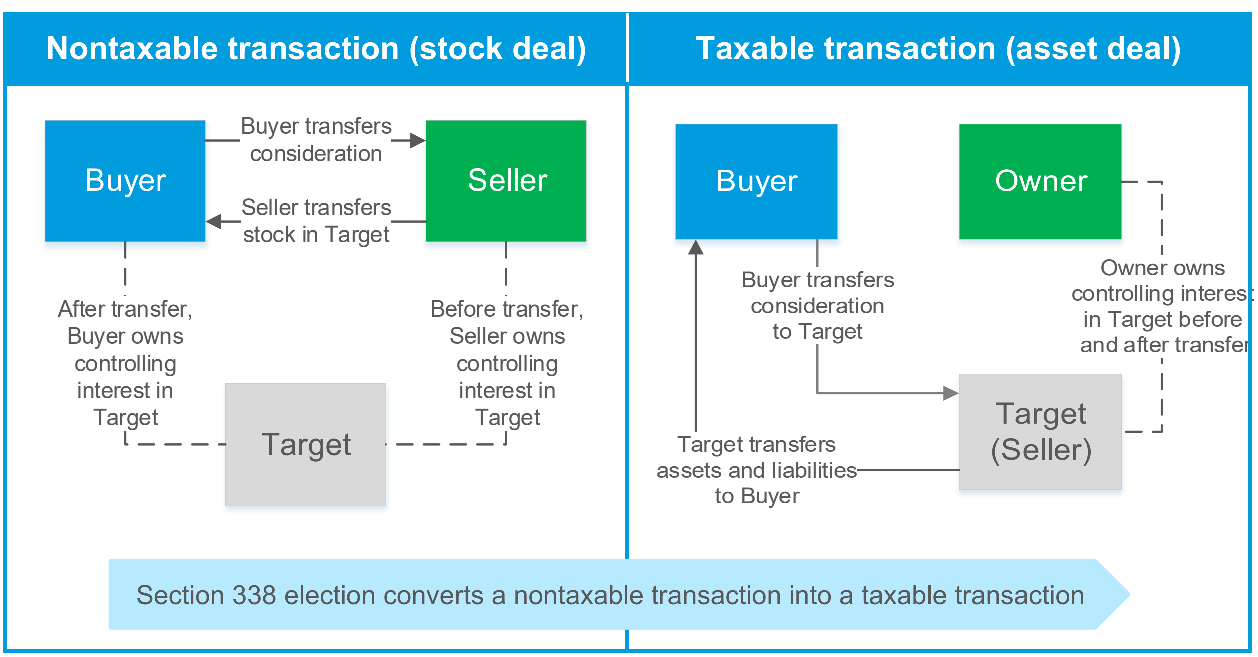
### 11.4.1.1 Acquisition treated as taxable or nontaxable transaction

For income tax purposes, business combinations are treated as either a taxable or nontaxable transaction, which is determined at the entity level. Taxable transactions are taxable to the target because the assets, and often the liabilities, are sold and assigned to the buyer. The target pays tax on the transaction and the buyer's tax bases in the assets and liabilities are stepped up, generally to fair value. These transactions are often referred to as asset deals. Nontaxable transactions are generally not taxable to the target because the ownership interests (i.e., C corporation shares) are sold to the buyer. These transactions are often referred to as stock deals. However, a buyer in a sale of a partnership or LLC interest, under certain circumstances, may have a taxable transaction. The major distinction between a taxable and nontaxable transaction is that a taxable transaction results in the buyer having a tax basis in the acquired assets and liabilities equal to the consideration that is paid for those assets; while a nontaxable transaction results in the buyer generally having a carryover tax basis in the acquired assets and liabilities. Transactions may also be partially taxable and partially nontaxable.

Taxable transactions will have few temporary differences because the book bases and tax bases of the acquired assets and liabilities will be the same amounts for most assets and liabilities. Conversely, nontaxable transactions will often result in many temporary differences because the tax bases of the assets and liabilities of the target will be the same after the acquisition as they were before the acquisition (i.e., carryover basis is used for tax purposes), while the book bases will be based predominantly on the acquisition-date fair values of the assets and liabilities of the target as required by ASC 805.

Under appropriate circumstances, the U.S. Internal Revenue Code provides elections to treat certain transactions that are structured as sales of entities (such as the sale of stock in an entity) as a purchase of assets by the buyer. One such election is a section 338 election (either a section 338[h][10] election, which is a joint election between a buyer and seller, or a section 338[g] election, which is a unilateral election by a buyer).

The table that follows illustrates and compares key elements of nontaxable and taxable transactions. Keep in mind that whether there is a transfer of stock in a nontaxable transaction or a transfer of assets and liabilities in a taxable transaction, the transfer must meet the definition of a business combination (see Section 2.1) to be in the scope of ASC 805, which includes the target or assets and liabilities sold by the target meeting the definition of a business (see Section 4.1).



| Nontaxable transaction (stock deal) | Taxable transaction (asset deal) |
|---|---|
| • Book bases of Target's assets are stepped up (primarily to fair value) under ASC 805.<br>• Tax bases of Target's assets are not stepped up because the transaction is not taxable to Target.<br>• Results in many temporary differences and deferred taxes. | • Book bases of Target's assets are stepped up (primarily to fair value) under ASC 805.<br>• Tax bases of Target's assets are stepped up because the transaction is taxable to Target.<br>• Results in relatively few temporary differences and deferred taxes. |

For purposes of the discussion in this guide, unless otherwise noted, when referring to the target in a business combination, we are referring to either: (a) the target itself, which is being acquired through a nontaxable transaction (or stock deal) or (b) the acquisition of assets and liabilities from the target through a taxable transaction (or asset deal).

### 11.4.2 Acquisition-date accounting: Acquired temporary differences and loss or credit carryforwards

Temporary differences may arise as a result of recognizing the identifiable assets acquired and liabilities assumed in a business combination in accordance with ASC 805. These temporary differences arise if the recognized amounts under ASC 805 (or book bases) differ from the tax bases of the acquired assets and assumed liabilities determined in accordance with the provisions of the enacted tax law. With limited exceptions, ASC 805-740 requires that deferred tax assets or liabilities be recognized as appropriate for these temporary differences, as well as any prior net operating loss (NOL) carryforwards, interest expense carryforwards (see Section 11.4.2.1) or credit carryforwards of the target that continue to be available to offset taxable income after the acquisition. These carryforwards typically only exist in nontaxable transactions (or stock deals) because they involve acquisition of the target as a legal entity as compared to taxable transactions (or asset deals), which involve acquisition of assets and liabilities of the target. In addition, while these carryforwards follow the target in a nontaxable transaction (or stock deal), they may be reduced or limited as a result of the transaction.

Specialized guidance exists with respect to the accounting for the tax effects of:

- The portion of goodwill for book purposes for which amortization or impairment is not deductible for tax purposes (which is addressed in Section 11.4.5)
- Leveraged leases acquired in a business combination (see ASC 840-30-30-15 before the effective date of ASC 842, and ASC 842-50 after the effective date of ASC 842)
- Various taxable temporary differences covered by ASC 740-10-25-3(a) (e.g., undistributed earnings of subsidiaries) that may be acquired in a business combination

The guidance in ASC 805-740 also applies to the accounting for the effects of uncertain tax positions that: (a) exist at the target as of the acquisition date or (b) arise as a result of the business combination. The effects of the uncertain tax positions should be reflected in the deferred tax assets or liabilities, payables to or receivables from taxing authorities or a liability for unrecognized tax benefits recognized in the accounting for the business combination.

As discussed in more detail in Section 11.4.1.1, taxable transactions (or asset deals) will have relatively few temporary differences as the book bases and tax bases of the acquired assets and liabilities will be the same amounts for most of those assets and liabilities. Those few temporary differences can result from differences between the agreed-upon allocation of purchase price for tax purposes and the fair value (or other appropriate amount) recognized for book purposes, or differences in the treatment of certain assets and liabilities for tax purposes vs. book purposes. One of the few temporary differences that could arise in a taxable transaction relates to a liability for a contingency recognized for book purposes that will not be deductible or added to the basis of tax-deductible goodwill for income tax purposes until paid. The deferred tax effects of this temporary difference when settlement of the liability will result in an immediate tax deduction are illustrated in Example 11-2. The deferred tax effects of this temporary difference when settlement of the liability will result in an increase in tax-deductible goodwill are discussed and illustrated in Section 11.4.4 and Example 11-5.

The following two examples illustrate the accounting for an acquired temporary difference related to a preacquisition contingency of the target and an acquired NOL carryforward.

**Example 11-2: Accounting for an acquired temporary difference related to a preacquisition contingency**

In its accounting for a business combination, Buyer recognizes a liability (in the amount of $1 million) for a preacquisition contingency of Target. For tax purposes (regardless of whether the business combination is treated as a taxable or nontaxable transaction), a liability will not be recognized at the acquisition date, and therefore, the tax basis of the liability is zero. The settlement of the liability will result in an immediate tax deduction rather than an increase to tax-deductible goodwill.

In the accounting for the business combination, Buyer identifies a deductible temporary difference of $1 million, which is the difference between the book basis of the liability ($1 million) and the tax basis of the liability ($0). If Buyer's tax rate is 30%, a deferred tax asset of $300,000 would be recognized by Buyer in the accounting for the business combination. If the settlement of the contingent liability resulted in additional tax-deductible goodwill in this illustration instead of an immediate tax deduction, the computation of the deferred tax asset would be consistent with the computation of the deferred tax asset that would arise when the settlement of contingent consideration results in additional tax-deductible goodwill, which is illustrated in Example 11-6.

**Example 11-3: Accounting for an acquired NOL carryforward**

Target has $5 million of NOL carryforwards that are being acquired by Buyer in the business combination (which is treated as a nontaxable transaction for tax purposes) and the carryforwards will be available to offset taxable income after the acquisition. If Buyer's tax rate is 30%, a deferred tax asset of $1.5 million is recorded by Buyer in the accounting for the business combination (subject to a potential valuation allowance as discussed in Section 11.4.2.1).

#### 11.4.2.1 Recognition of valuation allowances on deferred tax assets, including consideration of deferred tax assets and liabilities with indefinite reversal patterns

When the buyer recognizes deferred tax assets for deductible temporary differences (including interest expense carryforwards, which result from section 163(j) of the U.S. Internal Revenue Code as changed by the Tax Cuts and Jobs Act (TCJA)) or NOL and tax credit carryforwards in the accounting for a business combination, the buyer must also determine whether that accounting should reflect a valuation allowance for some or all of the gross deferred tax assets. The indefinite nature of any preexisting or acquisition-related NOL, interest expense and other carryforwards is an important consideration in addressing whether a buyer will be able to realize the deferred tax assets recognized in its accounting for the business combination.

ASC 740-10-30-18 includes the following four sources of taxable income that entities may consider as support for the realization of deferred tax assets:

a. Future reversals of existing taxable temporary differences

b. Future taxable income exclusive of reversing temporary differences and carryforwards

c. Taxable income in prior carryback years if carryback is permitted under the tax law

d. Tax-planning strategies (see paragraph 740-10-30-19 that would, if necessary, be implemented to, for example:

    1. Accelerate taxable amounts to utilize expiring carryforwards

    2. Change the character of taxable or deductible amounts from ordinary income or loss to capital gain or loss

    3. Switch from tax-exempt to taxable investments.

In addition, ASC 740-10-30-18 indicates that to the extent one (or more) sources of taxable income is (are) sufficient to support a conclusion that a valuation allowance is not necessary, other remaining sources need not be considered.

Because the TCJA (as amended by the Coronavirus Aid, Relief, and Economic Security Act) eliminated carrybacks for NOLs generated in years ending after December 31, 2020, the third source of taxable income listed in ASC 740-10-30-18 is somewhat limited in application. In addition, it is uncommon for the fourth source of taxable income to serve as the basis for realizing deferred tax assets recognized in the accounting for a business combination. Consequently, the analysis to support the realization of deferred tax assets rests largely on the first two sources of taxable income.

The modeling of the future reversal of existing taxable temporary differences or future taxable income (in accordance with ASC 740-10-30-18[a] and 30-18[b]) requires careful consideration for the following reasons:

- The interest expense that may be deducted after the TCJA is limited to 30% of adjusted taxable income. The interest expense in excess of the 30% limitation can be carried forward indefinitely, and therefore, creates an indefinite-lived deferred tax asset.
- The NOLs generated in tax years ending on or after December 31, 2017 are limited to 80% of taxable income. Those NOLs can be carried forward indefinitely, and therefore, create an indefinite-lived deferred tax asset. However, NOLs from years beginning before January 1, 2018 continue to have limited lives.
- U.S. Internal Revenue Code section 382 limits the amount of federal NOLs, interest expense carryforwards and tax credit carryforwards (collectively referred to as *tax attributes*) that may be used when there has been more than a 50% change in ownership of a business. These limitations must be considered in determining the ability to realize these tax attributes. States and foreign jurisdictions may have similar limitations.

In the analysis to determine whether deferred tax assets are realizable, the 30% interest expense limitation is considered before the 80% of taxable income limitation applicable to NOL carryforwards. In addition, when considering the source of taxable income listed in ASC 740-10-30-18(a), if a deductible temporary difference (other than one resulting from an interest expense carryforward) reverses prior to the existing taxable temporary differences, that deductible temporary difference will convert into an indefinite-lived NOL carryforward and deferred tax asset.

In addition to indefinite-lived deferred tax assets, there are also indefinite-lived deferred tax liabilities arising from the tax effects of amortizing indefinite-lived intangible assets and goodwill for tax purposes, while for book purposes, such assets are not amortized (unless for goodwill purposes, the private-company goodwill amortization alternative has been elected, in which case goodwill is amortized [see

Section 18.3]).If the private-company goodwill amortization alternative has been elected, and book goodwill is amortized, there are finite-lived intangible assets resulting from the tax effects of the differences between the amortization period for tax purposes (5 years under IRS Section 179) and the amortization period for book purposes (generally 10 years).

In evaluating whether the buyer will generate sufficient future taxable income from the reversal of existing taxable temporary differences, the buyer need only consider the attributes of the temporary differences (e.g., amounts, reversal patterns) as of the acquisition date. In other words, even if the buyer is forecasting significant amounts of interest expense and expects these amounts to be limited under section 163(j) of the U.S. Internal Revenue Code as changed by the TCJA, when the buyer is relying on taxable temporary differences as a source of future income, its analysis should only reflect the interest expense carryforwards as of the acquisition date. An analysis of future interest expense and taxable income would be a separate source of taxable income under ASC 740-10-30-18(b).

While the following example presents a very simplistic fact pattern, it still illustrates the extreme complexity involved in assessing whether the buyer should recognize a valuation allowance on the deferred tax assets that will be recognized in the accounting for a business combination. We strongly recommend consulting with an income tax accounting subject matter expert to assist in this assessment.

**Example 11-4: Recognizing a valuation allowance on deferred tax assets, including consideration of deferred tax assets and liabilities with indefinite reversal patterns**

[**Note:** The example that follows is presented to illustrate the mechanics of evaluating the realizability of deferred tax assets to be recognized in the accounting for a business combination. To do so in as simplistic way as possible, the facts of this example are very basic. Keep in mind that any changes to the facts would significantly affect the evaluation of whether a valuation allowance is necessary. In addition, this example focuses on the deferred tax liability created by an indefinite-lived taxable temporary difference as the only basis to analyze the realizability of deductible temporary differences and the deferred tax assets created by those differences. If the taxable temporary difference in this example was not indefinite-lived, scheduling out the reversal of all the temporary differences would be required.]

Buyer acquires Target and will be accounting for the acquisition as a business combination. Buyer's tax rate is 30%.

Prior to the acquisition occurring, the only temporary differences for which Buyer has recognized deferred taxes is a $25 million indefinite-lived taxable temporary difference (for which Buyer has recognized a deferred tax liability because the tax basis is less than the book value). In the accounting for the business combination, the only deferred taxes recognized by Buyer are the following: (a) $3 million deferred tax asset for an interest expense carryforward deductible temporary difference of $10 million and (b) $4.5 million of deferred tax assets related to other deductible temporary differences of $15 million. Buyer forecasts that the $3 million deferred tax asset for the interest expense carryforward will grow by $1 million in each of the following five years based on forecasted book income and expected interest expense. Buyer first analyzes the need for a valuation allowance using the future reversal of existing taxable temporary differences (which is the source of income in ASC 740-10-30-18[a]).

In this step of the valuation allowance analysis, Buyer ignores the potential for the future growth in the interest expense carryforward caused by the future limitation and compares the $10 million existing interest expense carryforward deductible temporary difference to the 30% limitation of the $25 million indefinite-lived taxable temporary difference. Because the allowable interest expense of $7.5 million ($25 million × 30% limitation) on the $25 million of projected taxable income related to the indefinite-lived taxable temporary difference is less than the $10 million interest expense carryforward deductible temporary difference, Buyer would recognize a valuation allowance in the amount of $750,000 ([$10 million − $7.5 million] × 30% tax rate) on the $3 million deferred tax asset for the interest expense carryforward.

Continuing with this step of the valuation allowance analysis, after deducting the allowable interest expense of $7.5 million from the $25 million of adjusted taxable income related to the indefinite-lived taxable temporary difference there is $17.5 million of adjusted taxable income available to support the realizability of some or all of the other deductible temporary differences present in or resulting from the business combination of $15 million. While the $15 million of deductible temporary differences are not themselves indefinite lived, using the indefinite-lived taxable temporary difference to support their realizability is appropriate because those deductible temporary differences would hypothetically result in NOL carryforwards as they reverse, which are indefinite lived. Because post-2017 NOLs may only offset 80% of taxable income, only $14 million ($17.5 million × 80%) of the taxable temporary difference may be used to support the realizability of the other $15 million of deductible temporary differences. Therefore, Buyer would recognize a valuation allowance of $300,000 ([$15 million − $14 million] × 30% tax rate) on the remaining $4.5 million in deferred tax assets.

In summary, evaluating the realizability of deferred tax assets based on the income source in ASC 740-10-30-18(a) would require a valuation allowance of $1.05 million ([$2.5 million of interest expense carryforward deductible temporary difference that could not be offset by reversing taxable temporary differences + $1 million of other deductible temporary differences that could not be offset by taxable temporary differences] × 30% tax rate). Assuming that Buyer evaluated the other income sources in ASC 740-10-30-18 and determined those methods would all result in valuation allowances greater than $1.05 million, $6.45 million ($7.5 million gross deferred tax asset net of $1.05 million valuation allowance) of net deferred tax assets would be recognized in the accounting for the business combination.

The following table summarizes the calculations discussed in this example.

| | Gross timing difference | Deferred tax asset in accounting for business combination |
|---|---|---|
| Taxable temporary differences as a source of income (or adjusted taxable income) | $25,000,000 | |
| 30% of adjusted taxable income is maximum interest deduction | 30% | |
| Maximum amount of taxable temporary differences that are available to support realizability of an interest expense carryforward | $7,500,000 | |
| Actual amount of deductible temporary differences (and deferred tax asset at tax rate of 30%) for interest expense carryforward | $10,000,000 | $3,000,000 |
| Valuation allowance on deductible temporary differences (and deferred tax asset at tax rate of 30%) for interest expense carryforward | ($2,500,000) | ($750,000) |
| Remaining amount of taxable temporary differences that are available to support realizability of other deductible temporary differences ($25,000,000 − $7,500,000) | $17,500,000 | |
| NOL carryforwards may only offset 80% of taxable income | 80% | |

| | Gross timing difference | Deferred tax asset in accounting for business combination |
|---|---|---|
| Maximum amount of taxable temporary differences available to support realizability of other deductible temporary differences | $14,000,000 | |
| Actual amount of other deductible temporary differences (and deferred tax asset at tax rate of 30%) | $15,000,000 | $4,500,000 |
| Valuation allowance on deductible temporary differences (and deferred tax asset at tax rate of 30%) | ($1,000,000) | ($300,000) |
| Net deferred tax asset recognized in the accounting for the business combination ($3,000,000 − $750,000 + $4,500,000 − $300,000) (absent the other sources of income in ASC 740-10-30-18 providing a basis to recognize a smaller valuation allowance) | | $6,450,000 |

### 11.4.3 Acquisition-date accounting: Change in buyer's preexisting valuation allowance

The buyer's acquisition of a target may affect its assessment of the realizability of its own preexisting deferred tax assets. For example, as a result of the acquisition, the buyer may determine that a previously recorded valuation allowance on its deferred tax assets is no longer needed. Because of this, the buyer reverses the valuation allowance concurrent with the accounting for the business combination. The question that arises in this situation is whether the reversal of the valuation allowance should be accounted for as part of the business combination or as any other reversal of (or reduction in) a valuation allowance. A reversal or reduction of the buyer's preexisting valuation allowance resulting from the acquisition of a business should be treated the same as other reversals or reductions of valuation allowances. That is, reversals or reductions of the buyer's preexisting valuation allowance as a result of a business combination: (a) should be reflected as an income tax benefit or, in certain limited situations, as a credit to contributed capital as required by ASC 740-10-45-20 and (b) should not be reflected in the accounting for the business combination.

In rare cases, a valuation allowance previously recorded by the buyer may need to be increased as a result of an acquisition of a business. Such an increase is reflected in the tax provision and does not affect the accounting for the business combination.

The effects a business combination has on the buyer's preexisting valuation allowances is required to be disclosed to give users of the financial statements the opportunity to understand the true nature and financial effects of a business combination (see Section 14.2.7).

### 11.4.4 Acquisition-date and subsequent accounting: Tax treatment of contingent consideration

#### 11.4.4.1 Acquisition-date accounting: Contingent consideration in a taxable transaction

Usually, contingent consideration transferred in a business combination is not recognized for income tax purposes until the amount is fixed and determinable, or in some cases, until the contingent consideration has been settled. However, for book purposes, contingent consideration is recorded as of the acquisition date at its estimated fair value (see Section 12.4.2). In a taxable transaction, the settlement of the contingent consideration usually increases (if amounts are paid by the buyer) or decreases (if amounts are received by the buyer) tax-deductible goodwill. Therefore, to compute the related deferred tax effects of the contingent consideration, the fair value of the contingent consideration at the acquisition date is used to adjust the tax-deductible goodwill. This computation method should also be used in those cases where the settlement of an acquired contingent liability results in additional tax-deductible goodwill rather than an immediate tax deduction (which was illustrated in Example 11-2).

**Example 11-5: Calculation of deferred tax asset and goodwill when there is contingent consideration**

Buyer acquires Target in a taxable business combination and estimates the fair value of the contingent consideration to be $1 million at the acquisition date. Goodwill for book purposes is $1.2 million, the calculation of which includes the contingent consideration, but does not include the tax effects of the contingent consideration. Tax-deductible goodwill before the contingent consideration is considered is $500,000. The applicable tax rate for all periods is 30%, and when the contingent consideration is settled, it will result in additional tax-deductible goodwill.

To determine the deferred tax effects of the contingent consideration as of the acquisition date, the difference between goodwill for book purposes and tax-deductible goodwill should be calculated assuming that the contingent consideration will be settled at its acquisition-date fair value. Because initial goodwill for book purposes ($1.2 million) is less than tax-deductible goodwill after including the acquisition-date fair value of the contingent consideration ($1.5 million [$1 million + $500,000]), a deferred tax asset of $128,571 should be recorded along with a reduction to goodwill for book purposes of $128,571 (see Example 11-7 for an illustration of how the deferred tax asset is calculated in these facts and circumstances).

If initial goodwill for book purposes had been in excess of tax-deductible goodwill, no deferred tax liability would have been recorded.

#### 11.4.4.2 Subsequent accounting: Contingent consideration in a taxable transaction

For book purposes, adjustments to contingent consideration classified as a liability to reflect subsequent changes in its estimated fair value are almost always recorded in the income statement (see Section 12.4.4) unless the change is a result of a measurement period adjustment (see Section 12.7). Subsequent adjustments to the fair value of contingent consideration are recognized in the income statement for book purposes because they are considered to be outside of (or separate from) the accounting for the business combination. As such, those adjustments do not affect book goodwill. To the extent the subsequent adjustment to contingent consideration for book purposes indicates that taxable goodwill will be increased or decreased upon the ultimate settlement of the contingent consideration, deferred taxes should be recognized related to the subsequent adjustment. This is true even if the goodwill for book purposes exceeded tax-deductible goodwill at the acquisition date, and therefore, the buyer did not originally record related deferred taxes for that excess in the accounting for the business combination (i.e., the comparison of goodwill for book purposes to tax deductible goodwill is not reperformed when a subsequent adjustment occurs) (see Section 11.4.5).

If the estimated fair value of contingent consideration in a taxable transaction subsequently increases (e.g., increases a contingent consideration liability recognized in the accounting for the business combination), a deferred tax asset would be recognized outside of the business combination as a result of future tax deductions from tax-deductible goodwill in excess of the original estimated amount. If the estimated fair value of contingent consideration in a taxable transaction subsequently decreases (e.g., decreases a contingent consideration liability recognized in the accounting for the business combination), the decrease is treated similar to the amortization of tax-deductible goodwill and would first reduce any previously recognized deferred tax asset related to the goodwill until that asset is reduced to zero, at which time the excess would create a deferred tax liability. Example 11-6 illustrates this result. The remaining deferred tax asset or liability is ultimately derecognized in the future as tax-deductible goodwill is amortized or book goodwill is impaired or amortized under the private-company goodwill amortization alternative (see Section 18.3) or otherwise disposed of by the buyer.

**Example 11-6: Accounting for the deferred tax effects of subsequent adjustments to contingent consideration**

Reconsider Example 11-5 and further assume:

- There was no change in the fair value of contingent consideration between the acquisition date and the end of the first fiscal year (Year 1).
- The fair value of the contingent consideration decreased to $400,000 at the end of the second fiscal year (Year 2).
- The contingent consideration was settled in cash for $600,000 in the third fiscal year (Year 3).
- The changes in the fair value of the contingent consideration resulted in a reduction (Year 2) or increase (Year 3) to tax-deductible goodwill.
- Buyer has not elected the private-company goodwill amortization alternative (see Section 18.3), and as a result, does not amortize goodwill.

For ease of illustration, the effect of the amortization of tax-deductible goodwill is ignored in the illustration. The journal entries that would be recorded in Years 2 and 3 are as follows:

*Journal entry in Year 2:*

| | Debit | Credit |
|---|---|---|
| Liability for contingent consideration (Note 1) | $600,000 | |
| Deferred tax expense (Note 2) | 180,000 | |
| Deferred tax asset (Note 3) | | $128,571 |
| Deferred tax liability (Note 4) | | 51,429 |
| Other income and expense (Notes 1 and 5) | | 600,000 |

**Note 1:** This represents the difference between the contingent consideration liability recognized as of the acquisition date ($1 million) and the fair value of the contingent consideration liability at the end of the second fiscal year ($400,000).
**Note 2:** Calculated as follows: $600,000 decrease in liability for contingent consideration × 30% tax rate.
**Note 3:** This represents the reversal of the deferred tax asset recognized in the accounting for the business combination (see Example 11-5).
**Note 4:** This represents the balance of the tax basis difference caused by the reduction in the liability for contingent consideration ($180,000 total deferred tax effects [see Note 2] less the $128,571 reversal of the previously recorded deferred tax asset [see Note 3]).
**Note 5:** ASC 805 does not address the classification of this amount in the income statement. However, we believe that this amount should be included in the determination of operating income (loss) if the contingent consideration is a not a derivative. The classification of this amount if the contingent consideration is a derivative depends on the facts and circumstances.

*Journal entry in Year 3 to adjust contingent consideration liability to settlement amount:*

| | Debit | Credit |
|---|---|---|
| Other income and expense (Notes 1 and 2) | $200,000 | |
| Deferred tax asset (Note 3) | 8,571 | |
| Deferred tax liability (Note 4) | 51,429 | |
| Liability for contingent consideration (Note 1) | | $200,000 |
| Deferred tax expense (Note 5) | | 60,000 |

**Note 1:** This represents the difference between the contingent consideration liability as of the end of the second fiscal year ($400,000) and the settlement amount of the contingent consideration liability determined in the third fiscal year ($600,000).
**Note 2:** ASC 805 does not address the classification of this amount in the income statement. However, we believe that this amount should be included in the determination of operating income (loss) if the contingent consideration is a not a derivative. The classification of this amount if the contingent consideration is a derivative depends on the facts and circumstances.
**Note 3:** This represents the balance of the tax basis difference caused by the increase in the liability for contingent consideration ($60,000 total deferred tax effects [see Note 5] less the $51,429 reversal of the previously recorded deferred tax liability [see Note 4]).
**Note 4:** This represents the reversal of the deferred tax liability recorded in Year 2.
**Note 5:** Calculated as follows: $200,000 increase in liability for contingent consideration × 30% tax rate.

*Journal entry in Year 3 to record payment of liability for contingent consideration:*

| | Debit | Credit |
|---|---|---|
| Liability for contingent consideration | $600,000 | |
| Cash | | $600,000 |

Upon settlement of the contingent consideration, the balance in the deferred tax asset represents the deferred tax asset originally recognized less the tax effects of the amortization of tax-deductible goodwill. For ease of illustration, we ignored the actual tax amortization of goodwill taken on the tax return. As such, the amortization of tax-deductible goodwill in the following table only reflects the tax effects of the decrease in contingent consideration.

| | |
|---|---|
| Original tax-deductible goodwill recognized on the acquisition date (Note 1) | $1,500,000 |
| Final tax-deductible goodwill (Note 2) | 1,100,000 |
| Decrease in (or amortization of) tax-deductible goodwill from the change in fair value of contingent consideration | $400,000 |
| Tax effects of decrease in (or amortization of) tax-deductible goodwill (Note 3) | $120,000 |
| Original deferred tax asset (Note 1) | 128,571 |
| Deferred tax asset balance upon settlement of contingent consideration | $8,571 |

**Note 1:** See Example 11-5.
**Note 2:** $500,000 before considering contingent consideration (see Example 11-5) + $600,000 contingent consideration paid.
**Note 3:** $400,000 decrease in (or amortization of) tax-deductible goodwill × 30% tax rate.

The remaining deferred tax asset of $8,571 is ultimately derecognized in the future as tax-deductible goodwill is amortized or disposed of by Buyer.

The analysis performed in this example would have been the same if a contingent liability was involved instead of a contingent consideration liability and the settlement of the contingent liability would result in additional tax-deductible goodwill.

### 11.4.4.3 Contingent consideration in a nontaxable transaction

Generally, contingent consideration in a nontaxable transaction increases the outside tax basis of the investment in the target rather than the tax bases of the assets and liabilities acquired. Detailed discussions regarding when it is appropriate to provide for deferred taxes on outside basis differences of subsidiaries is beyond the scope of the guide given the additional complexity involved. However, unless the buyer is providing deferred taxes on outside basis differences, deferred taxes would not otherwise be affected by the contingent consideration in a nontaxable transaction at the acquisition date or upon subsequent adjustment or settlement. Therefore, subsequent changes in the amount of contingent consideration would result in permanent differences in the tax-rate reconciliation.

##### 11.4.4.4 Tax issue related to resolution of a specific tax position that could give rise to contingent consideration

A tax issue that could give rise to contingent consideration involves resolution of a specific tax position. Consider a situation in which the acquisition agreement specifies that resolution of a specific tax position taken by the target before the acquisition is resolved after the acquisition and results in the target receiving (and the buyer benefiting from) a refund from the taxing authority. In light of this possibility, the buyer and seller may include in the acquisition agreement a requirement for the buyer to pay the seller additional consideration contingent upon the target receiving a refund from the taxing authority as a result of the specific tax issue being favorably resolved. In this situation, the buyer should: (a) apply ASC 740 to determine whether a receivable from the taxing authority related to the specific tax position should be recognized in the accounting for the business combination and (b) recognize a contingent consideration liability at its fair value in the accounting for the business combination. In addition, the buyer should also consider whether there are deferred tax implications related to the amounts recorded.

##### 11.4.4.5 Tax issue related to section 338 election that should not give rise to contingent consideration

In practice, the buyer and seller may make an amendment to the acquisition agreement (or reach a separate agreement) after closing to include a provision requiring the payment of additional consideration upon a section 338 election being made. Because the amended or separate agreement is executed after the acquisition date, its effects would not be accounted for as part of the business combination, which means the effects would not be considered a measurement period adjustment (i.e., an adjustment to goodwill) even if the amendment or separate agreement happened within one year of the acquisition date.

To the extent the acquisition agreement originally or subsequently (through amendment or a separate agreement) includes consideration contingent on a section 338 election, consultation with an income tax or business combination subject matter expert may be warranted.

#### 11.4.5 Acquisition-date accounting: Difference between tax-deductible goodwill and goodwill for book purposes

Generally, it is more likely in a taxable transaction for the book basis and tax basis of goodwill to be the same amount. Note, however, that the tax basis of goodwill in a taxable transaction is deductible, and in future periods:

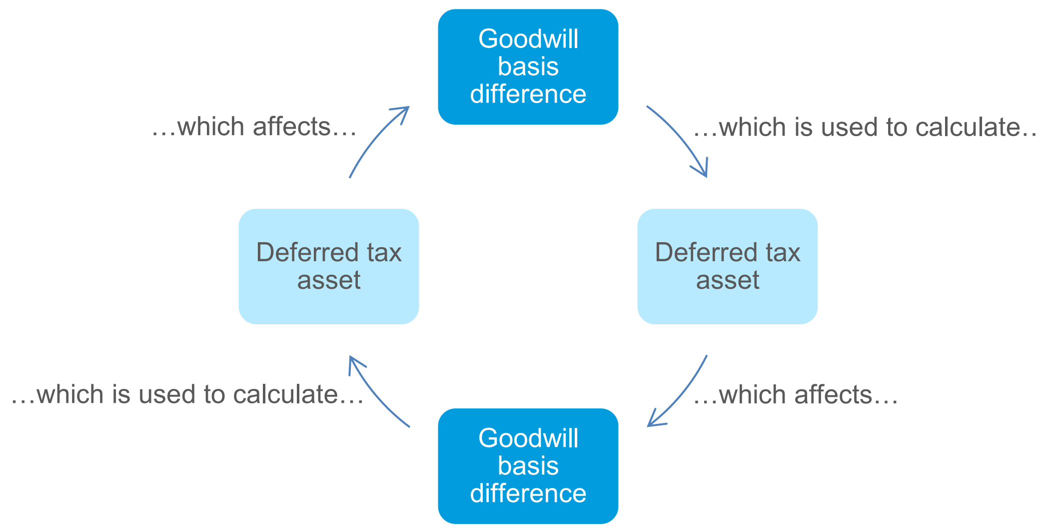
- For entities that have not elected the private-company goodwill amortization alternative (see Section 18.3), a deferred tax liability will be recorded as the tax-deductible goodwill is amortized and the goodwill for book purposes is not amortized.
- For entities that have elected the private-company goodwill amortization alternative, a deferred tax asset will likely arise in future periods as a result of the goodwill for book purposes being amortized over a shorter life (e.g., 10 years or less [see Section 18.3.1]) than the tax-deductible goodwill (e.g., 15 years).

Occasionally in a taxable transaction, the amount of tax-deductible goodwill will be different from the goodwill for book purposes. These situations usually arise when the transaction involves contingent consideration or other contingent liabilities that will not be included in tax-deductible goodwill until they are settled, or when there are differences between the agreed-upon allocation of purchase price for tax purposes and the fair value (or other appropriate amount) recognized for book purposes.

In a nontaxable transaction, if there is preexisting tax-deductible goodwill within the target related to a previous acquisition, that goodwill is not adjusted. In addition, there is no goodwill recognized for tax purposes for the current acquisition. As such, it would be extremely rare for the book and tax bases of goodwill to be the same amount in a nontaxable transaction.

If tax-deductible goodwill is less than goodwill for book purposes, technically a taxable temporary difference exists. In theory, the difference between the goodwill for book purposes and tax-deductible goodwill is a temporary difference. However, pursuant to ASC 805-740-25-9, the buyer is prohibited from recognizing a deferred tax liability when tax-deductible goodwill is less than goodwill for book purposes at the acquisition date.

If tax-deductible goodwill is greater than goodwill for book purposes, then a deductible temporary difference exists. A deferred tax asset should be recognized by the buyer in the accounting for the business combination for this deductible temporary difference. Determining the amount of the deferred tax asset to be recognized in this situation is not as simple as taking the deductible temporary difference and multiplying it by the appropriate tax rate. This is because goodwill is a residual that is reduced by the amount of any deferred tax asset recognized for the difference between tax-deductible goodwill and goodwill for book purposes. The reduction in goodwill for book purposes will then increase the temporary difference and so on and so forth.




As such, a simultaneous equation such as the following one in ASC 805-740-55-10 may be used to calculate the amount of the deferred tax asset, and ultimately, the amount of goodwill for book purposes, to be recognized:

$$\big(Tax\ Rate \div (1 - Tax\ Rate)\big) \times Preliminary\ Temporary\ Difference = Deferred\ Tax\ Asset$$

Completing this simultaneous equation is broken out into its separate components in Example 11-7. The simultaneous equation or another appropriate approach may be used to make the necessary calculations.

**Example 11-7: Calculation of deferred tax asset and goodwill for book purposes when there is an excess of tax-deductible goodwill over goodwill for book purposes**

Buyer acquires Target in a business combination. After determining the amount that should be recorded for the identifiable assets acquired and liabilities assumed (including any related deferred tax assets and liabilities), as well as any NCI in Target, the amount of goodwill for book purposes is $1.2 million while the amount of tax-deductible goodwill is $1.5 million (note that both of these amounts also include the acquisition-date fair value of contingent consideration [see Example 11-5]). Buyer's tax rate is 30%.

The following steps can be used to calculate the amount of the deferred tax asset and the amount of goodwill for book purposes to be recognized by Buyer:

1. *Calculate the initial or preliminary amount of the deductible temporary difference (PDTD).* In Buyer's fact pattern, the PDTD is $300,000 (the amount of tax-deductible goodwill [$1.5 million] over the initial amount of goodwill for book purposes [$1.2 million]).
2. *Use the PDTD calculated in Step 1 and the following formula to solve for the deferred tax asset (DTA): (Tax Rate ÷ (1 – Tax Rate)) × PDTD.* In Buyer's fact pattern, the amount of the DTA to be recognized is $128,571 ([30% tax rate ÷ (1 – 30% tax rate)] × $300,000 PDTD).
3. *Determine the amount of goodwill for book purposes to be recognized by reducing the initial amount of goodwill for book purposes by the amount of the DTA calculated in Step 2.* In Buyer's fact pattern, the amount of goodwill for book purposes to be recognized is $1,071,429 ($1.2 million of initial goodwill for book purposes – $128,571 DTA).
4. *Check the calculations performed in Steps 1 to 3, using the following formula: (Tax-Deductible Goodwill – Goodwill for Book Purposes Recognized [as calculated in Step 3]) × Tax Rate = Recognized DTA (as calculated in Step 2).* In Buyer's fact pattern, the product of the formula is $128,571 ([$1.5 million of tax-deductible goodwill – $1,071,429 of recognized goodwill for book purposes] × 30% tax rate), which equals the recognized DTA calculated in Step 2.

Because goodwill is a residual, when calculating the deferred tax asset for the excess of tax-deductible goodwill over goodwill recognized for book purposes, either a simultaneous equation or another appropriate approach may be used to make the necessary calculations to ensure the deferred tax asset takes into account the fact that the amount of goodwill ultimately recognized for book purposes is affected by the amount of the deferred tax asset ultimately recognized.

### 11.4.6 Acquisition-date accounting: Tax treatment of transaction costs

As discussed in detail in Section 13.5.1, costs that the buyer incurs in a business combination, other than those related to debt or equity issuance and registration, should be expensed when incurred and when the related services have been received by the buyer. These transaction costs generally do not represent assets and they result from transactions that should be accounted for separate from the business combination.

In a nontaxable transaction (stock deal), nondeductible transaction costs are included in the tax basis of the stock acquired, which means there is not an expected future deduction, so a deferred tax asset is not recognized. Conversely, in a taxable transaction (asset deal), nondeductible transaction costs are included in the tax basis of the assets acquired (usually increasing the amount of tax-deductible goodwill), which gives rise to a temporary difference because the transaction costs are deductible for tax purposes, but not in the same financial reporting period as the costs are expensed for book purposes. Because these costs are accounted for separate from the business combination, the deferred taxes relating to the temporary differences for the nondeductible transaction costs are also not accounted for as part of the business combination. In other words, the nondeductible transaction costs that are included for tax purposes as a component of tax-deductible goodwill should not be considered in the comparison of tax-deductible goodwill to goodwill for book purposes or in the approach used in Example 11-7. These amounts should be accounted for as a separate and distinct deferred tax asset by the buyer.

**Example 11-8: Accounting for the tax effects of nondeductible transaction costs**

In a taxable business combination, Buyer recorded $600,000 in goodwill for book purposes. Buyer also incurred $300,000 of nondeductible transaction costs for services received related to that business combination, which resulted in $900,000 in tax-deductible goodwill.

Even though the tax-deductible goodwill was $900,000, only the portion of that tax-deductible goodwill that does not relate to transaction costs should be considered by Buyer in calculating the difference between tax-deductible goodwill and goodwill for book purposes, which is zero in this situation because tax-deductible goodwill ($600,000) and goodwill for book purposes ($600,000) are the same amount. Therefore, consistent with accounting for transaction costs outside of a business combination, Buyer accounts for the tax effects of the transaction costs ($90,000 [$300,000 of transaction costs × 30% tax rate]) outside of the business combination. The following journal entry captures Buyer's accounting for the transaction costs and their tax effects:

| | Debit | Credit |
|---|---|---|
| Operating expense | $300,000 | |
| Deferred tax asset | 90,000 | |
| Cash | | $300,000 |
| Deferred tax expense | | 90,000 |

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### 11.4.7 Subsequent accounting: Change in valuation allowance or uncertain tax positions that were recorded in the acquisition-date accounting

#### 11.4.7.1 Change in valuation allowance recorded on acquisition date

Subsequent to the acquisition-date accounting for the business combination, the buyer may determine that it is necessary to increase or decrease the amount of the valuation allowance reflected in the acquisition-date accounting for the business combination. If that happens, then the accounting for that change depends on the answers to the following two questions:

1. Did the buyer make that determination *during* the measurement period (see Section 12.7.1)?
2. Did the buyer make that determination based on newly discovered information about the facts and circumstances *in existence* at the acquisition date?

If the answer to *both* of these questions is yes, then a measurement period adjustment exists and the buyer adjusts goodwill for book purposes for the change in the valuation allowance. If the adjustment is a reduction to goodwill for book purposes, then goodwill is adjusted until its balance reaches zero, at which point the remaining amount of the adjustment (if any) is recognized as a gain from a bargain purchase (see Section 12.2). The measurement period adjustment is reflected in the reporting period in which the adjustment is determined.

If the answer to either or both of these questions is no, then the buyer recognizes the change in the valuation allowance within income tax expense, or in certain limited situations, as a direct adjustment to contributed capital as required by ASC 740-10-45-20.

Example 11-9 illustrates the two different outcomes that could result from the buyer's determination that the amount of a valuation allowance recognized in the accounting for a business combination should subsequently be increased or decreased.

**Example 11-9: Change in a deferred tax asset valuation allowance recognized in the accounting for the business combination**

In Example 11-2 and Example 11-3, Buyer recognized deferred tax assets totaling $1.8 million in its accounting for the business combination. Assume that Buyer also recognized a valuation allowance of $1 million on those deferred tax assets in the accounting for the business combination.

Buyer determines, subsequent to the acquisition-date accounting for the business combination, that the amount of the valuation allowance should be reduced by $300,000 to $700,000. The amount of goodwill Buyer recognized for book purposes for this business combination was in excess of $500,000 and Buyer has not elected the private-company goodwill amortization alternative (see Section 18.3) (which means goodwill is not amortized). Consider the following two scenarios:

1. Buyer determined *during* the measurement period that a reduction in the valuation allowance of $300,000 was necessary based on new information it obtained concerning the facts and circumstances *in existence as of* the acquisition date (i.e., the reduction is a measurement period adjustment).
2. Buyer determined *after* the measurement period that a reduction in the valuation allowance of $300,000 was necessary based on new information it obtained concerning the facts and circumstances *in existence after* the acquisition date (i.e., the reduction is not a measurement period adjustment).

The journal entry that Buyer records in each of these scenarios is as follows:

| | Scenario 1 | | Scenario 2 | |
|---|---|---|---|---|
| | Debit | Credit | Debit | Credit |
| Deferred tax asset – Valuation allowance | $300,000 | | $300,000 | |
| Goodwill | | $300,000 | | |
| Income tax expense | | | | $300,000 |

As these journal entries illustrate, subsequently adjusting a valuation allowance recorded in the accounting for a business combination may or may not affect net income in the period in which the adjustment is made.

#### 11.4.7.2 Change in uncertain tax positions

The buyer in a business combination may recognize assets and liabilities related to uncertain tax positions as a result of one or both of the following: (a) uncertain tax positions of the target or (b) additional uncertain tax positions arising from the acquisition. As discussed earlier in Section 11.4.2, these uncertain tax positions are accounted for as part of the business combination and are recognized and measured in accordance with ASC 805-740. However, subsequent to the acquisition-date accounting for the business combination, the buyer may determine that it is necessary to increase or decrease the amounts recognized in the accounting for a business combination that are affected by an uncertain tax position (e.g., deferred tax assets or liabilities, payables to or receivables from taxing authorities, a liability for unrecognized tax benefits) because of a change related to that uncertain tax position. The accounting for this change is similar to that required when the buyer determines that it is necessary to increase or decrease the amount of a valuation allowance reflected in the acquisition-date accounting for the business combination (see Section 11.4.7.1). In other words:

- If the buyer determines *during* the measurement period that it is necessary to change a tax-related amount recognized in the accounting for a business combination because of a change in an uncertain tax position acquired in or resulting from a business combination and the buyer makes that determination based on new information about the facts and circumstances *in existence* at the acquisition date, then the buyer adjusts goodwill for book purposes for the effects of changing the amount related to the uncertain tax position. If the adjustment is a reduction to goodwill for book purposes, then goodwill is adjusted until its balance reaches zero, at which point the remaining amount of the adjustment (if any) is recognized as a gain from a bargain purchase (see Section 12.2).

- If the buyer determines that it is necessary to change a tax-related amount recognized in the accounting for a business combination because of a change in an uncertain tax position acquired in or resulting from a business combination *after* the measurement period or as a result of new information about facts and circumstances that were *not in existence* at the acquisition date, then the buyer recognizes the effects of that change as it would recognize the effects of a change in an uncertain tax position that was not acquired in, or did not result from, a business combination. In other words, the accounting for the business combination is not affected.

## 11.5 Employee benefits

### 11.5.1 Defined benefit pension and postretirement plans

For a single-employer defined benefit pension plan or a single-employer defined benefit postretirement plan sponsored by the target, the buyer should recognize an asset or liability in the accounting for the business combination that represents the funded status of the plan. This is consistent with the guidance that requires the plan sponsor to recognize an asset or liability for the funded status of any of its single-employer defined benefit pension or postretirement plans (regardless of whether the plan sponsor is a target in a business acquisition). The measurement guidance generally applicable to recognizing an asset or liability for the funded status of a single-employer defined benefit pension or postretirement plan should be used to measure the asset or liability recognized in the accounting for a business combination for such a plan. This measurement guidance can be found in ASC 715-30 and 715-60.

Expected plan amendments, terminations or curtailments that the employer has no obligation to make are not taken into consideration when measuring the asset or liability to be recognized in the accounting for the business combination for the funded status of one of the target's plans. While expected plan amendments, terminations or curtailments that the employer is not obligated to make are not taken into consideration when recognizing an asset or liability on the acquisition date for the funded status of the plan, other assumptions integral to measuring the asset or liability should be changed to reflect the buyer's expectations about relevant future events. In addition, ASC 715-30 and 715-60 provide guidance for those settlements, curtailments or other termination benefits that should be taken into consideration (e.g., those that have occurred) in recognizing and measuring the asset or liability for the funded status of one of the target's plans.

For withdrawals from multiemployer plans that are probable of occurring at the acquisition date, a withdrawal liability is recognized in accordance with ASC 450-20.

The FASB acknowledges that there is somewhat of an inconsistency in how *expected* plan amendments, terminations or curtailments of single-employer plans and *expected* withdrawals from multiemployer plans are treated in the accounting for a business combination. However, the FASB's rationale for accepting an inconsistency in this area is captured in paragraph B298 of Statement 141R:

> ... [the FASB] observed that the liability recognized upon withdrawal from a multiemployer plan represents the previously unrecognized portion of the accumulated benefits obligation, which is recognized as it arises for a single-employer plan. In addition, the FASB observed that some might consider the employer's contractual obligation upon withdrawal from a multiemployer plan to be an unconditional obligation to "stand-ready" to pay if withdrawal occurs and therefore to represent a present obligation.

### 11.5.2 Other employee benefits

The accounting in the business combination for other employee benefits offered by the target should follow the relevant recognition and measurement guidance provided in the Codification for the specific type of benefit provided. For example:

- If the target has deferred compensation contracts, the buyer should follow the relevant recognition and measurement guidance in ASC 710-10-25 and 710-10-30.
- If the target provides compensated absences, the buyer should follow the relevant recognition and measurement guidance in ASC 710-10-25.
- If the target provides nonretirement postemployment benefits, the buyer should follow the relevant recognition and measurement guidance in ASC 712-10-25.
- If the target has provided one-time termination benefits in connection with an exit or disposal activity, the buyer should follow the relevant recognition and measurement guidance in ASC 420-10-25 and 420-10-30 (see Section 10.15 and Section 13.6).

To the extent the target undertakes restructuring activities between the date the business combination is announced and the date it is closed and those activities will (or have) resulted in one-time termination benefits, consideration should be given to whether those activities were undertaken by the target on behalf of, or at the request of, the buyer. If so, it may be appropriate to take that into consideration in accounting for those termination benefits and the business combination (see Section 13.6).

## 11.6 Reacquired rights

### 11.6.1 Definition

The buyer may have previously licensed certain rights (e.g., the right to use a trade name under a franchise agreement) to the target. When the buyer acquires the target, it is reacquiring these rights. ASC 805 provides accounting guidance for both the initial and subsequent accounting for these reacquired rights.

### 11.6.2 Initial accounting

When the buyer acquires the target, any reacquired rights should be recognized in the accounting for the business combination as an intangible asset. In doing so, the buyer must first determine whether it should recognize a gain or loss on the settlement of the preexisting contract with the target in which those rights were granted separate and apart from the accounting for the business combination (see Section 13.2). Determining whether a gain or loss should be recognized depends on whether the terms of the contract associated with the reacquired rights are favorable or unfavorable in comparison to the terms of current market transactions for the same or similar rights.

In measuring the amount at which the reacquired rights should be recognized, the buyer should only take into consideration the remaining contractual term associated with the reacquired rights. In other words, future renewals should not be taken into consideration in measuring the fair value of the reacquired rights even if market participants would do so. This is an exception to the overall fair value measurement principle included in ASC 805.

### 11.6.3 Subsequent accounting

An intangible asset recognized in a business combination for a reacquired right should subsequently be amortized over the remaining term of the agreement that existed between the buyer and the target.

If a reacquired right for which an intangible asset was recognized in a business combination is sold, a gain or loss on the sale of that intangible asset should be recognized using its carrying amount.

## 11.7 Share-based payment awards

In a business combination, the buyer may replace share-based payment awards held by grantees (which may include both employees and nonemployees of the target) with its own share-based payment awards. The measurement principle and related guidance in ASC 718 should be used when measuring these replacement awards. While ASC 718 does not use a pure fair value approach to measure share-based payment awards, the overall approach used is sometimes referred to as a fair-value-based measure. In addition, in certain circumstances, ASC 718 permits use of either a calculated value method or intrinsic value method. Use of any of the measurement methods in ASC 718, including the fair-value-based measure, for purposes of determining the amounts at which replacement awards should be recognized is an exception to the overall fair value measurement principle included in ASC 805.

ASC 805 provides further guidance on accounting for replacement awards. This additional guidance addresses:

- Whether the buyer is obligated at the acquisition date to replace the target's awards with its own awards (i.e., issue replacement awards)
- If the buyer is obligated to issue replacement awards, determining the portion of the replacement awards' fair-value-based measure that should be treated as consideration transferred in the business combination vs. the portion that should be treated as postcombination costs (e.g., postcombination compensation costs for employee awards) (see Section 13.4)
- Whether (and if so, how) any of the following affects the amounts treated as (a) consideration transferred in the business combination or (b) postcombination costs:
  - Use of the calculated value or intrinsic value methods in ASC 718
  - The buyer's expectations about the number of replacement awards for which the requisite service will or will not be rendered as well as changes in these expectations (see Section 13.4.3)
  - Other postacquisition date events affecting the replacement awards, such as modifications or the ultimate outcome of awards with performance conditions
  - Classification of a replacement award as a liability or an equity instrument
- The accounting implications of the target's awards expiring as a result of the business combination.
- The accounting effects of a replacement award requiring postcombination vesting regardless of whether the target's awards had all vested by the acquisition date (see Section 13.4)
- How to account for the income tax effects of replacement awards classified as equity

In addition, replacement share-based payment awards treated as postcombination costs should subsequently be accounted for in accordance with ASC 718. For additional information on the aforementioned subjects, refer to ASC 805-30-30-9 to 30-13. For additional discussion on determining the consideration transferred in a business combination, see Section 12.3.

## 11.8 Assets held for sale

To the extent the buyer in a business combination acquires a long-lived assets or disposal group that was classified as held for sale by the target, then the buyer must determine at the acquisition date whether that classification continues to be appropriate (see Chapter 9). In addition, the buyer may have plans at the acquisition date to sell a long-lived assets or disposal group acquired in a business combination that was not previously classified as held for sale by the target. In both of these situations, the buyer should only classify the long-lived assets or disposal group acquired in the business combination as held for sale if: (a) it will be sold, (b) the one-year requirement in ASC 360-10-45-9 is met and (c) the other requirements in ASC 360-10-45-9 are probable of being met within a short period of time (usually no more than three months) following the acquisition date.

A long-lived asset or disposal group that is treated as held for sale at the acquisition date should be measured at its fair value less cost to sell. This measurement approach is an exception to the fair value measurement principle included in ASC 805. Without this exception, a day two loss equal to the cost to sell the asset or disposal group would be recognized on the long-lived asset or disposal group when it is subsequently accounted for under the general guidance in the Codification applicable to assets held for sale.

## 11.9 Contract assets and liabilities (after adoption of ASU 2021-08)

As discussed in Section 10.6.2.1, with the implementation of ASC 606, one question raised was whether a contract liability (i.e., deferred revenue) should be recognized based on the underlying legal obligation (as was generally done prior to ASC 606) or the underlying performance obligation as that concept is used in ASC 606. In addition, questions were raised about the measurement of the contract liability recognized in a business combination. These questions centered around use of the fair value of the legal obligation or performance obligation under ASC 805, which often resulted in the buyer recognizing a contract liability in an amount less than (and in some cases, significantly less than) the contract liability recognized by the target prior to the acquisition under ASC 606 (see Section 10.6.4.1 and Example 10-3). These questions were addressed in October 2021 by the FASB with the issuance of ASU 2021-08.

To understand the effects of ASU 2021-08, it is important to understand what constitutes a contract asset and contract liability under ASC 606:

- A contract liability arises under ASC 606 when the customer's performance is greater than that of the entity (i.e., the consideration paid by the customer plus any amount recognized as a receivable is greater than the revenue recognized for the promised goods or services transferred to the customer).
- A contract asset arises under ASC 606 when the entity's performance is greater than that of the customer (i.e., the revenue recognized for the promised goods or services transferred to the customer is more than the consideration paid by the customer or recognized as a receivable).

Adoption of ASU 2021-08 may change the manner in which the buyer in a business combination recognizes and measures contract assets and contract liabilities related to acquired customer contracts as follows:

| Before adoption of ASU 2021-08 | After adoption of ASU 2021-08 |
|---|---|
| The buyer should recognize contract assets and contract liabilities at their fair values.<br><br>However, we believe there is diversity in practice that results in the recognition of contract liabilities based on the fair value of either: (a) the legal obligation (using the definition of a liability in paragraph E37 of CON 8) or (b) the performance obligation (using the definition in ASC 606-10-25-14). | The buyer should recognize and measure contract assets and contract liabilities based on the guidance in ASC 606 (except when one of the practical expedients provided in ASC 805-20-30-29 has been elected). |

The adoption of ASU 2021-08 also may affect the amount of revenue recognized after the acquisition date. In some cases, measuring a contract liability under ASC 606 in the accounting for a business combination will result in the recognition of a higher contract liability than would have been recognized had it been measured at its fair value as was required before the adoption of ASU 2021-08. As a result, all other things being equal in these cases, the buyer likely will recognize more post-acquisition revenue after its adoption of ASU 2021-08 than it would have recognized before its adoption of ASU 2021-08.

### 11.9.1 Scope of ASU 2021-08

The guidance in ASU 2021-08 applies to the recognition and measurement of contract assets and contract liabilities related to customer contracts within the scope of ASC 606 that are acquired in a business combination. The guidance also applies to other acquired contracts accounted for in accordance with ASC 606, such as contracts within the scope of ASC 610-20 and certain parts of collaborative agreements within the scope of ASC 808.

It is important to note that ASU 2021-08 only added exceptions to the general recognition and measurement principles in ASC 805 for contract assets and contract liabilities related to acquired customer contracts. In other words, this guidance did not change the accounting guidance in ASC 805 applicable to recognizing and measuring other assets and liabilities related to customer contracts acquired in a business combination, including the following:

- Accounts receivable (see Section 10.3 and Section 10.6.2)
- Inventory (see Section 10.7)
- Refund liabilities that do not meet the definition of contract liabilities or an asset for related returned inventory (see Section 7.3.6 of our revenue recognition guide)
- Backlog intangible assets (see Section 10.6.2)
- Off-market contract intangible assets (above market) or liabilities (below market) (see below and Section 10.6.2)
- Customer relationship intangible assets (see Section 10.6.2 and Section 10.6.3)

In addition, ASU 2021-08 did not change how deferred costs of the target related to either of the following should be treated by the buyer in the accounting for a business combination:

- Fulfillment costs and costs to obtain a customer contract within the scope of ASC 340-40 (see Chapter 13 of our revenue recognition guide)
- Upfront payments to a customer for which the target either (a) has not or will not receive a distinct good or service from the customer or (b) has not received a purchase commitment from the customer (see Section 7.5 of our revenue recognition guide)

For example, a target may have deferred costs related to obtaining a customer contract under ASC 340-40. As discussed in Section 10.6.7, we believe those deferred costs should not be recognized by the buyer in the accounting for the business combination because they do not meet the definition of an asset in CON 8. We also believe this continues to be the appropriate accounting after the adoption of ASU 2021-08.

*Indirect effects of ASU 2021-08 on the recognition of off-market contract intangible assets and liabilities*

While ASU 2021-08 does not address the accounting for off-market contract intangible assets or liabilities, we believe the change in how contract assets and contract liabilities are recognized in the accounting for a business combination could have an indirect effect on how off-market contract intangible assets and liabilities are recognized. For example, prior to its adoption of ASU 2021-08, an entity may have included the fair value of an off-market contract intangible asset or liability for an acquired customer contract in the fair value of the contract liability recognized for that contract. After the adoption of ASU 2021-08, the contract liability no longer is measured at fair value, which means the entity will need to separately consider whether an off-market contract asset or liability should be recognized, and if so, the amount that should be recognized. This is similar to considering whether an intangible asset or liability should be recognized for an operating lease that has favorable or unfavorable terms compared to market that was acquired in a business combination in which the acquiree is the lessee (see Section 10.13.2).

### 11.9.2 Recognition and measurement of contract assets and contract liabilities in a business combination

ASU 2021-08 adds both a recognition exception and a measurement exception to ASC 805 for contract assets and contract liabilities acquired in a business combination. These exceptions require such assets and liabilities to be recognized and measured in accordance with ASC 606, as if the buyer itself had originated the related customer contracts. In other words, the exceptions require the recognition of contract assets and contract liabilities at the amounts that would have resulted from the buyer applying ASC 606 to the acquired customer contract since its origination. As such, to the extent ASC 606 requires an assessment or judgment to be made at contract inception, upon contract modification or on a recurring basis, the buyer's measurement of contract assets and contract liabilities should reflect those assessments or judgments of the buyer as of when they were otherwise required to be made under ASC 606. However, the following practical expedients are available for election by the buyer on an acquisition-by-acquisition basis:

- When a customer contract has been modified prior to the acquisition date, the buyer may base the following on the terms of the contract as of the acquisition date (instead of the origination and subsequent modification dates):
  - Identification of the performance obligations in the contract and whether they have been satisfied
  - Determination of the transaction price
  - Allocation of the transaction price to the performance obligations
- The buyer may use the acquisition-date standalone selling prices for the performance obligations in the customer contract (instead of the origination-date standalone selling prices) when allocating the transaction price to the performance obligations in the contract.

If the buyer elects to apply one or both practical expedients to its accounting for an acquisition, it must do so consistently for *all* customer contracts acquired in that acquisition.

The recognition of a contract liability in the accounting for a business combination generally increases the amount of goodwill recognized, while the recognition of a contract asset may or may not affect the amount of goodwill recognized (it will depend on the facts and circumstances because the recognition of a contract asset may affect the amount recognized for another customer-contract-related asset with the net effect on goodwill being zero). However, the effects of recognizing contract assets and contract liabilities on goodwill only captures one piece of the overall effects of accounting for customer contracts acquired in a business combination. As discussed in Section 11.9.1, the buyer may need to recognize other assets and liabilities related to customer contracts acquired in a business combination, including accounts receivable, refund liabilities, backlog intangible assets, off-market contract intangible assets or liabilities, and customer relationship intangible assets. Only after considering all of the customer-contract-related assets and liabilities that should be recognized in the accounting for a business combination does the buyer get a complete picture of the effects of the customer contract on the amount of goodwill recognized.

When a business combination is treated as a taxable transaction (see Section 11.4.1.1), the contract assets and contract liabilities recognized under ASC 805 likely would create a temporary difference for which deferred income taxes should be recognized. Given the complexities involved in the accounting for the income tax effects of a business combination, we recommend the buyer seek the assistance of a tax specialist to help with that accounting. For additional information about the accounting for income taxes in a business combination, see Section 11.4.

The examples in the remainder of this section illustrate the initial accounting under ASC 606 for contract assets and contract liabilities recognized in the accounting for a business combination.

*Using the target's contract assets and contract liabilities recognized and measured in accordance with ASC 606*

If the target has not applied ASC 606 (i.e., it does not prepare financial statements in accordance with U.S. GAAP), the amounts it has recognized at the acquisition date related to its customer contracts should not be used by the buyer in its accounting for the business combination. If the target has applied ASC 606, the contract assets and contract liabilities recognized by the target as of the acquisition date generally should be used by the buyer for purposes of its accounting for the business combination after incorporating the adjustments that may result from considering the following questions:

- *Has the target made any errors in its application of ASC 606?* The degree of complexity involved in accounting for customer contracts under ASC 606 varies based on a number of factors, including the complexity of an entity's customer contracts. As the complexity increases, so too may the possibility for errors.
- *Are there differences in the judgments and estimates used by the target in applying ASC 606 to its contracts compared to the judgments and estimates that would be used by the buyer in applying ASC 606 to those same contracts?* Examples of judgments and estimates that may differ between the buyer and target are those involved in determining the amount of variable consideration to include in the transaction price, determining standalone selling prices for performance obligations and measuring progress toward the complete satisfaction of a performance obligation satisfied over time (see Section 7.3, Section 8.2 and Section 9.3 of our revenue recognition guide, respectively).
- *Has the target elected different accounting policies and practical expedients under ASC 606 compared to those elected by the buyer?* ASC 606 provides various accounting policies and practical expedients that may or may not be elected by an entity. Each of these create the potential for the buyer and target to have made different elections.

If the answer to one or more of these questions is "yes," for purposes of its business combination accounting, the buyer would not be able to use the contract assets and contract liabilities recognized by the target as of the acquisition date without making the necessary adjustments. Central to correctly answering these questions is the buyer having an in-depth understanding of the target's application of ASC 606. To gain this in-depth understanding, the buyer should have processes and controls in place to evaluate the target's application of ASC 606 prior to the buyer accounting for its acquisition of the target.

*Fair value considerations related to non-ASC 606 customer-contract-related assets and liabilities*

As discussed in Section 11.9.1, ASU 2021-08 only addresses the accounting for contract assets and contract liabilities recognized in accordance with the provisions of ASC 606 and does not change the guidance in ASC 805 applicable to recognizing and measuring other assets and liabilities related to customer contracts acquired in a business combination. Those non-ASC 606 customer-contract-related assets and liabilities continue to be (a) recognized when they meet the definition of an asset or liability in CON 8 and (b) measured at their fair values.

The fair value of certain non-ASC 606 customer-contract-related assets may be based on future (i.e., post-acquisition) cash flow estimates. While cash flow estimates for a customer contract are unaffected by ASU 2021-08, using ASC 606 as a basis to measure contract assets after adoption could result in certain future cash flows being included or excluded from the measurement of the contract assets. As such, when it comes to estimating the fair value of certain non-ASC 606 customer-contract-related assets recognized in the accounting for a business combination, the buyer should ensure that (a) all appropriate future (i.e., post-acquisition) cash flows have been taken into consideration in estimating the fair value of non-ASC 606 customer-contract-related assets and (b) no future cash flows have been double counted in the overall accounting for the business combination. With respect to (a), the buyer should ensure that future cash flows expected from a customer contract that have not been reflected in the measurement of a contract asset due to the provisions of ASC 606 (such as those that exclude sales- or usage-based royalties [see Example 11-10] or constrained variable consideration from contract assets) have been taken into consideration (as appropriate) in determining the fair value of a non-ASC 606 customer-contract-related intangible asset (such as a customer relationship intangible asset). With respect to (b), the buyer should ensure that future cash flows expected from a customer contract that have been reflected in the measurement of a contract asset due to the provisions of ASC 606 (such as those expected cash payments that are included in the measurement of the contract asset recognized in Example 11-13 because the entity's performance exceeds the customer's performance) have not been taken into consideration in determining the fair value of a non-ASC 606 customer-contract-related intangible asset (such as a customer relationship intangible asset).

In addition, using ASC 606 as a basis to measure contract liabilities after the adoption of ASU 2021-08 could result in certain contract liabilities being recognized in the accounting for the business combination for which there are no associated future cash flows required to satisfy the liability. Because only future (i.e., post-acquisition) cash flows should be taken into consideration in estimating the fair value of other intangible assets (e.g., customer relationship intangible assets, intellectual property intangible assets), the future revenues from contract liabilities for which there are no associated future cash flows should not be included in estimating the fair value of those other intangible assets (see the note in Example 11-12).

Given the complexities involved in identifying the non-ASC 606 customer-contract-related assets and liabilities that are acquired in a business combination and measuring those assets and liabilities at fair value, we strongly recommend that the buyer seek the assistance of a valuation specialist to help with those identification and measurement activities.

*Subsequent accounting*

Both before and after the adoption of ASU 2021-08, ASC 606 is used to subsequently account for contract assets and contract liabilities recognized in the accounting for a business combination. After the acquisition-date accounting is complete, application of ASC 606 to these assets and liabilities does not affect the business combination accounting, and whether revenue is affected depends on the facts and circumstances.

*Examples*

The following examples do not provide a comprehensive description of all terms, facts or circumstances that could affect the accounting for the license agreements or construction contracts under ASC 606, nor do they provide the comprehensive analysis performed by Target or Buyer when accounting for the agreements under ASC 606. For an in-depth discussion of the guidance in ASC 606 related to the accounting for customer contracts that include a license of intellectual property, and comprehensive examples illustrating application of that guidance, see Chapter 10 of our revenue recognition guide. In-depth discussion of the guidance in ASC 606 that could affect the accounting for construction contracts is provided throughout our revenue recognition guide. Examples in that guide illustrating the application of certain concepts to construction contracts include Example 6-7, Example 7-6, Example 7-21, Example 9-4, Example 9-5, Example 9-7, Example 9-10 and Example 12-2.

**Example 11-10: Customer contract for the license of functional intellectual property in which all of the consideration is a sales-based royalty**

On November 30, 20X3, Target enters into a three-year license agreement with Customer. The agreement meets the definition of a contract in ASC 606-10-25-2 and meets the contract existence criteria in ASC 606-10-25-1. Under the terms of the agreement, Customer has the right to use the formula for one of Target's drug compounds (Formula X) in the production of a pharmaceutical product

(Product Z). There are no other promised goods or services in the agreement. Target provides Formula X to Customer on November 30, 20X3. Customer is obligated to pay Target 20% of the sales proceeds related to Product Z on a monthly basis. There is no other consideration payable between Target and Customer, and Customer does not have a refund right.

Target is acquired by Buyer on December 1, 20X4. For ease of illustration, Target's receivable for the sales-based royalty due from Customer for its sales of Product Z prior to the acquisition has been ignored. Target has no other assets or liabilities related to its license agreement with Customer on its balance sheet as of the acquisition date.

*How does Target account for the license agreement with Customer prior to its acquisition?*

Based on applying the guidance in ASC 606 to the terms of the contract and related facts and circumstances, Target accounts for the contract with Customer as follows prior to its acquisition:

- Treats the license as a right to use intellectual property, which is a performance obligation satisfied at the point in time Formula X is provided to Customer on November 30, 20X3.
- Recognizes the sales-based royalty under the license agreement as Customer sells Product Z, which results in Target not having a contract asset recorded at November 30, 20X4 despite Target's performance being greater than that of Customer as of that date (i.e., Target has completed its performance by providing Formula X, while Customer has not completed making all of the payments required under the contract). (This accounting treatment results from Target's application of the sales- or usage-based royalty exception in ASC 606-10-55-65 to 55-65B, which prohibits recognition of the sales- or usage-based royalty as revenue or a contract asset in this situation until the subsequent sale or usage occurs.)

*After its adoption of ASU 2021-08, how does Buyer account for Target's license agreement with Customer in its accounting for the business combination?*

Buyer reviews Target's accounting for its license agreement with Customer under ASC 606 and concludes:

- Target has not made any errors in its application of ASC 606 to the agreement
- In applying ASC 606 to the agreement, Buyer would use the same judgments and estimates that were used by Target
- There are no accounting policy or practical expedient elections made by Target under ASC 606 that would affect its accounting for the agreement (i.e., there are no accounting policy or practical expedient elections made by Target that need to be conformed with Buyer's elections)

Based on this analysis, Buyer concludes it should not recognize a contract asset related to the license agreement with Customer in its accounting for the business combination on December 1, 20X4, which is consistent with Target's accounting for the agreement prior to its acquisition.

While Buyer does not recognize a contract asset for the future sales-based royalties it expects to receive from Customer, those sales-based royalties should be considered in determining the fair value of any non-ASC 606 customer-contract-related intangible assets recognized related to the license agreement in the accounting for the business combination, such as a customer relationship intangible asset.

*How does Buyer recognize revenue for the license agreement with Customer after the acquisition date?*

Buyer recognizes revenue for the license agreement with Customer each month based on the sales-based royalty it is due to receive related to Customer's sales of Product Z.

**Example 11-11: Customer contract for software and PCS that includes both upfront and ongoing payments**

On November 30, 20X3, Target enters into a three-year contract with Customer. The agreement meets the definition of a contract in ASC 606-10-25-2 and meets the contract existence criteria in ASC 606-10-25-1. Under the terms of the contract, Customer has the right to use Target's software and receive post-contract customer support (PCS) from Target for three years. There are no other promised goods or services in the contract. Customer is obligated to pay Target $1 million on November 30, 20X3 and $200,000 on November 30, 20X4 and November 30, 20X5. There is no other consideration payable between Target and Customer, and Customer does not have a refund right. On November 30, 20X3, Target provides the software to Customer and Customer pays $1 million to Target. In addition, on November 30, 20X4, Customer pays $200,000 to Target.

Target is acquired by Buyer on December 1, 20X4. Buyer determines that Target's contract with Customer is at market (neither favorable nor unfavorable) as of the acquisition date.

Customer pays $200,000 to Buyer on November 30, 20X5.

*How does Target account for the contract with Customer prior to its acquisition?*

Based on applying the guidance in ASC 606 to the terms of the contract and related facts and circumstances, Target accounts for the contract with Customer as follows prior to its acquisition:

- Treats the software and PCS as separate performance obligations
- Determines the transaction price is $1.4 million
- Allocates $800,000 of the transaction price to software and $600,000 of the transaction price to the PCS (based on their respective standalone alone selling prices)
- Treats the software as a right to use intellectual property, which is a performance obligation satisfied at the point in time the software is provided to Customer
- Treats the PCS as a performance obligation ratably satisfied over the three-year term of the contract

The following represents Target's accounting for the revenue associated with satisfying the software performance obligation as of November 30, 20X3:

| | Debit | Credit |
|---|---|---|
| Cash | $1,000,000 | |
| Contract liability | | $200,000 |
| Revenue | | 800,000 |

The following represents the net effects of Target's accounting for the revenue associated with satisfying the PCS performance obligation over time for the 12 months ending November 30, 20X4:

| | Debit | Credit |
|---|---|---|
| Cash | $200,000 | |
| Revenue | | $200,000 |

As of the date it is acquired, Target has a contract liability of $200,000 related to its contract with Customer.

*After its adoption of ASU 2021-08, how does Buyer account for Target's contract with Customer in its accounting for the business combination?*

Buyer reviews Target's accounting for its contract with Customer under ASC 606 and concludes:

- Target has not made any errors in its application of ASC 606 to the contract
- In applying ASC 606 to the contract, Buyer would use the same judgments and estimates that were used by Target
- There are no accounting policy or practical expedient elections made by Target under ASC 606 that would affect Target's accounting for the contract (i.e., there are no accounting policy or practical expedient elections made by Target that need to be conformed with Buyer's elections)

Based on this analysis, Buyer concludes it should recognize a contract liability of $200,000 related to Target's contract with Customer in its accounting for the business combination on December 1, 20X4, which is consistent with Target's accounting for the contract prior to its acquisition.

*How does Buyer account for the contract with Customer after the acquisition date?*

The following represents the net effects of Buyer's accounting for the revenue associated with satisfying the PCS performance obligation over time for the 12 months ending November 30, 20X5:

| | Debit | Credit |
|---|---|---|
| Cash | $200,000 | |
| Revenue | | $200,000 |

The following represents Target's accounting for the revenue associated with satisfying the PCS performance obligation over time for the 12 months ending November 30, 20X6:

| | Debit | Credit |
|---|---|---|
| Contract liability | $200,000 | |
| Revenue | | $200,000 |

*What if Buyer determines as of the acquisition date that Target's contract with Customer is favorable compared to market by an amount of $10,000 (and Buyer has not elected the private-company intangible asset alternative)?*

For the same reasons noted earlier, Buyer would conclude it should recognize a contract liability of $200,000 related to Target's contract with Customer in its accounting for the business combination on December 1, 20X4. In addition, Buyer would conclude it should separately recognize an off-market contract intangible asset of $10,000 for the favorable position of the contract. Buyer concludes this intangible asset should be derecognized ratably over the remaining two years of the contract with Customer.

**Example 11-12: Customer contract for the license of symbolic intellectual property in which all of the consideration is paid upfront**

On November 30, 20X3, Target enters into a three-year license agreement with Customer. The agreement meets the definition of a contract in ASC 606-10-25-2 and meets the contract existence criteria in ASC 606-10-25-1. Under the terms of the agreement, Customer has the right to use Target's cartoon mascot for three years. There are no other promised goods or services in the agreement. Customer is obligated to pay Target $1.2 million on November 30, 20X3. There is no other consideration payable between Target and Customer, and Customer does not have a refund right. On

November 30, 20X3, Target provides Customer with access to its cartoon mascot, and Customer pays $1.2 million to Target.

Target is acquired by Buyer on December 1, 20X4. Buyer determines that Target's contract with Customer is at market (neither favorable nor unfavorable) as of the acquisition date.

*How does Target account for the license agreement with Customer prior to its acquisition?*

Based on applying the guidance in ASC 606 to the terms of the license agreement and related facts and circumstances, Target treats the license as a right to access intellectual property that is satisfied over time on a ratable basis, which results in Target recognizing revenue of $400,000 per year over the three-year term of the agreement.

The following represents Target's accounting for the $1.2 million received from Customer on November 30, 20X3:

| | Debit | Credit |
|---|---|---|
| Cash | $1,200,000 | |
| Contract liability | | $1,200,000 |

The following represents Target's accounting for the revenue associated with the license agreement for the 12 months ending November 30, 20X4:

| | Debit | Credit |
|---|---|---|
| Contract liability | $400,000 | |
| Revenue | | $400,000 |

As of the date it is acquired, Target has a contract liability of $800,000 related to its license agreement with Customer ($1,200,000 initial balance − $400,000 derecognized in the 12 months ending November 30, 20X4).

*After its adoption of ASU 2021-08, how does Buyer account for Target's license agreement with Customer in its accounting for the business combination?*

Buyer reviews Target's accounting for its license agreement with Customer under ASC 606 and concludes:

- Target has not made any errors in its application of ASC 606 to the agreement
- In applying ASC 606 to the agreement, Buyer would use the same judgments and estimates that were used by Target
- There are no accounting policy or practical expedient elections made by Target under ASC 606 that would affect Target's accounting for the agreement (i.e., there are no accounting policy or practical expedient elections made by Target that need to be conformed with Buyer's elections)

Based on this analysis, Buyer concludes it should recognize a contract liability of $800,000 related to Target's license agreement with Customer in its accounting for the business combination on December 1, 20X4, which is consistent with Target's accounting for the agreement prior to its acquisition.

**Note:** When determining the fair value of the intangible asset for the cartoon mascot that should be recognized in the accounting for the business combination, the future revenue from the contract liability of $800,000 recognized for Target's license agreement with Customer should not be considered because there are no future cash flows associated with that liability.

*How does Buyer account for the license agreement with Customer after the acquisition date?*

The following represents Buyer's accounting for the revenue associated with the license agreement for the 12 months ending November 30, 20X5 and November 30, 20X6:

| | Debit | Credit |
|---|---|---|
| Contract liability | $400,000 | |
| Revenue | | $400,000 |

**Example 11-13: Customer contract with a single performance obligation satisfied over time and progress payments made over the contract's term**

On November 30, 20X3, Target enters into a contract with Customer to construct a building. The agreement meets the definition of a contract in ASC 606-10-25-2 and meets the contract existence criteria in ASC 606-10-25-1. Under the terms of the contract, Customer is required to make progress payments of $400,000 on May 31, 20X4, November 30, 20X4 and May 31, 20X5, and a final payment of $800,000 when Target completes construction of the building, which is expected to be on or about November 30, 20X5. There is no other consideration payable between Target and Customer, and Customer does not have a right of return. Customer pays Target $400,000 on May 31, 20X4 and November 30, 20X4.

Target is acquired by Buyer on December 1, 20X4. Buyer determines that Target's contract with Customer is at market (neither favorable nor unfavorable) as of the acquisition date.

Customer pays $400,000 to Buyer on May 31, 20X5, and on November 30, 20X5, Buyer completes construction of the building and Customer pays $800,000 to Buyer.

*How does Target account for the contract with Customer prior to its acquisition?*

Based on applying the guidance in ASC 606 to the terms of the contract and related facts and circumstances, Target accounts for the contract with Customer as follows prior to its acquisition:

- Treats construction of the building as a single performance obligation that is satisfied over time.
- Determines the transaction price is $2 million.
- Uses a cost-to-cost method to measure progress toward the complete satisfaction of the performance obligation to construct the building, which indicates that the construction is 55% complete at November 30, 20X4.

The following represents Target's accounting for the construction contract with Customer for the 12 months ending on November 30, 20X4:

| | Debit | Credit |
|---|---|---|
| Cash | $800,000 | |
| Contract asset | 300,000 | |
| Revenue ($2,000,000 × 55%) | | $1,100,000 |

*After its adoption of ASU 2021-08, how does Buyer account for Target's construction contract with Customer in its accounting for the business combination?*

Buyer reviews Target's accounting for its contract with Customer under ASC 606 and concludes:

- Target has not made any errors in its application of ASC 606 to the contract.

- In applying ASC 606 to the contract, Buyer would use the same judgments and estimates that were used by Target. (See the last question in this example for a scenario in which Buyer would use a different measurement of progress toward the complete satisfaction of the performance obligation.)
- There are no accounting policy or practical expedient elections made by Target under ASC 606 that would affect Target's accounting for the contract (i.e., there are no accounting policy or practical expedient elections made by Target that need to be conformed with Buyer's elections).

Based on this analysis, Buyer concludes it should recognize a contract asset of $300,000 related to Target's construction contract with Customer in its accounting for the business combination on December 1, 20X4, which is consistent with Target's accounting for the contract prior to its acquisition.

*How does Buyer account for the contract with Customer after the acquisition date?*

The following represents Buyer's accounting for the revenue from the construction contract with Customer (and excludes Buyer's accounting for the related costs) for the 12 months ending on November 30, 20X5:

| | Debit | Credit |
|---|---|---|
| Cash | $1,200,000 | |
| Contract asset | | $300,000 |
| Revenue ($2,000,000 × 45%) | | 900,000 |

*What if Buyer's acquisition-date estimate of the progress toward the complete satisfaction of the performance obligation to construct the building was different from Target's estimate?*

Assume that Buyer's costs of construction are less than Target's costs because Buyer is able to obtain volume discounts from many of its suppliers that Target was not able to obtain from its suppliers. Further assume that, based on its cost estimates, Buyer would have estimated that construction of the building was 60% complete at the acquisition date. Using Buyer's estimate of 60% complete instead of Target's estimate of 55% complete would result in Buyer recognizing a contract asset of $400,000 related to the construction contract with Customer in its accounting for the business combination on December 1, 20X4 ([$2 million transaction price × 60% complete] − $800,000 cash received).

The following would represent Buyer's accounting for the construction contract with Customer for the 12 months ending on November 30, 20X5 when a $400,000 contract asset (instead of a $300,000 contract asset) was recognized in the accounting for the business combination:

| | Debit | Credit |
|---|---|---|
| Cash | $1,200,000 | |
| Contract asset | | $400,000 |
| Revenue ($2,000,000 × 40%) | | 800,000 |

### 11.9.3. Required disclosures

The incremental disclosures required by ASU 2021-08 only apply when the buyer has elected one or both of the measurement practical expedients discussed in Section 11.9.2. When that is the case, the buyer must disclose its election of the expedients, and if reasonably possible, a qualitative assessment of the effects of doing so.

As discussed in paragraphs BC54 and BC55 of ASU 2021-08, the FASB did not add any incremental disclosures beyond those applicable to the practical expedients because they believed the existing disclosure requirements in ASC 606 and ASC 805 would provide sufficient information about contract assets and contract liabilities acquired in a business combination. Paragraph BC55 of ASU 2021-08 specifically mentions the following disclosure requirements in this context:

- For all entities, each major class of assets acquired and liabilities assumed
- For public entities (as defined in the Master Glossary of the ASC):
  - The post-acquisition-date revenue and net income attributable to the target that are included in the consolidated financial statements
  - Supplemental pro forma consolidated revenue and net income for the current and prior period (if comparative financial statements are presented), as well as information about any material, nonrecurring adjustments related to the business combination that are reflected in the pro forma amounts
  - Qualitative and quantitative explanation of what caused significant changes in the contract assets and contract liabilities during the reporting period (with business combinations being provided as an example of what could cause a significant change)
  - With limited exceptions, the aggregate transaction price allocated to certain unsatisfied (or partially unsatisfied) performance obligations at the balance-sheet date and either a quantitative or qualitative description of when the buyer expects to recognize that amount as revenue

#### 11.9.4. Effective date of the ASU and transition

ASU 2021-08 should be applied on a prospective basis and is effective:

- For *public business entities*, in fiscal years beginning after December 15, 2022, including interim periods therein. For example, ASU 2021-08 is effective for a calendar-year-end public business entity as of January 1, 2023.
- For *all other entities*, in fiscal years beginning after December 15, 2023, including interim periods therein. For example, ASU 2021-08 is effective for a calendar-year-end private company as of January 1, 2024.

However, ASU 2021-08 may be adopted early in an annual or interim period, provided the financial statements for that period have not been issued (for public entities) or made available for issuance (for all other entities). If an entity elects to early adopt ASU 2021-08 in an interim period, it is required to apply the provisions of ASU 2021-08 to all business combinations for which the acquisition date occurred on or after the beginning of the fiscal year that includes that interim period, as well as all business combinations that occur on or after the early adoption date. We believe early adoption does not affect the accounting for business combinations that occurred in the prior fiscal year for which the measurement period remains open in the fiscal year of adoption. In other words, we believe the accounting for those business combinations should be finalized by continuing to apply ASC 805 prior to the amendments made by ASU 2021-08.

Complexity may arise in the retrospective application of ASU 2021-08 to business combinations that occurred in earlier interim periods within the same fiscal year as the interim period in which the ASU is early adopted (which will be referred to as *earlier interim-period business combinations*). For example, the buyer would have applied the pre-ASU 2021-08 guidance to recognize and measure contract assets and contract liabilities for any customer contracts acquired in an earlier interim-period business combination. Retrospective application of ASU 2021-08 to this business combination would require the buyer to re-evaluate the contract assets and contract liabilities to recognize them in accordance with ASC 606, which likely would result in adjustments to the business combination accounting that occurred in the earlier interim period. These adjustments may affect more than just the amounts of contract assets, contract liabilities and goodwill recognized in the business combination accounting. For example, the buyer should carefully consider whether any retrospective application adjustments to contract assets and contract liabilities would affect the amounts recognized for any non-ASC 606 customer-contract-related intangible assets or liabilities. In addition, retrospective changes to the amounts recognized in an earlier interim-period business combination likely would affect the income statement subsequent to the acquisition date. For example, an increase to a contract liability recognized in the accounting for the business combination typically would affect the amount of revenue recognized by the buyer subsequent to the acquisition date. These income statement effects should be taken into consideration in the retrospective application of ASU 2021-08 to earlier interim-period business combinations.

**Example 11-14: Early adoption of ASU 2021-08**

Private Company (PC) has a calendar year end and decides to early adopt ASU 2021-08 in the third quarter of 2022, for which it has not yet made its interim financial statements available for issuance. PC had one business combination in the first quarter of 2022 (Q1 2022 business combination), no business combinations in the second quarter of 2022 and one business combination in the third quarter of 2022 (Q3 2022 business combination). In addition, PC had one business combination in the fourth quarter of 2021 (Q4 2021 business combination) for which the measurement period related to accounting for the acquired customer contracts remains open in the third quarter of 2022. PC completed its accounting for the Q1 2022 business combination in the second quarter of 2022, which reflected its application of ASC 805 prior to the amendments made by ASU 2021-08. In this business combination, PC recognized a contract liability at its fair value on the acquisition date of $1 million. In remeasuring this contract liability as of the acquisition date under ASC 606, PC increases the contract liability to $4 million, which is appropriately consistent with the contract liability recognized by the target under ASC 606 as of the acquisition date.

PC must retrospectively apply ASU 2021-08 to its Q1 2022 business combination and prospectively apply ASU 2021-08 to its Q3 2022 business combination. We believe PC’s Q4 2021 business combination is unaffected by its adoption of ASU 2021-08. In other words, we believe PC should finalize the accounting for its Q4 2021 business combination by continuing to apply ASC 805 prior to the amendments made by ASU 2021-08.

In retrospectively applying ASU 2021-08 to its Q1 2022 business combination, PC must increase the amount of the contract liability recognized from $1 million to $4 million. In doing so, PC should carefully consider which other amounts recognized in the accounting for the business combination should be adjusted (e.g., goodwill, any non-ASC 606 customer-contract-related intangible assets or liabilities). In addition, increasing the amount of the contract liability from $1 million to $4 million affects the amount of revenue recognized by PC subsequent to the acquisition date, which should be taken into consideration in the retrospective application of ASU 2021-08 to the Q1 2022 business combination.

# 12. Elements and results of goodwill calculation

## 12.1 Determining whether goodwill or a bargain purchase exists and the related amount

Goodwill is defined in the Master Glossary of the Codification as "An asset representing the future economic benefits arising from other assets acquired in a business combination or an acquisition by a not-for-profit entity that are not individually identified and separately recognized. For ease of reference, this term also includes the immediate charge recognized by not-for-profit entities in accordance with paragraph 958-805-25-29." The amount of goodwill to be recognized by the buyer in a business combination, if any, is a residual. The four elements involved in determining the amount of goodwill recognized in a business combination, to the extent they exist, include the amount of:

1. Consideration transferred (measured predominantly at fair value) (see Sections 12.3 to 12.5 and Section 12.10)
2. The acquisition-date fair value of any NCI in the target (if the buyer acquires less than 100% of the target) (see Section 10.19)
3. The acquisition-date fair value of the buyer's PHEI in the target (if the business combination is a step acquisition) (see Section 12.6)
4. Net assets acquired by the buyer (which is 100% of the target's net assets measured predominantly at fair value) (see Chapters 7 to 11)

The aggregate of Elements 1, 2 and 3 represents the fair value of the target as a whole. If this aggregate is greater than Element 4, then the excess amount is recognized as goodwill. If this aggregate is less than Element 4, then the excess may represent a bargain purchase for which a gain should be recognized (see Section 12.2). The nature of this approach will result in either goodwill or a gain from a bargain purchase. In other words, there should never be a situation in which both goodwill and a gain from a bargain purchase are recognized. In addition, the nature of this approach does not allow for the recognition of a loss on the acquisition date if the buyer overpaid for the target.

As indicated next to each element, additional discussion is provided in this guide on Elements 1, 2 and 3 as are the extra steps that must be performed prior to the recognition of a gain from a bargain purchase. Element 4 represents the difference between the following amounts recognized by the buyer in the accounting for the business combination: (a) the total identifiable assets acquired by the buyer and (b) the total liabilities assumed by the buyer. Discussion related to the recognition and measurement of identifiable assets acquired, as well as liabilities assumed, by the buyer in a business combination can be found in Chapters 7 to 11. In addition, disclosures that must be provided when the accounting for a business combination results in the recognition of goodwill or a gain from a bargain purchase are discussed in Section 14.2.3.

ASC 805's approach to accounting for the net assets acquired in a business combination results in recognizing 100% of the net assets acquired, measured in accordance with ASC 805 (which primarily requires measurement at fair value) (see Section 8.1). This is the case regardless of whether 51% or 100% (or any percent in between) of the target is acquired by the buyer. As such, in cases in which less than 100% of the target is acquired by the buyer, the buyer must also recognize the fair value of the NCI (see Section 10.19). This approach results in the buyer recognizing both its and the NCI's share of goodwill (i.e., the buyer recognizes 100% of goodwill).

While the buyer recognizes 100% of the goodwill that arises in a business combination in its financial statements as goodwill, it may still be necessary to allocate the goodwill between itself and any NCI for purposes of allocating any goodwill impairment charge at a later date. The amount of goodwill allocated to the buyer is determined as: (a) the fair value of the buyer's equity interest in the target over (b) the buyer's proportionate share of the fair value of the net assets acquired. The difference between the total amount of goodwill recognized by the buyer and the amount of goodwill allocated to the buyer represents the amount of goodwill allocated to the NCI. To reiterate, the buyer still recognizes 100% of the goodwill in its financial statements as goodwill. The allocation of goodwill between the buyer and the NCI is done purely as a memorandum entry to facilitate the accounting for any goodwill impairment charge recognized at a future date. In addition, the allocation of goodwill between the buyer and the NCI also facilities the allocation of goodwill amortization between the buyer and the NCI to the extent the buyer has elected the private-company goodwill amortization alternative (see Section 18.3). Section 12.8 and Section 12.9 discuss the circumstances under which a buyer may need to assign goodwill to reporting units and foreign subsidiaries, respectively.

**Example 12-1: Determination of goodwill**

Buyer acquires 70% of Target by transferring cash consideration of $5.25 million to Target's owners. Additional information about Buyer's acquisition of Target includes the following:

- Buyer previously owned 20% of Target and accounted for its investment in Target using the equity method.
- The carrying amount of Buyer's PHEI in Target on the acquisition date is $900,000. The fair value of that investment on the acquisition date is $1.24 million.
- Buyer's 70% acquisition results in it owning 90% of Target.
- The fair value of the 10% NCI that still exists after Buyer's acquisition of 70% of Target is $620,000.
- Target's net assets have a fair value of $6.5 million, which consists of $10 million of identifiable assets acquired and $3.5 million of liabilities assumed.

The amount of goodwill to be recorded by Buyer as a result of its 70% acquisition of Target is determined as follows:

| | |
|---|---|
| Element 1: Consideration transferred | $5,250,000 |
| Element 2: Acquisition-date fair value of 10% NCI | 620,000 |
| Element 3: Acquisition-date fair value of Buyer's 20% PHEI in Target | 1,240,000 |
| Total | 7,110,000 |
| Element 4: Net assets acquired | 6,500,000 |
| Goodwill: Excess of Elements 1 to 3 over Element 4 | $610,000 |

A summary journal entry representing the overall effects of the business combination on Buyer's consolidated financial statements at the acquisition date is as follows:

| | Debit | Credit |
|---|---|---|
| PHEI in Target (Note 1) | $340,000 | |
| Gain | | $340,000 |
| | | |
| Identifiable assets | $10,000,000 | |
| Goodwill | 610,000 | |
| Cash | | $5,250,000 |
| Liabilities | | 3,500,000 |
| NCI | | 620,000 |
| PHEI in Target | | 1,240,000 |

**Note 1:** This journal entry is necessary given that the business combination involves a step acquisition (see Section 12.6). The amount of the gain is calculated as the excess of the fair value of Buyer's 20% interest in Target as of the acquisition date ($1.24 million) over the carrying amount of the related investment recorded by Buyer at the acquisition date ($900,000).

## 12.2 Additional considerations in a bargain purchase

### 12.2.1 General

As discussed in Section 12.1, a business combination may result in a gain from a bargain purchase when the aggregate of Elements 1, 2 and 3 of the goodwill calculation is less than Element 4 of that calculation. This result may occur when the owners of the target are forced or compelled to sell their interests in the target. This may also result from certain identifiable assets acquired and liabilities assumed being recognized and measured using alternatives to the general recognition and measurement principles of ASC 805. These exceptions are discussed in Chapter 11.

ASC 805 requires the buyer to effectively perform a thorough self-review of its accounting for the business combination if a bargain purchase initially results from that accounting. In this thorough self-review, the buyer should double check:

- The accuracy and completeness of the identifiable assets acquired and liabilities assumed
- The appropriateness of: (a) the procedures used to measure the individual components within each of Elements 1 to 4 (e.g., the identifiable assets acquired and liabilities assumed within Element 4) and (b) the results of applying those procedures

With respect to Element 4 of the goodwill calculation, the initial accounting for the business combination should be changed (or adjusted) if the thorough self-review results in:

1. Discovering additional identifiable assets of the target that meet the recognition threshold, but that were not included in the initial accounting
2. Discovering additional liabilities of the target that meet the recognition threshold, but that were not included in the initial accounting
3. Determining that certain assets included in the initial accounting do not meet the recognition threshold
4. Determining that certain liabilities included in the initial accounting do not meet the recognition threshold
5. Finding measurement errors in the initial accounting that resulted in the overstatement of assets or understatement of liabilities

6. Finding measurement errors in the initial accounting that resulted in the understatement of assets or overstatement of liabilities

Erroneously arriving at a gain from a bargain purchase in the initial accounting for the business combination (i.e., the accounting prior to performing the thorough self-review) can typically be attributed to Items 2, 3 and 5 in the preceding list. In other words, correcting the initial accounting for those items should result in either: (a) the elimination of the bargain purchase and recognition of goodwill or (b) a reduction in the gain from the bargain purchase.

There is no prescriptive guidance in ASC 805 regarding where a gain from a bargain purchase should be reflected in the income statement. As such, judgment must be exercised in determining the appropriate income statement line item in which to include the gain. In addition, the buyer is required to disclose which line item includes the gain.

ASC 805-30-25-2 requires the gain recognized from a bargain purchase to be attributed entirely to the buyer. In other words, none of the gain from a bargain purchase is attributed to the NCI. An example of attributing the entire gain from a bargain purchase to the buyer is included in ASC 805-30-55-14 to 55-16.

When on the verge of recognizing a gain from a bargain purchase, the buyer should have a general understanding as to what is giving rise to that bargain purchase (e.g., the seller was experiencing a liquidity crisis, and as a result, was forced to sell the target to the buyer). If the buyer does not have this general understanding, then serious concerns arise about whether a bargain purchase has, in fact, occurred. In other words, the buyer being unaware of what is giving rise to the bargain purchase is almost certainly an indication that the perceived bargain purchase actually results from a measurement error or other error in the application of ASC 805. The necessity for the buyer to understand the cause of the bargain purchase is also relevant to the disclosures that must be provided in that situation (see Section 14.2.3).

At the end of the day, appropriate skepticism should be exercised in recognizing a gain from a bargain purchase.

### 12.2.2 Frequency of bargain purchases

When the guidance in ASC 805 was issued, it was expected that bargain purchases would be a rare occurrence. In fact, the FASB indicated in paragraph B371 of Statement 141R that it "…consider[s] bargain purchases to be anomalous transactions—business entities and their owners generally do not knowingly and willingly sell assets or businesses at prices below their fair values." That said, the FASB acknowledged in ASC 805-30-25-2 that bargain purchases may occur occasionally for the reasons discussed in Section 12.2.1.

Given that ASC 805 has been effective for some time, the question has been asked as to whether the frequency of bargain purchases is more or less than the FASB anticipated when they issued Statement 141R. In general, bargain purchases are still expected to occur infrequently. However, economic factors and regulatory actions may affect the overall nature and frequency of bargain purchases. For example, in the past, the Federal Deposit Insurance Corporation and the National Credit Union Administration offered substantial incentives to healthy financial institutions to assume the deposits and acquire selected assets of failed financial institutions. Sometimes this incentive came in the form of a loss sharing arrangement on the acquired loans. As a result of the substantial incentives being offered by regulators, for a period of time, bargain purchases occurred more frequently than originally expected with respect to transactions in which one financial institution acquired another financial institution.

Regardless of the frequency of bargain purchases and whether economic factors or regulatory actions contributed to a bargain purchase, the buyer is still required to perform a thorough self-review of its accounting to ensure that a bargain purchase has, in fact, occurred. In addition, the buyer is also required to explain in its disclosures the factors that gave rise to the gain (e.g., explain the actions of regulators that resulted in the bargain purchase).

## 12.3 Consideration transferred

### 12.3.1 General

Normally, consideration is transferred to the sellers from the buyer upon executing a business combination. The nature of the consideration transferred by the buyer in a business combination typically results in one or more of the following:

- Transferring cash or other assets on a contingent or noncontingent basis
- Incurring liabilities payable to former owners of the target
- Issuing equity interests

Contingent consideration issued in a business combination, which could be a contingent form of one or more of the listed items, is discussed in Section 12.4.

Specific information about the consideration transferred in a business combination must be disclosed by the buyer in its financial statements (see Section 14.2.4).

#### 12.3.1.1 Buyer pays off seller's debt

The buyer's accounting when it pays off the seller's debt in conjunction with a business combination will either result in the buyer treating that payment as: (a) consideration transferred or (b) payoff of a liability assumed in the business combination. While the amount of goodwill reflected in the accounting for the business combination would be the same regardless of how the payment is treated, the amounts disclosed for the consideration transferred and liabilities assumed would be affected, as would the classification of the payment on the cash flow statement.

Whether a payment to pay off the seller's debt is treated as consideration transferred or payoff of a liability assumed in the business combination requires judgment and depends on whether the debt has been assumed by the buyer or if the buyer is simply paying off the debt on the seller's behalf as contemplated in the business combination. When the substance of the transaction indicates that the debt has not been assumed by the buyer, the payoff of the seller's debt should be treated as consideration transferred. When the substance of the transaction indicates that the debt has been assumed by the buyer, the payoff of the seller's debt is treated as a liability assumed in the business combination. Indicators that should be considered in determining whether the payment should be treated as consideration transferred or a payoff of an assumed liability include the following:

- *Does the payment to the seller's lender happen contemporaneous with the closing of the acquisition?* If so, that would be indicative of the payment being akin to consideration transferred. If the buyer does not pay the seller's lender on the acquisition date or shortly thereafter, that would be indicative of the buyer paying off an assumed liability.
- *Does the acquisition agreement indicate either of the following: (a) the buyer will not assume the seller's debt or (b) the buyer is purchasing the net assets of the target exclusive of the seller's debt?* If so, that would be indicative of the payment being akin to consideration transferred. If the acquisition agreement indicates that the buyer will assume the seller's debt or that the buyer is purchasing the net assets of the target inclusive of the seller's debt, that would be indicative of the buyer paying off an assumed liability.
- *Do the terms of the debt indicate that the debt cannot be assumed upon a change in control?* If so, that would be indicative of the payment being akin to consideration transferred. If the terms of the debt indicate that the debt can be assumed upon a change in control, that would be indicative of the buyer paying off an assumed liability.

Based on an analysis of the facts and circumstances in the context of these indicators, the buyer should determine whether the payment it makes to pay off the seller's debt in conjunction with a business combination represents consideration transferred or paying off an assumed liability.

To illustrate the effects of the different conclusions, consider a situation in which Buyer acquires 100% of Target by agreeing to pay: (a) $60 million in cash to Seller and (b) $40 million in cash to Lender to pay off Seller's outstanding debt with Lender. If Buyer concludes based on the facts and circumstances that the $40 million payment to Lender is consideration transferred, then the consideration transferred in the business combination is $100 million and the fair value of the net assets acquired is otherwise unaffected. If the Buyer instead concludes that the $40 million payment to Lender is the payoff of an assumed liability, then the consideration transferred is $60 million and the fair value of the net assets acquired would be $40 million less than it otherwise would be. While goodwill is the same regardless of whether the $40 million payment to Lender is treated as consideration transferred or the payoff of an assumed liability, the classification of the payment in the cash flow statement and its characterization in the notes to the financial statements would be affected.

#### 12.3.1.2 Consideration transferred held in escrow

When some or all of the consideration transferred is held in escrow before being released to the seller (or perhaps even the buyer), the question arises with respect to whether the amounts held in escrow initially represent consideration transferred or contingent consideration. To answer this question, it is important to understand why amounts are being held in escrow and the circumstances upon which and to whom the escrow would be released. It is also important to understand whether the release of amounts in escrow are based on the facts and circumstances *as of* the acquisition date (which would mean it is not contingent consideration) or *after* the acquisition date (which means it could be contingent consideration depending on the other facts and circumstances). Only after obtaining this understanding is the buyer able to determine whether the amounts held in escrow initially represent consideration transferred or contingent consideration.

Consider a situation in which amounts are held in escrow related to the seller satisfying general representations and warranties in the acquisition agreement. In general, the expectation is that such representations and warranties would be valid as of the acquisition date because they are based on the facts and circumstances as of that date. In other words, it would generally not make sense for the seller to make representations and warranties on the acquisition date that are not or cannot be satisfied. As a result, unless there is evidence to the contrary, we believe amounts held in escrow related to the seller's satisfaction of general representations and warranties should be treated as consideration transferred. In addition, we do not believe such amounts are contingent consideration because release of amounts from escrow is not based on something happening or not happening after the acquisition date to resolve a contingency. In other words, the facts and circumstances as of the acquisition date drive whether amounts will be released from escrow in this situation.

Further assume in this situation that ultimately there are disagreements between the buyer and the seller about whether certain representations and warranties in the acquisition agreement not directly related to the consideration transferred were satisfied by the seller, and as a result, the buyer is seeking damages from the seller. As indicated in Section 12.10.2, SEC staff member Randolph P. Green stated the following in a speech he gave at the 2003 Thirty-First AICPA National Conference on Current SEC Developments: "…claims that assert one party misled the other or that a provision of the agreement is unclear are not unique to business combination agreements and do not generally establish a clear and direct link to the purchase price and, therefore, should be reflected in the income statement." As such, if resolution of the disagreement between the buyer and seller results in some of the amounts in escrow being returned to the buyer, that returned amount should not be treated as a measurement period adjustment (see Section 12.7) to the consideration transferred. In other words, the returned amount should not affect the accounting for the business combination. Instead, the returned amount should typically be reflected in the income statement.

To further illustrate the variety of reasons that amounts are held in escrow related to a business combination, consider another situation in which there is litigation against the target, which is assumed by the buyer in the business combination. A payout to the plaintiffs of up to $3 million could occur with respect to this litigation. The sellers indemnify the buyer for this pending litigation, and $3 million of the consideration that would otherwise be transferred to the sellers on the acquisition date is placed in escrow. In addition, the escrow arrangement indicates that amounts will only be released from escrow when the litigation is settled. Any amounts due to the plaintiffs at settlement will be paid out of escrow and any remaining amounts in escrow would be released to the sellers. Assume the buyer recognizes a contingent litigation liability and indemnification asset for $2 million in the accounting for the business combination, based on the guidance in Section 11.2 and Section 11.3, respectively. The measurement of the indemnification asset reflects the fact that the seller performing under the indemnification is protected by the $3 million held in escrow. Because the $3 million in escrow is based on the facts and circumstances in existence as of the acquisition date, and none of it will be returned to Buyer under any circumstances, it is treated as consideration transferred (but not contingent consideration) at the acquisition date. Next, assume the litigation is settled nine months after the acquisition date for $2 million. In accordance with the terms of the escrow arrangement, $2 million is released from escrow to the plaintiffs, and $1 million is released from escrow to the sellers. Buyer's accounting for the settlement is to derecognize the contingent litigation liability and related indemnification asset.

This section touched on just two situations involving amounts held in escrow related to a business combination. In any of the variety of other situations that could arise, make sure to understand why amounts are being held in escrow and the circumstances under which the escrow would be released to the buyer or the seller. Without that understanding, it will be difficult to properly account for the business combination.

#### 12.3.2 Measurement basis

With only one exception, the buyer should measure the consideration transferred at its acquisition-date fair value. The one exception relates to replacement share-based payment awards that the buyer determines, in whole or in part, should be treated as consideration transferred in the accounting for the business combination. These replacement awards are measured in accordance with ASC 718. For additional discussion related to the accounting for share-based payment awards involved in the accounting for a business combination, see Section 11.7. For additional discussion related to determining the allocation of replacement awards between consideration transferred and a cost incurred (e.g., compensation), see Section 13.4.

If the consideration transferred by the buyer has a carrying amount at the acquisition date that is different from its fair value, then, with one exception, the buyer must first recognize a gain or loss for that difference prior to using the acquisition-date fair value of the consideration in the accounting for the business combination. In other words, that gain or loss does not become part of the buyer's accounting for the business combination. The only exception involves consideration that will still be under the control of the buyer after such consideration is transferred. The buyer measures consideration of this sort for purposes of the goodwill calculation at its carrying amount immediately before the acquisition date (i.e., the buyer should not recognize a gain or loss prior to transferring the consideration).

When a buyer finances some or all of a business combination by entering into debt with the seller, the buyer must determine the fair value of the debt for purposes of including it in the consideration transferred. The fair value of a liability is based on its transfer price. It is not appropriate to assume that the price to transfer the liability is the same as the price to settle the liability or the same as the carrying amount of the liability. How the buyer should estimate the amount at which it would be able to transfer its seller-financed debt presents unique challenges given the lack of market information on transfer prices for entity-specific liabilities. Oftentimes, there is little market information available because contractual or other legal restrictions prevent the transfer of such liabilities. Guidance on measuring the fair value of liabilities is included in ASC 820-10-35. When faced with the challenge of determining the fair value of seller-financed debt, we strongly encourage the buyer to consult a valuation specialist for assistance.

**Example 12-2: Effects of seller-financed debt on the accounting for a business combination**

Buyer acquires 100% of Target from Seller. The fair value of Target's net assets is $40 million. Buyer finances the acquisition by entering into a loan with Seller for $50 million in principal due in five years with interest payable annually at 8%. Buyer transfers no additional consideration to Seller. If Buyer had obtained debt from a third-party lender to acquire Target, the annual interest rate on a $50 million loan due in five years would have been 10%. The valuation specialist hired by Buyer to determine the fair value of the seller-financed debt concludes that its fair value is $46.2 million. The fair value of the loan is less than its face amount because the interest rate Seller provided to Borrower is below-market. Using this information, Buyer calculates the amount of goodwill it should recognize related to its acquisition of Target as follows:

| | |
|---|---:|
| Consideration transferred (which is the fair value of the seller-financed debt) | $46,200,000 |
| Net assets acquired | 40,000,000 |
| Goodwill | $6,200,000 |

It is important to note that if Buyer had erroneously assumed that the fair value of its debt was equal to its face value of $50 million, it would have erroneously overstated goodwill by $3.8 million ([$50 million – $40 million] – $6.2 million). In this situation, Seller offered Buyer a below-market interest rate on the debt, perhaps to induce the sale of Target to Buyer. To properly account for the acquisition of Target, Buyer had to determine the fair value of the seller-financed debt, which adjusted for the favorable terms Seller provided Buyer.

### 12.3.3 Equity securities transferred

Equity securities that are part of the consideration transferred by the buyer in a business combination must be measured at their *acquisition-date* fair value (see Chapter 6). The fair value of the buyer's own equity securities should be measured in accordance with the principles in ASC 820.

ASC 820-10-35-16 to 35-18C point out that the fair value of an entity's own equity securities should be measured from the perspective of a market participant that holds the equity securities as an asset. If there is an active market for the buyer's own equity securities on the acquisition date (e.g., the shares trade on the NYSE), then the fair value of the securities transferred as consideration would be the number of securities issued multiplied by the active market price for those securities on the acquisition date. In some situations, it may not be clear whether the market that produces a quoted price is an active market. ASC 820-10-35-54C to 35-54H provides guidance on this subject.

If there is not an active market for the buyer's own equity securities, then the fair value of the securities issued as consideration transferred would be estimated using one or more valuation techniques (e.g., market or income approaches). There is typically not an active market for the buyer's own equity securities when the buyer is a private company. As such, a valuation technique (which may require the consideration of applicable discounts) is used to estimate the fair value of the buyer's own equity securities when that situation arises. It is important to note that the fair value of the buyer's own equity securities is not established by the buyer including a statement in the business acquisition agreement that its own equity securities are worth a certain amount. A fair value estimate for the buyer's own equity securities should be based on the principles and guidance in ASC 820, including the use of a market participant's perspective for purposes of estimating fair value.

The fair value of the buyer's equity securities should reflect the value of the combined entity. In other words, the value of the buyer's shares should reflect the value of the buyer after its acquisition of the target and not the value of the buyer's shares before its acquisition of the target. There can be significant differences between the value of the buyer's stock before the acquisition and the value of the buyer's stock after the acquisition. As such, it is important to make sure the value of the buyer's stock after the acquisition is used to measure the fair value of any of the buyer's stock included in the consideration transferred. This approach is consistent with the fact that the sellers of the target that are receiving the buyer's shares are receiving an ownership interest in the combined entity and not just an ownership interest in the buyer on a standalone basis. While the value of the buyer's shares should reflect the value of the buyer after its acquisition of the target, it is important to note that the measurement of the buyer's shares still needs to be made as of the acquisition date.

A practical implication that the buyer in a business combination should keep in mind with respect to determining the fair value of its own equity securities transferred as of the acquisition date is caused by fluctuations in the market price of the buyer's equity securities between the announcement date and the acquisition date. Because of these fluctuations, the amount of goodwill recorded by the buyer on the acquisition date may vary significantly from the amount of goodwill preliminarily calculated by the buyer at the announcement date. The possibility of this significant variance should be kept in mind when communicating about the *expected* accounting effects of the business combination.

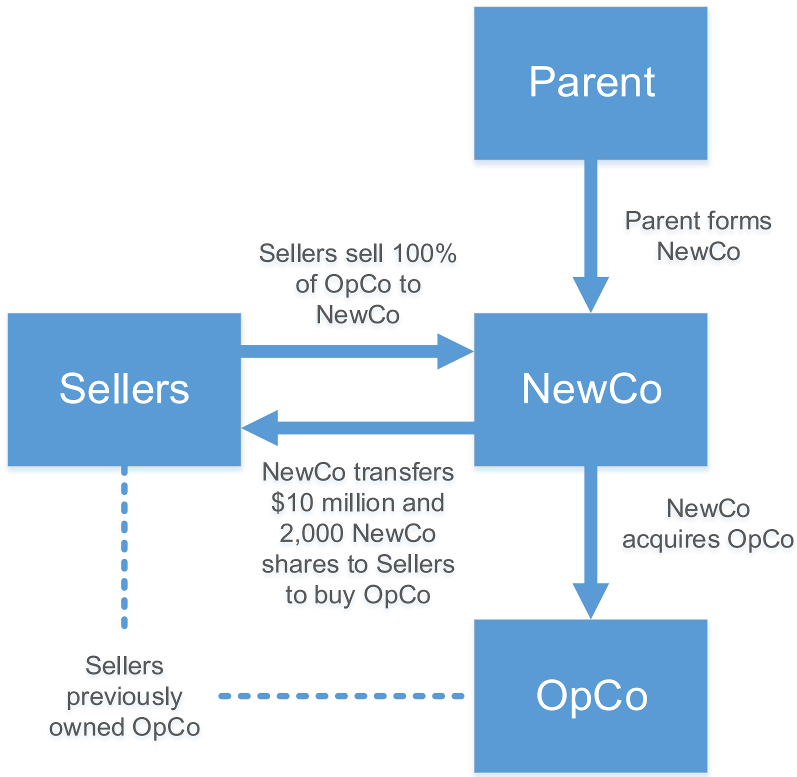
To the extent that a business combination is effectuated solely through the exchange of equity interests, consideration should be given to whether the acquisition-date fair value of the target's equity interests are more reliably measurable than the acquisition-date fair value of the buyer's equity interests. If the acquisition-date fair value of the target's equity interests are more reliably measurable than the acquisition-date fair value of the buyer's equity interests, then Element 1 of the goodwill calculation (i.e., consideration transferred) (see Section 12.1) should be based on the acquisition-date fair value of the target's equity interests. This situation may arise if the target's equity interests are traded on an active market while the buyer's equity interests are closely held and not traded on an active market. When the target is a private company, it would be unusual for the acquisition-date fair value of the target's equity interests to be more reliably measurable than the acquisition-date fair value of the buyer's equity interests.

In 2013, the AICPA issued its Private Equity Securities AVG. While the guide is not part of the authoritative accounting literature, it still provides very useful and helpful guidance on how to estimate the fair value of privately held company equity securities. In fact, the SEC staff has referred to a previous edition of this guide in comment letters. While the scope of the guide is focused on the valuation of privately held company equity securities issued as compensation, many of the concepts discussed are equally applicable to the valuation of privately held company equity securities issued as consideration transferred in a business combination.

#### 12.3.3.1 Rollover equity

Rollover equity arises in the context of a business combination when the buyer issues its own equity to the sellers as part of the overall consideration to obtain a controlling interest in the target. In this context, the sellers have essentially rolled over their equity interests in the target in exchange for equity interests in the buyer. Rollover equity is often used in private-equity backed transactions where a group of existing shareholders, typically consisting of founders or key management, reinvest a portion of their transaction proceeds into the company they just sold. The reinvestment usually takes place in a newly-formed entity or holding company.

Consider a situation in which Parent forms NewCo as the core element in implementing its strategic entry into a new market. NewCo was capitalized with equity issued to Parent and debt with unrelated third parties. NewCo will survive the transaction as a continuing reporting entity. An important part of the strategy to enter a new market is NewCo's acquisition of 100% of OpCo from Sellers. The manner in which NewCo compensates Sellers for OpCo is by transferring $10 million and issuing 2,000 shares in NewCo to Sellers. Prior to NewCo's acquisition of OpCo, Parent owned 8,000 shares in NewCo, which at the time, accounted for 100% of NewCo's issued shares. After NewCo's acquisition of OpCo, Parent still controls NewCo with its 80% ownership interest. An illustration of this situation follows:




The 2,000 shares in NewCo transferred to Sellers to buy OpCo represents rollover equity. Sellers have essentially rolled over their equity interests in OpCo in exchange for equity interests in NewCo. In the simplest terms, for NewCo, the rollover equity is *consideration transferred* in the business combination and *is not* an NCI. For Parent, the rollover equity *does* create an NCI. Parent went from owning 100% of NewCo (in which there was no NCI), to owning 80% of NewCo. The 20% no longer owned by Parent (because it is owned by Sellers) is an NCI to Parent. Parent's accounting for the decrease in its controlling ownership interest in NewCo is discussed in Section 16.2.

Rollover equity (i.e., the equity transferred by NewCo) in a business combination is initially recognized at fair value. There are several important characteristics of rollover equity in private-equity backed transactions that factor into determining the rollover equity's fair value:

- Private-equity investors look to rollover equity to reduce their cash outlay, in effect financing a portion of the transaction with the selling shareholders' reinvestment.
- Private-equity investors look to align the interests of management with their investment thesis.
- Selling shareholders receive liquidity and continue to participate in the future upside of the business alongside the private-equity investors.
- Private-equity investors and selling shareholders negotiate the terms of the transaction, including the consideration transferred that is cash vs. rollover equity, on an arms-length basis suggesting an outcome agreed upon by market participants.

Based on these typical characteristics, which generally align the interests of the private-equity investors with the rollover shareholders (i.e., the rollover shareholders will only accept rollover shares with value equivalent to what they would have otherwise received in cash), it is frequently inappropriate to apply discounts to determine the fair value of rollover equity. However, an example of a situation in which it may be appropriate to apply a discount is when the selling shareholders roll into a class of stock that is different than the class of stock of the controlling private-equity investor. In this circumstance, the buyer should first consider value differences attributable to the buyer's complex capital structure, and then consider whether discounts are applicable to the rollover equity class of stock. This approach and the factors to consider in calculating value and applying discounts is discussed in Section 10.19.3.4.

The typical fact pattern presented for private-equity backed transactions and the related conclusion does not mean a buyer may forgo consideration of its own specific facts and circumstances and assume the fair value of rollover equity on a per-unit basis is the same as the amount paid by the buyer for its controlling interest on a per-unit basis. The buyer must assess its own facts and circumstances to determine whether any discounts to the amount paid by the buyer are necessary when using that amount as the starting point to estimate the fair value of the rollover equity. To the extent all of the typical characteristics for rollover equity do not exist in a particular transaction, or the selling shareholders roll into a class of stock that is different than the class of stock of the controlling private-equity investor, consultation with valuation specialists is often necessary to determine the discounts that must be applied to the amount paid by the buyer for the controlling interest to arrive at the fair value of the rollover equity.

#### 12.3.3.2 Preferred shares

The buyer may issue preferred shares to the sellers as part of the consideration transferred in a business combination. Like any other equity issued as consideration transferred, the preferred shares issued to the sellers should be measured at their fair value on the acquisition date. When there is not an active market for the preferred shares, which is often the case, the valuation technique used to measure their fair value must take into consideration all of the terms of the preferred shares. Examples of the terms that could affect the fair value of preferred shares include:

- Dividend rights, including the rate and whether they are cumulative vs. noncumulative
- Voting rights, including any related to corporate governance (e.g., board composition) or that are protective in nature
- Liquidation preferences
- Call provisions
- Convertibility provisions
- Preemptive rights to participate in future rounds of financing
- Fixed maturity date or no fixed maturity date (i.e., perpetual)
- Redemption features (conditional vs. mandatory)

The number and nature of these and other terms included in preferred shares could significantly increase the complexity involved in estimating their fair value. As such, when a buyer issues preferred shares as consideration transferred in a business combination, it should consider seeking the assistance of a valuation specialist in estimating the fair value of those shares.

The terms of the preferred shares are equally as important to the classification of those shares as debt or equity and the determination as to whether there are any embedded features that may require separate recognition as derivatives. The classification and accounting for preferred stock is covered in detail in Chapter 4 of our debt and equity guide.

### 12.3.4 Consideration is paid before control is obtained

The buyer in a business combination may pay consideration to the sellers prior to it obtaining control over the target. For example, as a sign of good faith, the seller may require the buyer to make a payment prior to the acquisition closing, with the payment being refunded if the acquisition does not close. In this situation, the question arises with respect to how the buyer should account for the consideration transferred to the seller prior to the acquisition closing. The buyer in this situation does not have a business combination to account for at the time it makes the payment because the acquisition has not closed and the buyer has not obtained control of the target. As such, any payments made to the sellers before there is a business combination to account for should be reflected as an asset on the balance sheet, provided it meets the definition of an asset (see Section 7.2). Depending on the facts and circumstances, it may be appropriate to reflect this asset as a deposit or prepaid asset.

## 12.4 Contingent consideration

### 12.4.1 General

Prior to accounting for a contingent payment the buyer may make to the sellers of the target in a business combination, the buyer must first determine whether the contingent payment is: (a) *contingent consideration* that affects the accounting for the business combination or (b) *compensation* to the target's employees or selling shareholders for future services. In some situations, the business acquisition agreement may specifically state that the contingent consideration payments are consideration for acquisition of the business and not compensation for future services. In these situations, the buyer must still analyze the payments and apply the guidance in ASC 805 to determine whether the payments should be treated as contingent consideration or compensation for accounting purposes. In other words, just because the business acquisition agreement characterizes the payments as consideration transferred does not mean that the payments should be treated as consideration transferred for accounting purposes. For example, as discussed further in Section 13.3.1.1, if the payment is contingent upon the continued employment of a selling shareholder that is also an employee of the combined entity, the payment is generally going to be considered postacquisition compensation for accounting purposes regardless of what the agreement indicates. For additional discussion on how to determine whether a contingent payment is contingent consideration or compensation, see Section 13.3.

The Master Glossary of the Codification defines contingent consideration as follows:

> Usually an obligation of the acquirer to transfer additional assets or equity interests to the former owners of an acquiree as part of the exchange for control of the acquiree if specified future events occur or conditions are met. However, contingent consideration also may give the acquirer the right to the return of previously transferred consideration if specified conditions are met.

The guidance in ASC 805 and other topics of the Codification that apply to the accounting, classification and disclosure of contingent consideration are discussed in this section.

Section 11.4.4.4 discusses how the resolution of a specific tax position could give rise to contingent consideration.

### 12.4.2 Initial accounting and classification

The acquisition-date fair value of contingent consideration is recognized as an asset, liability or equity (as appropriate) in the accounting for the business combination. An asset is generally recognized if resolution of the contingency would result in the return or repayment of consideration already transferred by the buyer to the sellers. For example, as part of a business combination, the buyer acquires mortgage servicing rights and the seller has to refund some of the cash consideration transferred by the buyer if the level of assets being serviced declines below a certain dollar amount. If the consideration to be returned is in the form of equity rather than cash or other assets, consideration should be given to ASC 815-40 to determine if an asset or reduction to equity should be recognized for the right to the return of the equity.

If resolution of the contingency would result in the buyer transferring additional consideration to the sellers, then a liability or equity is recognized based on: (a) the nature of the contingent consideration and (b) the guidance in ASC 480 and 815-40, as well as any other applicable U.S. GAAP.

Classification of the contingent consideration is important not only to the acquisition-date accounting for the business combination, but also to the accounting for the contingent consideration in subsequent reporting periods. In other words, the initial classification of the contingent consideration dictates how adjustments to the contingent consideration should be accounted for in subsequent periods.

Determining whether contingent consideration should be classified as a liability or equity can be a complicated exercise that requires working through many decision points. In practice, working through all of the required decision points typically results in the classification of contingent consideration as a liability. In other words, it is unusual for contingent consideration to meet all of the necessary conditions required for classification as equity. Contingent consideration payable in a fixed number of shares is one of the few types of contingent consideration that might meet all of the criteria for classification as equity after considering all of the facts and circumstances. However, both buyers and sellers are often reluctant to include contingent consideration payable in a fixed number of shares in a business combination. Buyers are reluctant to have contingent consideration payable in a fixed number of shares because it exposes the buyer to the possibility of economically overpaying for the target. This would occur if the fair value of the fixed number of shares increases between the acquisition date and the date the contingency is resolved (and shares are issued). Sellers are reluctant to have contingent consideration payable to them in a fixed number of shares because it exposes the sellers to the possibility of being economically underpaid for the target. This would occur if the fair value of the fixed number of shares decreases between the acquisition date and the date the contingency is resolved (and shares are issued).

The following is a list of some of the decision points and considerations involved in determining the appropriate classification of contingent consideration.

- *Is the contingent consideration required to be settled in cash or other assets?* A requirement to settle contingent consideration in cash or assets other than the buyer's own shares indicates that the contingent consideration should be classified as a liability.
- *Is the contingent consideration one of the instruments covered by the guidance in ASC 480-10-25?* The instruments covered by the guidance in ASC 480-10-25 include most mandatorily redeemable financial instruments (see Section 4.2.1 of our debt and equity guide), obligations to repurchase the buyer's equity shares by transferring assets (see Section 5.2.1.1 of our debt and equity guide) and certain obligations to issue a variable number of shares (see Section 5.2.1.2 of our debt and equity guide, except see Section 4.2.2.1 of that guide for instruments in the form of a share). It is most common for contingent consideration that will be settled in a variable number of shares to fall within the scope of ASC 480-10-25. This could be the case if the variability in the number of shares is designed to provide the seller with a value that is: (a) predominantly fixed, (b) predominantly inversely related to changes in the value of the buyer's shares or (c) predominantly based on something other than the fair value of the shares. Another example of contingent consideration that falls within the scope of ASC 480-10-25 (through ASC 480-10-25-8) is an obligation to issue shares that are redeemable or puttable, either mandatorily, at the holder's option, or upon the occurrence of an event that is not within the issuer's control. To the extent the contingent consideration is one of the instruments covered by the guidance in ASC 480-10-25, then the contingent consideration should be classified as a liability.
- *Does the contingent consideration fall within the scope of ASC 815-40?* ASC 815-40 addresses the classification of contracts that are indexed to, and potentially settled in, an entity's own equity. Contingent consideration that is potentially settled in the buyer's own equity is within the scope of ASC 815-40 if it is a freestanding financial instrument (which is generally the case in the context of contingent consideration), or if it meets the definition of a derivative and no scope exceptions apply. (ASC 815-10-15-59 includes a scope exception that may apply when the underlying is revenue, net income or cash flow from operations.)

- *If the contingent consideration falls within the scope of ASC 815-40, does it meet the conditions to be considered indexed to the buyer's own stock?* This determination is addressed in Section 5.2.2.1 of our debt and equity guide. If the contingent consideration is not indexed to the buyer's own stock, liability classification would be appropriate.
- *If the contingent consideration falls within the scope of ASC 815-40 and it is considered indexed to the buyer's own stock, does it meet the conditions for equity classification in ASC 815-40-25?* This determination is addressed in Section 5.2.2.2 of our debt and equity guide. If any of the conditions for equity classification in ASC 815-40-25 are not met, liability classification would be appropriate.

In Example 12-5, Buyer agrees to pay Sellers an additional $600,000 in cash if Target's revenue growth is 10% or more for the nine-month period following the acquisition date. Because the contingent consideration must be settled in cash and it is not otherwise tied to Buyer's (or one of its consolidated subsidiaries') equity, it should be classified as a liability. If the example were revised such that Buyer agrees to issue Sellers an additional 25,000 shares of common stock if Target's revenue growth is 10% or more for the nine-month period following the acquisition date, the analysis that should be performed to determine the appropriate classification of the contingent consideration becomes much more complex. While this situation is uncommon in practice for the reasons described earlier in this section, it is still instructional to consider the revised example as a means to understanding how even the most basic contingent consideration involving the buyer's equity may need to be classified as a liability after considering all of the relevant literature.

Some of the decision points that Buyer needs to work through in the revised example to determine whether the contingent consideration should be classified as a liability or equity include: (a) is the contingent consideration one of the instruments covered by the guidance in ASC 480-10-25, (b) does the contingent consideration fall within the scope of ASC 815-40, (c) does the contingent consideration meet the conditions to be considered indexed to the buyer's own stock and (d) does the contingent consideration meet the conditions for equity classification in ASC 815-40-25? All of the relevant decision points must be considered before concluding such an arrangement should be classified as equity due to the many factors provided in the authoritative accounting literature that could trigger liability classification even in the most plain vanilla of situations. Given that the number of shares in the revised example is fixed, ASC 480 would typically not apply unless the shares that would be issued are redeemable at the holder's (seller's) option or upon the occurrence of an event that is not within the buyer's control. Because the obligation to issue shares is freestanding, it is within the scope of ASC 815-40. Given that the settlement terms are fixed (25,000 shares of common stock assuming there are no contractual provisions for adjustment) and the exercise contingency (revenue growth of 10%) is not based on a market or index unrelated to the buyer, the obligation would typically be considered indexed to the buyer's own stock. However, there are certain factors that could trigger liability classification in the revised example if the equity classification requirements are not met, including (but not limited to) the following:

- Buyer does not have sufficient authorized and unissued shares.
- Buyer is required to settle the contingent consideration in registered shares.
- The terms of the contingent consideration include cash-settled top-off or make-whole provisions.

Alternatively, if the number of shares to be issued in the revised example varied based on revenue growth, the obligation to issue shares would not be indexed to the buyer's own stock, and as a result, would be classified as a liability.

In working through the relevant decision points, once one of the decision points results in liability classification, no further decision points need to be considered. In other words, if any one decision point results in liability classification, the obligation to issue shares should be classified as a liability. Equity classification of the obligation to issue shares is only appropriate if none of the relevant decision points result in liability classification.

To the extent contingent consideration should be classified as an asset or liability, the buyer must also determine whether the contingent consideration falls within the scope of the derivative guidance in the Codification (i.e., ASC 815-10). Making that determination could affect the subsequent accounting for the contingent consideration if the buyer intends to designate it as a hedging instrument (which is uncommon, as discussed later in Section 12.4.4.2), as well as the presentation and disclosure requirements applicable to the contingent consideration. The subsequent accounting for contingent consideration is discussed in detail in Section 12.4.4.

### 12.4.3 Reassessment of classification

If the contingent consideration falls within the scope of ASC 815-40, the classification of the contingent consideration should be reassessed at each balance-sheet date. To the extent the circumstances giving rise to the classification of the contingent consideration as a liability or equity have changed at a subsequent balance-sheet date, it may be necessary to change the classification of the contingent consideration. ASC 815-40-35-8 to 35-13 provide guidance on how to record the reclassification.

### 12.4.4 Ongoing accounting

#### 12.4.4.1 Measurement period adjustments affecting contingent consideration

When the buyer determines it is necessary to make an adjustment to contingent consideration recognized in the accounting for a business combination, the accounting for that adjustment depends on a number of factors. Depending on those factors, the buyer could be required to account for the adjustment as a measurement period adjustment. For example, the buyer may have recognized a provisional amount for contingent consideration in its initial accounting for the business combination because it was waiting for the report from a valuation specialist that includes the final fair value estimate of the contingent consideration as of the acquisition date. In that situation, the buyer should make an adjustment to the provisional amount of contingent consideration recorded in the initial accounting for the business combination, which affects the amount of contingent consideration recognized, as well as the amount of goodwill (or gain from a bargain purchase) recognized in the accounting for the business combination. The guidance in Section 12.7 should be used to determine if an adjustment to contingent consideration should be accounted for as a measurement period adjustment.

A few points to highlight when determining whether an adjustment to contingent consideration should be accounted for as a measurement period adjustment include the following:

- A contingent consideration adjustment identified within one year of the acquisition date is not automatically considered a measurement period adjustment. If the adjustment does not relate to the facts and circumstances that existed as of the acquisition date, it is not a measurement period adjustment.
- A contingent consideration adjustment identified more than one year after the acquisition date may still need to be accounted for as a measurement period adjustment. If the contingent consideration adjustment should have been identified within one year of the acquisition date and it would have otherwise met the definition of a measurement period adjustment, the buyer would apply the guidance in ASC 250 to properly account for the contingent consideration adjustment as a measurement period adjustment.
- To account for an adjustment to contingent consideration as a measurement period adjustment, the contingent consideration should have been identified in the buyer's disclosures as a provisional amount in the initial accounting for the business combination (see Section 12.7.1).
- Events occurring after the acquisition date should not be confused with measurement period adjustments because events occurring after the acquisition date may or may not constitute

additional information about the facts and circumstances *in existence* at the acquisition date (a prerequisite for a measurement period adjustment). Examples of such events in the context of contingent consideration that do not give rise to a measurement period adjustment include achieving an earnings target, a specified share price or a predetermined milestone.

To the extent an adjustment to contingent consideration does not meet the definition of a measurement period adjustment or an error, the subsequent accounting guidance applicable to contingent consideration discussed in the next section should be used to account for that adjustment.

#### 12.4.4.2 Subsequent accounting guidance applicable to contingent consideration

The subsequent accounting guidance applied to contingent consideration depends on whether the contingent consideration is classified as an asset, liability or equity:

- If the contingent consideration is classified as an asset or liability, it is remeasured to its fair value at the end of each reporting period and the change in fair value is reflected in income or expense until the contingency is resolved. While not common, the only exception would be if the contingent consideration qualifies for and is designated as the hedging instrument in a hedge relationship for which ASC 815-20-35 requires the change in fair value to be recognized in other comprehensive income (OCI).
  - If the contingent consideration is a derivative, the presentation and disclosure requirements generally applicable to a derivative are also applicable to the contingent consideration.
  - If a contingency remains unresolved at the end of a reporting period, there generally will be a change in the fair value of the contingent consideration asset or liability that is recognized in the income statement even when there is not a change in expectations about meeting the contingency. This is due to the fair value of the contingent consideration changing over reporting periods because of the time value of money. In other words, the fair value of a contingent consideration asset or liability should change between reporting periods, at a minimum, due to the time value of money.
  - We believe the change in the fair value of contingent consideration that is not a derivative should be reflected on the income statement in a line item that is included within operating expense or operating income. This position is based on an analogy to the guidance in ASC 410-20-35-5, which addresses changes in an ARO due to the passage of time. Such changes are not considered part of interest costs. The line item in which the change in the fair value of contingent consideration that is a derivative is reflected in the income statement depends on the facts and circumstances.
- If the contingent consideration is classified as equity, it is not remeasured to its fair value at the end of each reporting period. If shares are issued or returned upon resolution of the contingency, then a reclassification within equity may be necessary. For example, the par value of the stock issued may need to be reclassified from additional paid-in capital to common stock.

#### 12.4.4.3 Derecognition of a contingent consideration liability recorded by the buyer

A liability recognized for contingent consideration in the accounting for a business combination should only be derecognized upon settlement or expiration of the contingency. Derecognizing a contingent consideration liability is different from determining that the fair value of a contingent consideration liability at the end of a reporting period is zero. A contingency exists until it has expired or been settled. Until that time, the buyer may need to make disclosures about the contingent consideration even if its fair value at the end of the reporting period is zero.

Amounts recognized in equity when accounting for the contingent consideration involved in a business combination are not derecognized even if the shares or other equity consideration are not subsequently issued.

### 12.4.5 Income tax effects

The income tax effects of contingent consideration are discussed in Section 11.4.4.

### 12.4.6 Classification of cash payment for contingent consideration on the cash flow statement

The cash flow statement classification of a cash payment to partially or fully settle a contingent consideration liability depends on the following:

- *Was the payment made soon after the business combination's acquisition date?* If so, the payment should be classified as an investing activity.
- *When the payment was not made soon after the business combination's acquisition date, how was the recognition of the liability treated from an accounting perspective?* Payments to settle the contingent consideration liability up to the amount ultimately included in the consideration transferred used in the accounting for the business combination should be reflected as a financing activity in the cash flow statement. Payments to settle the portion of the contingent consideration liability ultimately not included in the accounting for the business combination (because they were reflected in the income statement), if any, should be reflected as an operating activity in the cash flow statement. In other words, the only time some or all of the contingent consideration payment would be reflected in operating activities is when the amount of the payments exceeds the amount reflected in the accounting for the business combination.

**Example 12-3: Classification of payment for contingent consideration in the cash flow statement when the amount ultimately paid is more than what was recognized in the accounting for the business combination**

Buyer acquires Target in a business combination and recognizes a contingent consideration liability in the amount of $1 million in its initial accounting for the business combination. The contingent consideration is identified as a provisional amount as Buyer is still waiting for the final valuation of the obligation from a valuation specialist it hired. The final valuation indicates that a contingent consideration liability in the amount of $1.25 million should have been recognized in the accounting for the business combination. As such, Buyer increases the contingent consideration liability through a measurement period adjustment (which effectively increases the amount of goodwill recorded in the business combination) (see Section 12.4.4.1).

In a subsequent accounting period, there is a change in the facts and circumstances, and Buyer determines that the fair value of the contingent consideration liability at the end of that subsequent accounting period is $1.75 million. As such, Buyer increases the contingent consideration liability through a subsequent accounting adjustment, which results in Buyer recognizing $500,000 of operating expenses in the income statement (see Section 12.4.4.2).

One year after the acquisition date, when Buyer subsequently makes a cash payment of $1.75 million to settle the contingent consideration liability, the payment should be classified as follows in the cash flow statement:

| | Amount | Classification |
|---|---|---|
| Portion of payment reflected in the consideration transferred (i.e., the accounting for the business combination) | ($1,250,000) | Cash outflow from financing activities |
| Portion of payment reflected in the income statement | ($500,000) | Cash outflow from operating activities |

**Example 12-4: Classification of payment for contingent consideration in the cash flow statement when the amount ultimately paid is less than what was recognized in the accounting for the business combination**

Buyer acquires Target in a business combination and recognizes a contingent consideration liability in the amount of $1 million in its initial accounting for the business combination. The contingent consideration is identified as a provisional amount as Buyer is still waiting for the final valuation of the obligation from a valuation specialist it hired. The final valuation indicates that a contingent consideration liability in the amount of $1.25 million should have been recognized in the accounting for the business combination. As such, Buyer increases the contingent consideration liability through a measurement period adjustment (which effectively increases the amount of goodwill recorded in the business combination).

In a subsequent accounting period, there is a change in the facts and circumstances, and Buyer determines that the fair value of the contingent consideration liability at the end of that subsequent accounting period is $750,000. As such, Buyer decreases the contingent consideration liability through a subsequent accounting adjustment, which results in Buyer recognizing $500,000 of operating income in the income statement.

One year after the acquisition date, when Buyer subsequently makes a cash payment of $750,000 to settle the contingent consideration liability, it should classify that payment as a cash outflow from financing activities in the cash flow statement.

### 12.4.7 Disclosures

The disclosure requirements applicable to contingent consideration are discussed in Section 14.2.4 and Section 14.4.3.

**Example 12-5: Adjustments to contingent consideration**

Buyer enters into a business combination in which it acquires Target. The acquisition date is November 1, 20X1. Buyer is a private company and has a calendar year end. Buyer has not elected the private-company goodwill amortization alternative (see Section 18.3). Buyer must provide its audited comparative financial statements to one of its lenders annually on February 28. Buyer agrees to pay Sellers an additional $600,000 in cash if Target's revenue growth is 10% or more for the nine-month period following the acquisition date (i.e., November 1, 20X1 to July 31, 20X2). Buyer has hired a valuation specialist to determine the fair value of this contingent consideration. The valuation specialist does not expect to have the fair value estimate completed until March 15, 20X2. Buyer's best estimate of the fair value of the contingent consideration as of the acquisition date is $450,000, which Buyer uses as a provisional amount in its December 31, 20X1 financial statements. The amount of goodwill reflected in Buyer's December 31, 20X1 financial statements related to its acquisition of Target is $900,000. The fair value estimate received from the valuation specialist on March 31, 20X2 indicates the fair value of the contingent consideration as of the acquisition date is $400,000. On August 15, 20X2, Buyer determines Target's revenue growth for the nine-month period ending July 31, 20X2 was 10.5%. As such, Buyer is obligated to pay Sellers $600,000 of additional consideration.

Because the contingent consideration must be settled in cash and it is not otherwise tied to Buyer's (or one of its consolidated subsidiaries') equity, it should be classified as a liability.

The analysis of this fact pattern based on the discussion in Section 12.4.4.1 and Section 12.7.2 about measurement period adjustments is as follows:

- Has Buyer completed its identification and measurement of the contingent consideration when it issues its December 31, 20X1 financial statements?

*No.* While the identification activities related to the contingent consideration are completed prior to Buyer issuing its December 31, 20X1 financial statements, its measurement activities are not because it is waiting for the valuation specialist to finish the fair value estimate of the contingent consideration. As such, Buyer records a provisional amount for the contingent consideration in its December 31, 20X1 financial statements in the amount of $450,000 and makes the appropriate disclosures about the incomplete accounting for this item.

- Analysis of adjustment necessary upon receipt of fair value estimate from valuation specialist

Buyer receives the fair value estimate from the valuation specialist within the measurement period. As such, Buyer determines whether it is necessary to treat the adjustment to the provisional amount as a measurement period adjustment. The two critical questions that must be answered yes for the adjustment to be considered a measurement period adjustment are:

1. Does the valuation specialist's fair value estimate pertain to the facts and circumstances that existed as of the acquisition date?
2. If Buyer had the valuation specialist's fair value estimate at the acquisition date, would that information have affected: (a) whether it recognized an asset or liability as of that date or (b) its measurement of an asset, liability or other amount involved in the accounting for the business combination?

*Yes* to both. The valuation specialist estimated the fair value of the contingent consideration as of the acquisition date. In addition, if Buyer had access to the completed fair value estimate prior to issuing its December 31, 20X1 financial statements, Buyer would have included its results in the accounting for the business combination. As such, Buyer should record the measurement period adjustment that is captured in the journal entry that follows on March 31, 20X2 (i.e., the measurement period adjustment should not be recognized retrospectively).

| | Debit | Credit |
|---|---|---|
| Liability for contingent consideration (Note 1) | $50,000 | |
| Goodwill (Notes 1 and 2) | | $50,000 |

**Note 1**: The adjustment to the liability for contingent consideration and goodwill is equal to the difference between the provisional amount recorded for the liability ($450,000) and the fair value determined by the valuation specialist ($400,000).

**Note 2**: If Buyer had elected the private-company goodwill amortization alternative (see Section 18.3), the measurement period adjustment would also have needed to reflect its effects on goodwill amortization.

Buyer should also disclose the nature and amount of the measurement period adjustment in its December 31, 20X2 financial statements.

- Analysis of adjustment necessary upon determining Target's revenue growth

During the measurement period, Buyer determines that Target's revenues grew by 10.5% for the nine-month period ending July 31, 20X2. As such, Buyer determines whether it is necessary to treat the adjustment to the liability for contingent consideration as a measurement period adjustment. The two critical questions that must be answered yes for the adjustment to be considered a measurement period adjustment are:

1. Does the 10.5% revenue growth rate pertain to the facts and circumstances that existed as of the acquisition date?
2. If the buyer had the information at the acquisition date, would that information have affected: (a) whether the buyer recognized an asset or liability as of that date or (b) the buyer's measurement of an asset, liability or other amount involved in the accounting for the business combination?

*No* to (1). Target's achievement of 10.5% in revenue growth for the nine-month period ending July 31, 20X2 does not pertain to the facts and circumstances that existed as of the acquisition date (November 1, 20X1). In other words, the facts and circumstances that gave rise to the 10.5% revenue growth all occurred after the acquisition date. As such, Buyer does not treat the adjustment to the liability for contingent consideration as a measurement period adjustment. Instead, Buyer should record the adjustment on August 15, 20X2 as follows:

| | Debit | Credit |
|---|---|---|
| Other expense (Note 1) | $200,000 | |
| Liability for contingent consideration (Note 2) | | $200,000 |

**Note 1**: While ASC 805 does not address the classification of this amount in the income statement, we believe this expense should enter into the determination of operating income because the payment resulted from Target's operating performance after being acquired.

**Note 2:** The adjustment to the liability for contingent consideration is equal to the difference between the carrying amount of the liability ($400,000, after recording the measurement period adjustment to reflect the valuation specialist's fair value estimate of the liability) and the amount Buyer is obligated to pay Sellers upon determining that Target achieved the necessary revenue growth ($600,000).

### 12.4.8 Counterintuitive nature of subsequent accounting guidance applicable to contingent consideration

The subsequent accounting for a nonderivative contingent consideration asset or liability recognized in the accounting for a business combination could result in the recognition of income if the amount of contingent consideration paid out is less than the amount reflected in the accounting for the business combination. In other words, if the amount of the contingent consideration liability recognized in the accounting for the business combination is greater than the contingent consideration actually paid out, the buyer will recognize income. Recognizing income may seem counterintuitive if the consideration is contingent upon reaching a specific milestone or threshold (e.g., additional consideration is payable if a certain amount of revenue is generated in the first 12 months after the acquisition) because not reaching that milestone (which is generally viewed as a negative outcome) results in the recognition of income (which is generally viewed as a positive outcome).

Consider the situation in which a liability is recognized by the buyer related to the contingent consideration it would owe if the target generates $50 million in revenue during the first 12 months after the acquisition date. Assume the following in this situation:

- The liability does not meet the definition of a derivative.
- The amount payable if the revenue threshold is met is $2 million.
- The fair value of the contingent consideration on the acquisition date is $1 million. As such, this is the amount that is recognized as a liability in the accounting for the business combination.
- The fair value of the contingent consideration is $1 million at the end of each reporting period that occurs in the first 11 months after the acquisition date. As such, no adjustments are made to the contingent consideration liability recognized in the accounting for the business combination. For ease of illustration, the time value of money has been ignored in this situation.
- In the last month of the 12-month period, a major customer unexpectedly cancels a large order due to financial difficulties, which will result in the target only generating $48 million in revenue during the first 12 months after the acquisition date.

As a result of the target not reaching the revenue threshold, it is necessary for the buyer to make an adjustment to the contingent consideration recognized in the accounting for the business combination. Because the buyer identified this adjustment during the measurement period, the question that must be considered is whether the buyer should account for the adjustment as a measurement period adjustment or a subsequent accounting adjustment. The thought process described in Section 12.7.2 is used for this purpose. The first critical question the buyer should consider is the following: Does the major customer unexpectedly cancelling a large order due to financial difficulties pertain to the facts and circumstances that existed as of the acquisition date? The answer to this question is *no*. The major customer unexpectedly cancelling a large order due to financial difficulties does not pertain to the facts and circumstances that existed as of the acquisition date. In other words, the facts and circumstances that gave rise to the major customer cancelling their large order occurred after the acquisition date. As such, the buyer does not treat the adjustment to the liability for contingent consideration as a measurement period adjustment. Instead, the buyer uses the subsequent accounting guidance applicable to contingent consideration, which results in the buyer recognizing income of $1 million when it derecognizes the contingent consideration liability.

It may seem counterintuitive to recognize $1 million in income (a positive event) as a result of a major customer unexpectedly cancelling an order (a negative event). However, one of the accounting considerations that might counteract this seemingly counterintuitive accounting result involves goodwill. The buyer should consider whether the target not achieving the revenue threshold is an event that would trigger an interim goodwill impairment analysis. The value of the target when it was purchased likely took into consideration the major customer generating a certain amount of revenue for the target over a period of time. When the major customer unexpectedly cancels a large order due to financial difficulties, the buyer should consider whether that is an indicator that the goodwill (or other intangible assets, such as a customer relationship intangible asset) recognized in the accounting for the business combination is impaired. While there may be an impairment loss in this situation, it is unlikely that the impairment loss and the contingent consideration income would exactly offset each other.

### 12.4.9 Contingent consideration arrangements of the target

When the buyer acquires the target and the target has existing contingent consideration arrangements related to previous acquisitions in which it was the acquirer, those contingent consideration arrangements should be accounted for by the target's buyer using the contingent consideration model. In other words, contingent consideration arrangements of the target that are acquired by the buyer should initially be accounted for at fair value and, in many cases, subsequently accounted for at fair value with changes in fair value recorded in earnings. Contingent consideration arrangements of the target are not accounted for using the guidance applicable to most other contingencies acquired in a business combination.

### 12.4.10 Seller's accounting for contingent consideration

In 2009, the EITF discussed in EITF 09-4 how a seller should account for contingent consideration involved in its sale of a business. The impetus for this issue was a practice issue that arose related to certain guidance issued that is now included in ASC 810-10-40-5. More specifically, that paragraph addresses how a parent should account for the deconsolidation of a subsidiary, which is addressed in more detail in Section 16.2.

As noted in the minutes for the last meeting in which EITF 09-4 was discussed (September 2009), prior to the guidance in ASC 810-10-40-5, the typical accounting by the seller for contingent consideration depended on whether the contingent consideration both: (a) met the definition of a derivative and (b) did not qualify for one of the exceptions to accounting for it as a derivative (see Section 12.4.2):

- If yes to both, the contingent consideration was accounted for as a derivative at fair value in accordance with the guidance in ASC 815.
- If not yes to both, the contingent consideration was accounted for as a contingent gain in accordance with ASC 450, which generally resulted in the seller not recognizing the contingent consideration until its realization (i.e., the contingency was resolved).

The guidance in ASC 810-10-40-5 that raised the question as to whether the seller's accounting for contingent consideration should have changed when that guidance became effective was the inclusion of "The fair value of any consideration received" in the calculation of the gain or loss recognized on the deconsolidation of a subsidiary or group of assets meeting the definition of a business that is within the scope of that guidance.

While the EITF discussed how a seller should account for contingent consideration back in 2009, it did not reach a final consensus. In the minutes for the last meeting in which this issue was discussed, the FASB staff member who served as the chairman of the EITF observed that support exists in the authoritative literature for a seller to account for contingent consideration (that presumably is not a derivative that should be accounted for in accordance with ASC 815) using either of the following approaches: (a) recognize contingent consideration at fair value upon selling the business based on the guidance in ASC 810-10-40-5(a)(i) or (b) account for contingent consideration using the guidance for contingent gain recognition in ASC 450.

If the seller chooses an initial accounting policy that results in recognizing contingent consideration at fair value, a follow-on question that arises has to do with how the seller should subsequently account for that contingent consideration. With respect to this question, the same FASB staff member observed that the subsequent accounting for contingent consideration initially recognized at fair value is unclear. In addition, one reason the EITF did not come to a consensus on this issue was the practical difficulties with the subsequent measurement of amounts initially recorded at fair value. A seller may be able to obtain financial information about the subsequent performance of a business, but may not have insights into management's plans and expectations of the future sufficient to make appropriate fair value or impairment estimates.

Based on this discussion and current practice, we believe the seller has the following options with respect to selecting its initial and subsequent accounting policies for contingent consideration upon the sale of a business within the scope of ASC 810-10-40-5 when that contingent consideration should not otherwise be accounted for as a derivative:

| Option 1: Gain contingency | Option 2: Fair value | Option 3: Fair value initially and contingency subsequently |
|---|---|---|
| **Initial (i.e., acquisition-date accounting)** | | |
| No recognition (given that realization of a gain contingency, by definition, would not have occurred upon the sale of the business) | Recognize the contingent consideration at its acquisition-date fair value. | |
| **Subsequent accounting** | | |
| Recognize the contingent consideration in income upon its realization. | Remeasure the contingent consideration at its fair value at the end of each subsequent reporting period with the change in fair value recorded in income. | Only recognize increases in the initial fair value of the contingent consideration in income upon the realization of those increases (which is an analogy to ASC 450-30-25-1). Recognize decreases in the initial fair value of the contingent consideration in income if it is probable that a decrease has been incurred at the end of a subsequent reporting period and the amount of that decrease can be reasonably estimated (which is an analogy to ASC 450-20-25-2). |

If the seller contemplates initially accounting for contingent consideration at fair value, it should contemporaneously consider how it will subsequently account for the contingent consideration. In doing so, the seller should consult with experts on the subject to assist in identifying an appropriate subsequent accounting policy for the contingent consideration.

## 12.5 No consideration is transferred

As discussed in Section 3.1.2, business combinations achieved without the transfer of consideration are accounted for using the acquisition method (see Section 2.2). Examples of these types of business combinations include those in which:

- The buyer obtains control of the target through contract alone.
- The buyer is an existing investor in the target and obtains control as a result of the target acquiring its own shares.
- The buyer is the existing majority (but noncontrolling) owner and obtains control of the target as a result of minority veto rights lapsing.

This is not an exhaustive list of situations in which a business combination can be effectuated without the transfer of consideration.

When the buyer gains control of the target without transferring any consideration, the question that arises is how to calculate the amount of goodwill or gain from a bargain purchase that should be recognized in connection with the business combination. As discussed in Section 12.1, the four elements potentially involved in determining the amount of goodwill or gain from a bargain purchase recognized in a business combination include the amount of:

1. Consideration transferred (measured predominantly at fair value)
2. The acquisition-date fair value of any NCI in the target
3. The acquisition-date fair value of the buyer's PHEI in the target (if any)
4. Net assets acquired by the buyer (which is 100% of the target's net assets measured predominantly at fair value)

When the buyer obtains control of a target in which it had a PHEI, and it does so without transferring consideration, we believe that the PHEI (Element 3 of the goodwill calculation) should be valued at the acquisition-date fair value of the buyer's interest in the target after it obtains control. As such, the fair value of the buyer's PHEI in the target should be determined on a controlling interest basis. As discussed in Section 12.6, any difference between the acquisition-date fair value and the carrying amount of the buyer's PHEI in the target should be recognized as a gain or loss in the income statement. While on the surface measuring the acquisition-date fair value of the buyer's PHEI in the target on a controlling interest basis may seem inconsistent with the discussion in Section 12.6.2, one of the fundamental principles of a business combination is that the calculation of goodwill (or a gain from a bargain purchase) should be based on the residual difference between the fair value of the target as a whole (which includes the value of control) and the net assets acquired (measured predominantly at fair value). To adhere to that principle in a business combination in which the buyer had a PHEI in the target and obtains control of the target without transferring consideration, we believe the acquisition-date fair value of the buyer's PHEI should be measured on a controlling interest basis.

Because of the unique circumstances often involved in business combinations that occur without the transfer of consideration, the buyer may need to use one or more valuation techniques to determine the acquisition-date fair value of its interest in the target, as well as the acquisition-date fair value of any NCI in the target (see Section 10.19.3). In determining these fair values, the guidance in ASC 820 on valuation techniques, and on determining fair value in general, should be consulted. These unique circumstances may also result in all of the equity interests in the target being attributed to the NCI in the case of a business combination that occurs through contract alone.

As discussed in more detail in Section 3.1.2, concluding that business combinations can occur without the transfer of consideration introduces the possibility of an entity being the buyer in a business combination through no direct action of its own. Business combinations occurring through no direct action of the buyer present a risk that an entity could be the buyer in a business combination without knowing it. To prevent this situation from occurring, an entity should have procedures in place to monitor its current ownership percentage in investees at each reporting date.

**Example 12-6: Buyer obtains control as a result of Target's acquisition of its own shares**

Buyer obtains control of Target as a result of Target acquiring 25,000 of the 150,000 shares it has outstanding. Buyer transfers no consideration to Target or Target's other owners. Additional information about the relationship between Buyer and Target includes the following:

- Prior to Target's acquisition of 25,000 of its own shares, Buyer owned 67,500 shares in Target (a 45% ownership interest) and accounted for its investment in Target using the equity method.
- The carrying amount of Buyer's investment in Target prior to gaining control of Target was $6.5 million.
- After Target's acquisition of 25,000 of its own shares, Buyer's ownership interest in Target is 54% (Buyer's 67,500 shares of Target ÷125,000 shares [150,000 of Target's outstanding shares before Target's acquisition of 25,000 of its own shares – 25,000 shares acquired by Target]).

- The fair value of Buyer's interest in Target on the acquisition date after it gains control is $9.6 million.
- The acquisition-date fair value of the NCI's 46% equity interest in Target is $6.9 million.
- Target's net assets acquired by Buyer are $15.2 million, which consists of $25.8 million of identifiable assets acquired and $10.6 million of liabilities assumed.

The amount of goodwill to be recorded by Buyer due to its obtaining control of Target as a result of Target acquiring 25,000 of its own shares is determined as follows:

| | |
|---|---|
| Element 1: Consideration transferred | $ – |
| Element 2: Acquisition-date fair value of NCI in Target | 6,900,000 |
| Element 3: Acquisition-date fair value of Buyer's PHEI in Target | 9,600,000 |
| Total | 16,500,000 |
| Element 4: Net assets acquired | 15,200,000 |
| Goodwill: Excess of Elements 1 to 3 over Element 4 | $1,300,000 |

A summary journal entry representing the overall effects of the business combination on Buyer's consolidated financial statements at the acquisition date is as follows:

| | Debit | Credit |
|---|---|---|
| PHEI in Target (Note 1) | $3,100,000 | |
| Gain | | $3,100,000 |
| | | |
| Identifiable assets | $25,800,000 | |
| Goodwill | 1,300,000 | |
| Liabilities | | $10,600,000 |
| NCI | | 6,900,000 |
| PHEI in Target | | 9,600,000 |

**Note 1**: This journal entry is necessary given that the business combination involves a step acquisition (see discussion earlier in this section and Section 12.6). The amount of the gain is calculated as the excess of the acquisition-date fair value of Buyer's PHEI in Target ($9.6 million) over the carrying amount of the related investment recorded by Buyer ($6.5 million).

**Example 12-7: Buyer obtains control through contract alone**

Buyer obtains control of Target through contract alone. More specifically:

- Buyer transfers no consideration to Target or Target's owners.
- The contract between Buyer and Target's owners results in Buyer obtaining control of Target.
- Buyer did not previously hold any equity interest in Target and the contract does not result in Buyer receiving any equity interest in Target.
- The fair value of the NCI's 100% equity interest in Target is $2.5 million.
- Target's net assets acquired by Buyer are $2.4 million, which consists of $5.2 million of identifiable assets acquired and $2.8 million of liabilities assumed.

The amount of goodwill to be recorded by Buyer as a result of obtaining control of Target through contract alone is determined as follows:

| | |
|---|---|
| Element 1: Consideration transferred | $ – |
| Element 2: Acquisition-date fair value of NCI's 100% interest in Target | 2,500,000 |
| Element 3: Acquisition-date fair value of Buyer's PHEI in Target | – |
| Total | 2,500,000 |
| Element 4: Net assets acquired | 2,400,000 |
| Goodwill: Excess of Elements 1 to 3 over Element 4 | $100,000 |

A summary journal entry representing the overall effects of the business combination on Buyer's consolidated financial statements at the acquisition date is as follows:

| | Debit | Credit |
|---|---|---|
| Identifiable assets | $5,200,000 | |
| Goodwill | 100,000 | |
| Liabilities | | $2,800,000 |
| NCI | | 2,500,000 |

## 12.6 Business combinations achieved in stages (i.e., step acquisitions)

### 12.6.1 General

The buyer in a business combination may have a preexisting ownership interest in the target. For example, assume the buyer owns 25% of the target when it purchases an additional 30% of the target. In that situation, the buyer obtains control of the target as a result of purchasing the additional 30% ownership interest. This situation is referred to as a business combination achieved in stages or a step acquisition.

When a step acquisition occurs, the buyer must first measure the acquisition-date fair value of its PHEI in the target and recognize either: (a) a gain for the excess of the acquisition-date fair value of its PHEI in the target over its carrying amount or (b) a loss for the excess of the carrying amount of its PHEI in the target over its acquisition-date fair value. The acquisition-date fair value of the buyer's PHEI in the target is then taken into consideration when measuring the goodwill or gain from a bargain purchase to be recognized in the accounting for the business combination (see Section 12.1).

As discussed in Section 12.1, there are four elements potentially involved in determining the amount of goodwill or gain from a bargain purchase recognized in the accounting for a business combination in which consideration is transferred. They consist of:

1. Consideration transferred (measured predominantly at fair value)
2. The acquisition-date fair value of any NCI in the target
3. The acquisition-date fair value of the buyer's PHEI in the target
4. Net assets acquired by the buyer (which is 100% of the target's net assets measured predominantly at fair value)

The amount of goodwill or gain from a bargain purchase to be recognized in a business combination is determined based on the difference between the total of Elements 1 to 3 and Element 4. If the total of Elements 1 to 3 is greater than Element 4, then goodwill is the result. If the inverse is true, then a gain from a bargain purchase may result (see Section 12.2).

As indicated earlier, if the buyer has a PHEI in the target at the time of the business combination, the buyer must recognize a gain or loss on that investment based on the difference between the carrying amount of the PHEI in the target and its fair value as of the acquisition date. This gain or loss is recorded in net income. When determining the amount of the gain or loss to be recognized, the buyer should take into consideration any amounts previously recognized in OCI related to its PHEI in the target. In other words, those amounts included in OCI should be reclassified out of OCI and into the gain or loss calculation. Examples of what could give rise to amounts previously recognized in OCI include gains and losses on derivatives used in cash-flow hedges, gains and losses on debt securities classified as available-for-sale and foreign-currency translation adjustments.

Recognition of the gain or loss on the buyer's PHEI in the target allows for the inclusion of such investment's fair value in the determination of the amount of goodwill or gain from a bargain purchase that should be recognized by the buyer. The fair value of the buyer's PHEI in the target is Element 3 of the four elements involved in the goodwill calculation for a business combination. Including this element in determining the amount of goodwill or gain from a bargain purchase to be recognized is important to the following aspects of the overall accounting model applied to business combinations: (a) recognizing the target's business *as a whole*, regardless of whether 51% or 99% of the target has been acquired, (b) using a measurement approach based predominantly on the *fair values* of the assets acquired and liabilities assumed and (c) recognizing the goodwill attributable to the buyer's entire ownership interest, as well as the goodwill attributable to any remaining NCI's ownership interest (see Section 7.1 and Section 8.1).

If a buyer gains control of a target through a step acquisition, there are incremental disclosures that must be made by the buyer, including the amount of the gain or loss recognized by the buyer on its PHEI in the target (see Section 14.2.9).

### 12.6.2 Determining fair value of buyer's previously held equity interest (PHEI) in target

The buyer's PHEI in the target is measured at its fair value on the acquisition date. To the extent there is an active market on the acquisition date for the shares held by the buyer prior to obtaining control (e.g., the shares trade on the NYSE), then the fair value of the PHEI should be the number of shares held by the buyer prior to obtaining control multiplied by the active market price for the shares on the acquisition date. This is supported by the guidance in ASC 820-10-35-41, which states the following: "A quoted price in an active market provides the most reliable evidence of fair value and shall be used without adjustment to measure fair value whenever available, except as specified in paragraph 820-10-35-41C." (The Codification reference included in the quote does not address measurement issues that would typically arise with respect to measuring the fair value of a buyer's PHEI in the target.) Adjusting the active market price for discounts (such as a DLOC or DLOM) is not appropriate when there is an active market price for the shares previously held by the buyer because any necessary discounts are presumed to be reflected in the active market price.

In some situations, it may not be clear whether the market that produces a quoted price is an active market. ASC 820-10-35-54C to 35-54H provide guidance on this subject.

When there is not an active market price on the acquisition date for the shares held by the buyer prior to obtaining control of the target (i.e., the buyer's PHEI in the target), then the fair value of the PHEI should be estimated by using one or more valuation techniques (e.g., market and [or] income approaches), which are discussed in ASC 820. When using a valuation technique, the following questions often arise:

- Can the consideration transferred by the buyer for its controlling interest in a target be used to extrapolate the fair value of the buyer's PHEI in that target?
- If there is an NCI in the target, and part of that NCI is purchased by a party other than the buyer at the same time the buyer purchases its controlling interest, can the amount paid by the other party for the NCI be used to calculate the fair value of the buyer's PHEI in that target?

- What factors should be considered in determining whether a DLOC or DLOM is necessary in estimating the fair value of the buyer's PHEI in a target?

Each of these questions is explored further in Section 10.19.3. While that section addresses estimating the fair value of an NCI when there is no active market price for the shares held by the NCI shareholders, the questions and discussion in Section 10.19.3 are also applicable to measuring the fair value of a buyer's PHEI in a target when there is also no active market price for that PHEI (except as discussed in Section 12.5 with respect to measuring the fair value of the buyer's PHEI in a target when no consideration was transferred in the business combination). The discussion in Section 10.19.3 makes readily apparent the fact that estimating the fair value of a buyer's PHEI in a target when there is not an active market price for the shares held by the buyer prior to the acquisition requires careful and thorough consideration of all the facts and circumstances. Because of the complexities involved, we recommend that a buyer consider engaging a valuation specialist to assist in estimating the fair value of any PHEI in a target when an active market price does not exist for the underlying shares.

Consider a situation in which the buyer has historically owned 20% of the target. In a step acquisition, the buyer obtains control of the target by obtaining an additional 40% ownership interest in the target. The amount the buyer pays for the additional 40% ownership interest in the target is $4 million. For the reasons discussed in Section 10.19.3, it is not appropriate in this situation to assume that the fair value of the buyer's PHEI in the target is $2 million (or that each individual percent ownership in the target is worth $100,000). The $4 million paid for the 40% interest in the target may reflect a control premium. The control premium should not be reflected in the valuation of the buyer's PHEI in the target because that PHEI should represent the fair value of the buyer's interest *prior* to it gaining control of the target.

The purpose of estimating the fair value of the buyer's PHEI in a target is to arrive at the fair value of the target as a whole for purposes of calculating the amount of goodwill (or gain from a bargain purchase) that should be recognized in the accounting for the business combination (see Section 12.1). To recognize goodwill that is based on the fair value of the target as a whole, the carrying amount of the buyer's PHEI in the target should be adjusted to its fair value at the acquisition date and a gain or loss should be recognized for any difference between its carrying amount and fair value.

Continuing with the previous example, assume that the 40% additional interest in the target acquired by the buyer represented 400,000 shares, and that correspondingly, the buyer's 20% PHEI in the target represented 200,000 shares. Because the buyer paid $4 million for a 40% interest, it effectively paid $10 per share. Assume the active market price for the target's stock on the acquisition date was $9 per share. The difference between the active market price for the target's stock on the acquisition date ($9 per share) and the price paid by the buyer for a controlling interest ($10 per share) likely represents a DLOC. The fair value of the buyer's PHEI in the target should be $1.8 million (200,000 shares multiplied by $9 per share).

**Example 12-8: Step acquisition**

Buyer pays $4 million to obtain an additional 400,000 shares (or an additional 40% interest) in Target. Buyer previously owned 200,000 shares (or 20%) of Target and accounted for its investment in Target using the equity method. Additional information related to Buyer's acquisition of the additional 40% interest includes the following:

- The carrying amount of Buyer's PHEI in Target on the acquisition date is $500,000.
- The fair value of Buyer's PHEI in Target on the acquisition date is $1.8 million.
- Buyer's 40% acquisition results in it owning 60% of Target.
- The fair value of the 40% NCI that exists after Buyer's acquisition of 40% of Target is $3.6 million.

- Target's net assets acquired by Buyer are $8,775,000, which consists of $10 million of identifiable assets acquired and $1,225,000 of liabilities assumed.

In accounting for the business combination, Buyer recognizes a gain for the excess of the acquisition-date fair value of its 20% PHEI in Target over its carrying amount on the acquisition date. The following journal entry illustrates recognition of this gain by Buyer.

| | Debit | Credit |
|---|---|---|
| Equity method investment in Target | $1,300,000 | |
| Gain | | $1,300,000 |

After recognition of this gain, the new carrying amount of Buyer's PHEI in Target is equal to $1.8 million (the acquisition-date fair value of Buyer's PHEI in Target). This amount represents Element 3 of the four elements that are used in determining the amount of goodwill or gain from a bargain purchase to be recognized by Buyer in the accounting for the business combination. The following demonstrates how Buyer should calculate the amount of goodwill to be recognized as a result of acquiring a controlling interest in Target:

| | |
|---|---|
| Element 1: Consideration transferred | $4,000,000 |
| Element 2: Acquisition-date fair value of NCI | 3,600,000 |
| Element 3: Acquisition-date fair value of Buyer's 20% PHEI in Target | 1,800,000 |
| Total | 9,400,000 |
| Element 4: Net assets acquired | 8,775,000 |
| Goodwill: Excess of Elements 1 to 3 over Element 4 | $625,000 |

The following summary journal entry together with the first journal entry represent the overall effects of the business combination on Buyer's consolidated financial statements at the acquisition date:

| | Debit | Credit |
|---|---|---|
| Identifiable assets | $10,000,000 | |
| Goodwill | 625,000 | |
| Cash | | $4,000,000 |
| Liabilities | | 1,225,000 |
| NCI | | 3,600,000 |
| Equity method investment in Target | | 1,800,000 |

## 12.7 Provisional amounts and measurement period adjustments

### 12.7.1 General

#### 12.7.1.1 What are provisional amounts, the measurement period and measurement period adjustments?

Through its measurement period guidance, ASC 805 implicitly acknowledges that identifying and measuring the various items involved in accounting for a business combination is often a complex and lengthy process. ASC 805-10-25-15 defines the measurement period as "...the period after the acquisition date during which the acquirer may adjust the provisional amounts recognized for a business combination." The objective of the measurement period is to provide the buyer with the time needed to complete the acquisition-date accounting for the business combination. Its objective is not to determine ultimate settlement amounts or to eliminate the uncertainties involved in estimating the fair value of many of the items involved in the accounting for a business combination. For example, if a calendar-year-end buyer acquires a business on November 30, 20X1, and has to issue its financial statements on March 15, 20X2, will that buyer have all the information it needs to finalize the business combination accounting when it issues its December 31, 20X1 financial statements on March 15, 20X2? Given the complexities involved in the accounting for a business combination, it is possible that the buyer will need additional time to gather all the information necessary to finalize its accounting for the business combination by March 15, 20X2, which is why ASC 805 provides guidance on provisional amounts, the measurement period and measurement period adjustments.

The concept of provisional amounts is integral to the measurement period guidance provided in ASC 805. Provisional amounts are preliminary acquisition-date estimates recognized in the accounting for the business combination as of the balance-sheet date that are expected to be adjusted to their final amounts during the measurement period when the buyer obtains additional information about the facts and circumstances that existed as of the acquisition date. The fact that an amount is considered a provisional estimate (that is expected to be adjusted in a future period) does not mean that less rigor should be exercised in arriving at that amount. In fact, we understand that the SEC staff and other regulators have questioned provisional amounts in the past to ensure that an appropriate level of rigor was exercised and that adequate supporting documentation existed for provisional amounts. When arriving at a provisional estimate, the buyer should ensure that it has used the best information available prior to the issuance of the financial statements and that it has adequate supporting documentation for the provisional amount.

Recognizing a provisional amount is necessary when the buyer has to issue financial statements that include the target prior to completing its accounting for the business combination (i.e., prior to the end of the measurement period). The measurement period begins on the acquisition date and ends on the earlier of either: (a) the buyer obtaining the information needed to finish the accounting for the business combination or (b) one year from the acquisition date. Continuing with the previous example, the buyer may not have all of the information it needs to determine the fair value of an acquired finite-lived intangible asset as of November 30, 20X1 (i.e., the acquisition date) by the time it issues its financial statements on March 15, 20X2. In that situation, the buyer should recognize a provisional amount representing its best estimate of the acquisition-date fair value of the intangible asset in the financial statements it issues on March 15, 20X2. The expectation is that the buyer would record a measurement period adjustment (if necessary) prior to November 30, 20X2 (i.e., the latest the measurement period may end) to bring the provisional fair value estimate to the final fair value estimate. While the adjustment is being made after the acquisition date, it is important to note that the fair value estimate should still reflect the facts and circumstances that existed as of November 30, 20X1 (i.e., the acquisition date).

Measurement period adjustments are necessary for different reasons. A measurement period adjustment may be necessary because the amount recorded for a particular asset or liability in the initial accounting for the business combination was a preliminary estimate that needed to be adjusted to the final fair value estimate provided by a valuation specialist. A different measurement period adjustment may be necessary because a contingent liability was not recognized in the initial accounting for the business combination because the underlying loss contingency had not been identified by the time the financial statements were issued. A measurement period adjustment would be necessary to recognize the contingent liability in the accounting for the business combination.

Not all adjustments made during the measurement period to amounts recorded in the accounting for a business combination should be treated as measurement period adjustments. Only an adjustment made during the measurement period that possesses both of the following characteristics is considered a measurement period adjustment, and accordingly, is reflected in the accounting for the business combination:

- Results from the buyer obtaining additional information about the facts and circumstances that existed *as of* the acquisition date
- Results from the buyer determining that if this additional information had been known, it would have affected the accounting for the business combination (e.g., recognition or measurement of an acquired asset, assumed liability or any NCI) *as of* the acquisition date

The accounting for an adjustment made during the measurement period that does not possess both of these characteristics depends on the facts and circumstances; however, such accounting will often affect the buyer's operating income (refer to Section 12.7.3 for additional discussion).

#### 12.7.1.2 What disclosures should be provided for provisional amounts and measurement period adjustments and why are those disclosures important?

As discussed in Section 14.2.6, the buyer is required to make certain disclosures if the initial accounting for a business combination is incomplete in the financial statements prepared for the financial reporting period that includes the acquisition date. The buyer's disclosures must provide information that answers the following questions:

- Why is the initial accounting incomplete?
- For which assets, liabilities, NCI or items of consideration is the initial accounting incomplete?

In addition, if the buyer subsequently records a measurement period adjustment, the nature and amount of the adjustment recorded during the reporting period must be disclosed (see Section 14.4.2).

As discussed earlier in this section, measurement period adjustments are made for different reasons. Ideally, for every measurement period adjustment made, there should be a corresponding disclosure in the prior period financial statements indicating why the business combination accounting for the related adjustment was not finished when those financial statements were issued. In the case of the measurement period adjustment in which a preliminary estimate for a particular asset or liability is being adjusted to the final estimate provided by a valuation specialist, the disclosure in the prior period financial statements would have identified the particular asset or liability recorded at a provisional amount and explained that the amount of the asset or liability recognized in the accounting for the business combination was provisional because the buyer was waiting for the final fair value estimate from the valuation specialist. In the case of the measurement period adjustment in which a contingent liability is recognized for a loss contingency that had not been identified before the prior period financial statements were issued, we believe it would often be appropriate to have a disclosure in the financial statements through the end of the measurement period indicating that the buyer is still in the process of determining whether it has identified all of the assets and liabilities that should be recognized in its accounting for the business combination. Providing this disclosure does not excuse the buyer from exercising the appropriate amount of rigor in identifying all of the assets and liabilities that could be recognized prior to issuing financial statements within the measurement period that include the acquisition date.

We understand that the SEC staff and other regulators have questioned situations in which a registrant makes a measurement period adjustment that does not have a corresponding disclosure in the prior period financial statements. As such, we strongly recommend that buyers be diligent in their efforts to provide complete and accurate disclosures about the status of their accounting for a business combination.

#### 12.7.1.3 What are the financial reporting implications of recording a measurement period adjustment?

The measurement period adjustment is recorded in the period in which it occurs. In other words, historical financial statements are not retrospectively adjusted. While the measurement period adjustment is recorded in the period in which it occurs, it is still measured as of the acquisition date. In addition, the buyer also needs to consider the income statement effects (if any) that would have resulted in the intervening period if the measurement period adjustment (hypothetically) had been recorded as of the acquisition date. For this purpose, the intervening period is the period from the acquisition date through the period that ended before the adjustment occurred. The following example illustrates the application of this guidance.

Continuing with the previous example from Section 12.7.1.1, assume the buyer makes the appropriate disclosures in its December 31, 20X1 financial statements related to the provisional amount it recognized for the acquired finite-lived intangible asset in the accounting for the business combination that occurred on November 30, 20X1. In May 20X2, the buyer determines that it is necessary (and appropriate) to make a measurement period adjustment to the provisional amount it recognized for the acquired intangible asset. The buyer measures this adjustment as of November 30, 20X1 (i.e., the acquisition date). The measurement period adjustment is recorded in May 20X2. The December 31, 20X1 financial statements are unaffected by the measurement period adjustment. In addition, given that the measurement period adjustment affected the amount recorded for a finite-lived intangible asset as of the acquisition date, the measurement period adjustment recorded in May 20X2 also includes the effects of adjusting the fair value of the asset on the amortization expense related to that asset for the intervening period (i.e., December 1, 20X1 through April 30, 20X2). If the buyer had elected the private-company goodwill amortization alternative (see Section 18.3), the measurement period adjustment would also include the effects of adjusting the fair value of the asset on the amortization expense related to goodwill for the intervening period.

Example 12-5 and Example 12-9 provide numerical examples illustrating the financial reporting implications of recording a measurement period adjustment.

#### 12.7.1.4 Which items could be the subject of a measurement period adjustment?

The items involved in the accounting for a business combination that could be the subject of a measurement period adjustment include:

- Identifiable assets acquired
- Liabilities assumed
- Any NCI in the target
- Consideration transferred
- Buyer's PHEI in the target (only in connection with a step acquisition [see Section 12.6])

In essence, any part of the four elements involved in determining the amount of goodwill or a gain from a bargain purchase recognized as a result of a business combination (and the goodwill or gain itself) could be the subject of a measurement period adjustment (see Section 12.1). In addition, more than one item could be affected by a particular measurement period adjustment. For example, if a contingent liability and indemnification asset are recognized for outstanding litigation in the accounting for the business combination, then a measurement period adjustment to the liability would likely also affect the indemnification asset (see Section 11.2.3 and Section 11.3.2).

### 12.7.2 Thought process

The thought process that follows should be considered by the buyer when accounting for each individual item identified in the accounting for the business combination that is included in the financial statements prepared for the first reporting period that includes the acquisition date:

- Has the buyer completed the identification and measurement related to the individual item prior to issuing its financial statements?
  - If *yes*, then any subsequent adjustment to that item should be accounted for in accordance with the subsequent accounting guidance in ASC 805 or other U.S. GAAP, as appropriate.

- If *no*, then the buyer records a provisional amount in the financial statements for the first reporting period that includes the acquisition date and provides the appropriate disclosures in the financial statements regarding the incomplete accounting for the item. The provisional amount is the buyer's best estimate of that individual amount based on the information it has available to it at that point in time. The buyer then has up to one year from the acquisition date to complete the identification and measurement of that individual item. During this time period, it is presumed that the buyer is seeking additional specific information necessary for it to complete the identification and measurement activities related to the item. When the identification and measurement activities are completed for that individual item, the buyer determines whether it should treat any necessary adjustments to the provisional amount as a measurement period adjustment. The two critical questions in this regard are:
  - Does the information giving rise to the adjustment pertain to the facts and circumstances that existed as of the acquisition date?
  - If the buyer had the information giving rise to the adjustment at the acquisition date, would that information have affected: (a) whether the buyer recognized an asset or liability as of that date or (b) the buyer's measurement of an asset, liability or other amount involved in the accounting for the business combination?
    - If *yes* to both, the adjustment to the provisional amount is reflected as a measurement period adjustment and appropriate disclosures are provided in the financial statements. This has the effect of adjusting the accounting for the business combination, which in turn may affect the amount of goodwill or gain from a bargain purchase previously recorded by the buyer.
    - If *no* to one or both, a measurement period adjustment does not result. Any subsequent adjustment to the provisional amount is accounted for in accordance with the subsequent accounting guidance in ASC 805 or other U.S. GAAP, as appropriate.

### 12.7.3 Accounting consequences

There are significant accounting consequences to determining whether an adjustment made during the measurement period is: (a) a measurement period adjustment that should be reflected in the accounting for the business combination or (b) an adjustment that should be accounted for outside the business combination. A measurement period adjustment affects the amounts recorded in the business combination, which may include the amount of goodwill or gain from a bargain purchase recognized in the accounting for the business combination. An adjustment during the measurement period that is not a measurement period adjustment will most likely affect net income.

As indicated earlier in Section 12.7.1, the measurement period ends upon the earlier of: (a) the buyer obtaining the information needed to finish the accounting for the business combination and (b) one year from the acquisition date. No measurement period adjustments should be made subsequent to the end of the measurement period. If a revision is discovered after the end of the measurement period and results from an improper or incomplete understanding of the facts and circumstances as of the acquisition date or from errors in the underlying calculations related to the initial accounting for a business combination, such a revision would be considered an error and accounted for in accordance with the guidance on the correction of errors in ASC 250.

The practical effects of accounting for an adjustment as a measurement period adjustment vs. the correction of an error can be significant given that a measurement period adjustment is not reflected retrospective to the acquisition date, while the correction of an error in the accounting for the business combination is reflected retrospective to the acquisition date. This further underscores the importance of reaching an appropriate conclusion as to how to account for an adjustment to an amount recognized in the accounting for a business combination.

**Example 12-9: Provisional and measurement period accounting for manufacturing facility**

Buyer enters into a business combination in which it acquires Target. The acquisition date is November 1, 20X1. Buyer is a private company and has a calendar year end. Buyer must provide its audited comparative financial statements to one of its lenders annually on March 31. Buyer is not required to provide interim financial statements to this lender. One of the identifiable assets acquired by Buyer in the business combination is a large manufacturing facility with an estimated useful life of 20 years. Buyer has hired a valuation specialist to perform an appraisal of the manufacturing facility as of the acquisition date. The valuation specialist does not expect to have its appraisal completed until April 30, 20X2. Buyer's best estimate of the fair value of the manufacturing facility prior to receiving the appraisal is $12.9 million, which Buyer uses as a provisional amount in its December 31, 20X1 financial statements. The amount of goodwill reflected in Buyer's December 31, 20X1 financial statements related to its acquisition of Target is $700,000. The appraisal received from the valuation specialist on April 30, 20X2 indicated the fair value of the manufacturing facility as of the acquisition date is $11.7 million. Buyer has not elected the private-company goodwill amortization alternative (see Section 18.3). As such, it does not amortize goodwill.

The analysis of this fact pattern in the context of the measurement period adjustment thought process included in Section 12.7.2 is as follows:

- Has Buyer completed its identification and measurement of the manufacturing facility prior to issuing its December 31, 20X1 financial statements?
  - **No**. While the identification activities related to the manufacturing facility are completed prior to Buyer issuing its December 31, 20X1 financial statements, its measurement activities are not as it is waiting for the valuation specialist to finish its appraisal of the facility. As such, Buyer records a provisional amount ($12.9 million) for the manufacturing facility in its December 31, 20X1 financial statements and provides the appropriate disclosures about the incomplete accounting for this item.

    *Analysis of adjustment necessary upon receipt of fair value estimate from valuation specialist:*

    When Buyer receives the appraisal from the valuation specialist (which occurs within the measurement period), Buyer determines whether it is necessary to treat the adjustment to the provisional amount as a measurement period adjustment. The two critical questions in this regard are:

    - Does the valuation specialist's appraisal pertain to the facts and circumstances that existed as of the acquisition date?
    - If the buyer had the valuation specialist's appraisal at the acquisition date, would that information have affected: (a) whether the buyer recognized an asset or liability as of that date or (b) the buyer's measurement of an asset, liability or other amount involved in the accounting for the business combination?
      - **Yes** to both. The valuation specialist estimated the fair value of the manufacturing facility as of the acquisition date. In addition, if Buyer had access to the completed appraisal prior to issuing its December 31, 20X1 financial statements, Buyer would have included the appraisal's results in the accounting for the business combination.

*Financial reporting effects*

Buyer should record the following measurement period adjustment on April 30, 20X2 (the date it receives the valuation report):

| | Debit | Credit |
|---|---|---|
| Goodwill (Note 1) | $1,200,000 | |
| Accumulated depreciation–manufacturing facility (Note 2) | 30,000 | |
| Property, plant and equipment–manufacturing facility (Note 1) | | $1,200,000 |
| Depreciation expense (Note 2) | | 30,000 |

**Note 1**: The adjustment to goodwill and property, plant and equipment–manufacturing facility is equal to the difference between the provisional amount recorded for the manufacturing facility ($12.9 million) and the fair value estimated by the valuation specialist ($11.7 million).

**Note 2**: The adjustment to accumulated depreciation–manufacturing facility and depreciation expense is equal to the difference between the amount of depreciation expense recorded on a cost basis of $12.9 million through April 30, 20X2 (assuming the April depreciation expense had already been recorded) and the depreciation expense that would have been recorded for November 20X1 through April 20X2 if a cost basis of $11.7 million had been used ([$12.9 million ÷ 20 × 6/12) – ($11.7 million ÷ 20 × 6/12)].

If Buyer had elected the private-company goodwill amortization alternative, an adjustment would also have been made for the effects of the measurement period adjustment on goodwill amortization for November 20X1 through April 20X2.

Buyer should also disclose the necessary information about the measurement period adjustment in the financial statements for the period in which it is included (see Section 14.4.2).

### 12.7.4 Additional examples

Additional examples of the accounting for adjustments made during the measurement period can be found in Example 11-1 (litigation contingency) and Example 12-5 (contingent consideration).

### 12.7.5 Disclosures

A buyer is required to provide disclosures about both provisional amounts (see Section 14.2.6) and measurement period adjustments (see Section 14.4.2).

## 12.8 Assigning goodwill to reporting units

The goodwill impairment topics within ASC 350-20-35 describe the models that must be used to recognize and measure a goodwill impairment loss. One model is applicable to entities that have elected the private-company goodwill amortization alternative (see Section 18.3) and the other model is applicable to entities that have not elected that alternative. Under the goodwill impairment model applicable to entities that have not elected (or cannot elect) the private-company goodwill amortization alternative, reporting units are the level at which goodwill is tested for impairment and the level at which a goodwill impairment loss is recognized and measured. Under the goodwill impairment model applicable to entities that have elected the private-company goodwill amortization alternative, private companies adopt an accounting policy to test and measure goodwill for impairment at either the reporting unit or entity level.

The Master Glossary of the Codification defines the term reporting unit as follows: “The level of reporting at which goodwill is tested for impairment. A reporting unit is an operating segment or one level below an operating segment (also known as a component).” The term operating segment is used in the context of segment reporting and is defined in ASC 280-10-50-1. In describing what would constitute one level below an operating segment, ASC 350-20-35-34 indicates that “[a] component of an operating segment is a reporting unit if the component constitutes a *business* or a nonprofit activity for which discrete financial information is available and segment management, as that term is defined in paragraph 280-10-50-7, regularly reviews the operating results of that component [emphasis added].” The same definition of a business is used for purposes of determining whether a component constitutes a business as is used for purposes of determining whether a business was acquired (see Section 4.1).

Once an entity’s reporting units have been identified, the entity must use a reasonable and supportable methodology to assign assets and liabilities to each reporting unit. A number of factors are considered in assigning assets and liabilities to each reporting unit, including the method used to determine the fair value of the target (particularly for assets and liabilities that relate to more than one reporting unit) and the reason for the acquisition. All of the factors taken into consideration in identifying the methodology used to assign assets and liabilities to each reporting unit should be documented at the acquisition date. The purpose of this documentation requirement is to facilitate the assignment of amounts to reporting units when goodwill is tested for impairment in the future. If an entity has elected the private-company goodwill amortization alternative and adopted an accounting policy to test for and measure goodwill impairment at the entity level, assignment of amounts to reporting units for purposes of testing goodwill for impairment is not necessary. However, as discussed in Section 12.9, it may be necessary to assign goodwill to foreign subsidiaries for impairment testing purposes. Section 18.3.6 discusses derecognition of goodwill under the alternative when part of the entity is sold.

## 12.9 Assigning goodwill and intangible assets to foreign subsidiaries

When an entity enters into a business combination affecting foreign subsidiaries, U.S. GAAP requires the entity to assign all applicable goodwill and related intangible assets to those foreign subsidiaries. This is particularly important when the subsidiaries have different functional currencies or are in situations where there are significant deferred income taxes on the opening balance sheet with different jurisdictional effective tax rates. The assignment of applicable goodwill and related intangible assets to foreign subsidiaries is required regardless of whether the entity has elected the private-company goodwill amortization alternative (see Section 18.3) because such assignment could affect the amount of initial goodwill that is recorded, as well as the entity’s future foreign currency translation gains (or losses), amortization or impairment charges. When a foreign subsidiary is affected by an acquisition, the entity should discuss with its valuation specialist the need to assign some portion of goodwill and intangible assets recorded in the accounting for the business combination to the foreign subsidiary irrespective of whether or not the entity elects to push down the assigned amounts to the foreign subsidiary’s local books. Often, assigning goodwill and intangible assets to a foreign subsidiary is also required for income tax purposes, which should be discussed with the entity’s tax specialist. If the assignment methods used for U.S. GAAP and tax purposes are different, the entity’s deferred income taxes will be affected.

## 12.10 Working capital adjustments

### 12.10.1 Description and example

It is very common for a business acquisition agreement to provide for adjustments to the purchase price for a business based on the finalization of the target’s working capital balances as of the acquisition date. For example, assume that the buyer and seller agree to sell the target to the buyer for $10 million on December 31, 20X1. One of the elements that was considered by the parties when negotiating the purchase price was the amount of working capital the target had on December 31, 20X1. While this amount could be estimated on the acquisition date, the parties acknowledged that the final amount of working capital on the acquisition date could be different than this estimate. As such, the parties agreed to allow for an adjustment to the purchase price to reflect any difference between the estimated amount of the target’s working capital on the acquisition date and the actual amount of the target’s working capital on the acquisition date. The parties agree that the amount of any adjustment to the purchase price will be determined by March 31, 20X2. Assume both parties agree, based on the terms of the business acquisition agreement, that the estimated amount of the target's working capital on the acquisition date (and the amount reflected in the $10 million purchase price) was $2.5 million and the buyer issued its financial statements on February 28, 20X2, which reflected consideration transferred of $10 million in the accounting for the business combination. Further, assume that on March 31, 20X2 the parties agree, based on the terms of the business acquisition agreement, that the final amount of the target's working capital on the acquisition date was $3 million. As a result, there is a $500,000 working capital adjustment that results in the buyer paying the seller an additional $500,000 of consideration.

The business acquisition agreement typically defines working capital, explains how the working capital adjustment is determined and provides a date by which the working capital adjustment must be finalized. In addition, the business acquisition agreement may provide a mechanism by which disputes related to the working capital adjustment may be resolved (e.g., use of a previously selected mediator). Disputes about the working capital adjustment may arise due to ambiguities in the business acquisition agreement. The terms in the business acquisition agreement pertaining to working capital adjustments are an integral component of the accounting for the consideration transferred and working capital adjustment within the accounting for the business combination.

### 12.10.2 Accounting guidance

The buyer in a business combination must determine whether a working capital adjustment represents a measurement period adjustment (see Section 12.7.1). Continuing with the example from Section 12.10.1, the buyer must determine whether the $500,000 working capital adjustment represents a measurement period adjustment. Making this determination in that relatively simple fact pattern is fairly straightforward because the buyer and the seller agreed on the estimated and actual amounts of working capital as of the acquisition date. The $500,000 working capital adjustment should be treated as a measurement period adjustment because:

- The working capital adjustment is based on the buyer obtaining additional information about the amount of working capital that existed as of the acquisition date.
- If the buyer had known the actual amount of working capital on the acquisition date (instead of just an estimate of the amount of working capital), the buyer would have reflected that actual amount in the accounting for the business combination.
- The working capital adjustment was finalized before the close of the measurement period.

It is key in this situation that the buyer: (a) identifies as of the acquisition date the potential for a working capital adjustment to result in a measurement period adjustment and (b) makes the appropriate disclosures regarding its initial accounting for the business combination not being complete in its December 31, 20X1 financial statements. In making these disclosures, the buyer should indicate that the amount of consideration transferred included in the accounting for the business combination was based on an estimate of working capital that had not been finalized at the time its December 31, 20X1 financial statements were issued. Keep in mind that there may be more measurement period adjustments resulting from the working capital adjustment. To the extent the account balances included in the target's working capital calculation were not final in the initial accounting for the business combination reflected in the December 31, 20X1 financial statements (which is what gave rise to the working capital adjustment), measurement period adjustments may also be necessary to record the final fair values for these account balances. For example, assume the $500,000 working capital adjustment discussed earlier was necessary because the initial estimate of accounts receivable on the acquisition date was $1.4 million (which was included in the initial estimate of working capital of $2.5 million) and the final amount of accounts receivable was $1.9 million (which was included in the final amount of working capital of $3 million). In this situation, it would be reasonable to expect that the measurement period adjustment to reflect the $500,000 working capital adjustment would also reflect an adjustment to accounts receivable.

It is often helpful to consider whether there is a clear and direct link between the working capital adjustment and the consideration transferred (i.e., the accounting for the business combination) when determining whether the adjustment possesses the characteristics of a measurement period adjustment. In the relatively simple example introduced earlier in Section 12.10.1 and further discussed in this section, there is a clear and direct link between the working capital adjustment and the consideration transferred. In other situations, this link may not be as clear or as direct. Accounting for these situations requires a complete understanding and analysis of all of the facts and circumstances. One factor the buyer should consider in this regard is whether an arbitrator was involved in determining the working capital adjustment. If an arbitrator was involved, the buyer would further consider whether the arbitrator is rendering a decision as to the facts of the working capital adjustment or whether the arbitrator is acting in the capacity of a mediator between the buyer and seller. The arbitrator rendering a decision as to the facts of the working capital adjustment would likely be indicative of a clear and direct link between the working capital adjustment and the consideration transferred. Another factor the buyer should consider is whether disagreements about other representations and warranties in the acquisition agreement are being settled as part of a compromise on the working capital adjustment. If this was the case, it would be indicative that there is not a clear and direct link between at least part of the working capital adjustment and the consideration transferred.

Taking into consideration whether there is a clear and direct link between the working capital adjustment and the consideration transferred when determining whether the working capital adjustment should affect the accounting for the business combination (i.e., be treated as a measurement period adjustment) is consistent with a position taken by SEC staff member Randolph P. Green in a speech he gave at the 2003 Thirty-First AICPA National Conference on Current SEC Developments. In this speech, the following observations were made by Mr. Green:

- “In order to reflect some or all of the settlement of such a claim as an adjustment of the purchase price of the acquired business, the acquirer should be able to persuasively demonstrate that all or a specifically identified portion of the mixed claim is clearly and directly linked to the purchase price.”
- “Similarly, claims that assert one party misled the other or that a provision of the agreement is unclear are not unique to business combination agreements and do not generally establish a clear and direct link to the purchase price and, therefore, should be reflected in the income statement.”

While this speech was given prior to the issuance of Statement 141R, the same conceptual issue existed under the predecessor guidance. We believe the thought process used to address the conceptual issue under the predecessor guidance continues to be relevant in addressing the same conceptual issue that exists today.

A situation in which at least a portion of a working capital adjustment should not be considered a measurement period adjustment involves a situation in which it is one year after the acquisition date and the buyer and seller cannot agree on the amount of the working capital adjustment. At the close of the measurement period (i.e., one year after the acquisition date), the buyer must make its best estimate of the acquisition-date fair value of the consideration transferred, which includes the working capital adjustment. Assume further that another year passes before the buyer and seller reach a compromise on the amount of the working capital adjustment. The accounting effects of the working capital adjustments made at the close of the measurement period and upon the buyer’s and seller’s compromise are different from one another:

- The effects of the working capital adjustment at the close of the measurement period should be reflected in the accounting for the business combination provided the adjustment possesses the characteristics of a measurement period adjustment. How the accounting for the business combination is affected by the working capital adjustment depends on a number of factors. For example, if the dispute between the buyer and seller was over what accounts should be included in the working capital definition in the business acquisition agreement, then it is likely that only goodwill would be affected by the adjustment to consideration transferred. However, if the dispute between the buyer and seller was over the amount within the working capital accounts as of the acquisition date, then it is likely that the acquisition-date fair values of the working capital accounts themselves (e.g., accounts receivable, accounts payable) would also be affected by the measurement period adjustment (as discussed earlier in this section).

- The effects of the working capital adjustment upon the buyer's and seller's compromise should be accounted for outside of the business combination with the effects likely reflected in the income statement. The amount of the final working capital adjustment should be the difference between the best estimate of the acquisition-date working capital adjustment made at the close of the measurement period and the compromised amount of the working capital adjustment.

To the extent part of the consideration transferred is held in escrow pending settlement of the working capital adjustment, additional accounting considerations arise, which are discussed in Section 12.3.1.2.

# 13. Determining what is part of the business combination

## 13.1 Determining what is or is not part of the business combination

The guidance in ASC 805 addresses the accounting for business combinations, not other transactions and relationships between the buyer and the target, the target's employees or the sellers of the target. The buyer, the target and its employees and the sellers in an impending business combination essentially become related parties, and they may be influenced by this relationship in their other dealings with each other. As such, to the extent another transaction or relationship occurs or exists between these parties prior to or on the acquisition date, it needs to be analyzed by the buyer to determine whether it gives rise to an accounting event that should be accounted for separate from the business combination. In some situations, a distinct transaction between the buyer and the target, the target's employees or the sellers is explicitly or implicitly executed or modified concurrent with, or during the negotiations of, the business combination. In other situations, the buyer and the target or the sellers may have a long-standing relationship and history of entering into transactions with each other. Each of these other transactions and relationships must be analyzed by the buyer to determine whether they give rise to accounting events that should be accounted for separately from the business combination. Additional considerations are involved in the analysis when the other transactions or relationships are with the target's employees or when contingent payments are involved. These considerations are discussed in detail in Section 13.3.

When there are other transactions and relationships between the buyer and the target or the sellers, the buyer must first identify any and all of these other transactions and relationships. While this sounds like a straightforward exercise, depending on the sizes and organization structures (e.g., centralized or decentralized purchasing function) of the buyer, sellers and target, ensuring that all of the other transactions and relationships between the buyer and the target or the sellers have been identified can be a rather complex exercise. The buyer should ensure it has processes and procedures in place to identify all of the other transactions and relationships between the buyer and the target or the sellers.

For each of the other transactions and relationships identified by the buyer, a determination must be made as to whether it is necessary to account for the transaction or relationship separate from the business combination. In a sense, some of these situations represent a form of multiple-element arrangement in which one of the elements is a business combination.

Questions that should be considered by the buyer in determining whether other relationships or transactions between it and the target or sellers should be accounted for separate from the business combination include the following:

- *Why did the buyer, target, sellers or other involved parties form the relationship or enter into or modify the transaction?* In considering this question, the beneficiaries of the relationship or transaction should be identified. In other words, the party to the business combination that receives the primary benefit of the relationship or transaction should be identified. If the party that receives the primary benefit is the buyer or the combined entity, then it is most likely that the relationship or transaction should be accounted for separate from the business combination.

- *Who initiated the relationship or transaction?* Determining the party that initiated the relationship or transaction may provide some insight into identifying the party that receives the primary benefit of the relationship or transaction. And, as discussed in the previous bullet point, if the party that receives the primary benefit is the buyer or the combined entity, then it is most likely that the relationship or transaction should be accounted for separate from the business combination.

- *When was the relationship or transaction entered into or modified?* If the buyer enters into or modifies the relationship or transaction in contemplation of the business combination, then it may be that the buyer is only doing so for the primary benefit of itself or the combined entity. If that is the case, the only benefit that the target or the sellers will receive results from their continuing involvement with the combined entity. Conversely, if the buyer and target entered into or modified the relationship or transaction well-in-advance of any negotiations on the business combination, then several parties would have had the opportunity to benefit from the relationship or transaction—the buyer, the target and the sellers.

The purpose of these questions is to determine which party or parties benefit from the other relationship or transaction. None of these questions are individually determinative in identifying the party that receives the primary benefit from the relationship or transaction. In addition, the analysis performed to answer one question could very well overlap with the analysis performed to answer a different question. The expectation is that a comprehensive analysis of all the facts and circumstances should be performed to identify those transactions and relationships that should be accounted for separate from the business combination.

Examples of situations in which there is a relationship or transaction between the buyer and the target or the sellers that may be required to be accounted for separate from the business combination can generally be placed into one of two categories: (a) those that arise from a relationship between the relevant parties that existed prior to their contemplating the business combination and that are effectively settled concurrent with the business combination and (b) those that arise from an arrangement entered into or modified by the relevant parties during the negotiations of, or concurrent with, the business combination. As it relates to the first category, the settlement of that preexisting relationship should be accounted for separate from the business combination. For additional discussion on the settlement of a preexisting relationship between the buyer and the target or the sellers, see Section 13.2. As it relates to the second category, an analysis of the nature and terms of the transaction or relationship should be performed to determine whether it should be accounted for within or separate from the accounting for the business combination. Examples of transactions that may be entered into or modified by the buyer and the target or the sellers during the negotiations of, or concurrent with, a business combination include:

- The buyer may request that the seller or target pay the buyer's acquisition-related costs associated with the business combination in return for the transfer of additional consideration. In this situation, the buyer's reimbursement for the acquisition-related costs should be accounted for separate from the buyer's accounting for the business combination and expensed as incurred instead of effectively being included in goodwill. For additional discussion of this type of arrangement and the accounting for transaction costs incurred in connection with a business combination in general, see Section 13.5.
- The buyer may enter into a transaction or modify an existing transaction that effectively represents payment for future goods or services to be provided by sellers of the target. This payment could be embedded in what, at first glance, appears to be contingent consideration. If the payment represents a cost (e.g., expense, inventory), then the buyer should account for it separate from the business combination. For additional discussion related to identifying whether a transaction with a seller (including sellers who continue as employees) should be accounted for separate from the business combination as a cost, see Section 13.3 and Section 13.4.
- The target may announce restructuring activities between the date the business combination is announced and the date it is closed (i.e., the acquisition date). If that occurs, consideration should be given to whether those activities were undertaken by the target on behalf of, or at the request of, the buyer. If the target did undertake the restructuring activities on behalf of or at the request of the buyer, the restructuring activities should be accounted for separate from the business combination. For additional discussion related to accounting for restructuring activities involving the target's operations, see Section 10.15 and Section 13.6.

The ultimate end goal in analyzing the other transactions and relationships between the buyer and the target or the sellers is to identify those items to which the acquisition method should be applied (i.e., those items that are part of the business combination) and those items to which other U.S. GAAP should be applied (i.e., those items that should be accounted for separate from the business combination). That end goal should be kept in mind throughout the analysis.

Specific information about transactions and relationships between the buyer and the target or the sellers that are accounted for separate from the business combination must be disclosed by the buyer in its financial statements (see Section 14.2.8).

## 13.2 Effective settlement of preexisting relationship between buyer and target or sellers

As discussed in Section 13.1, the buyer and the target may have a relationship that predates any contemplation of the business combination. Examples of these relationships include the following:

- *Lawsuits*. The target may have a lawsuit against the buyer. As a result of the business combination, that lawsuit may effectively be settled. That effective settlement should be accounted for separate from the buyer's accounting for the business combination.
- *Executory contracts*. The buyer may have a supply contract with the target. To the extent the supply contract is favorable or unfavorable compared to market terms for the same or a similar supply contract, the buyer should recognize a gain or loss on the settlement of the supply contract separate from the buyer's accounting for the business combination.
- *Reacquired rights*. The target licenses from the buyer an intangible asset or intellectual property (e.g., the target licenses the right to use the buyer's trade name). By acquiring the target, the buyer is effectively reacquiring the right to the intangible asset or intellectual property. To the extent the license agreement is favorable or unfavorable compared to the terms of current market transactions for the same or similar rights, the buyer should recognize a gain or loss related to the settlement of the license agreement with the target separate from the buyer's accounting for the business combination. The reacquired right itself would likely be recognized as an intangible asset in the accounting for the business combination as discussed in Section 11.6.

Some of the preexisting relationships between the buyer and the target may be contractual. From the preceding list of examples, those involving executory contracts and the reacquisition of rights previously granted to the target are contractual. Other preexisting relationships between the buyer and the target may be noncontractual. From the preceding list of examples, those involving lawsuits could be considered contractual or noncontractual depending on the facts and circumstances. The accounting for the settlement of a preexisting relationship between the buyer and the target depends, at least in part, on whether the nature of the relationship was contractual or noncontractual.

If the buyer concludes that a preexisting relationship between it and the target is effectively settled as a result of the business combination, then a gain or loss is recognized apart from the accounting for the business combination. The measurement of the gain or loss depends on whether the preexisting relationship was contractual or noncontractual:

- *Noncontractual*—The gain or loss is measured at fair value.
- *Contractual*—The gain or loss is measured at the lesser of: (a) the amount by which the contract is favorable or unfavorable, from the buyer's perspective, when it is compared to the current market pricing for the same or similar type of contract and (b) the contractual settlement amount available to the party (i.e., the buyer or the target) for whom the contract is unfavorable.

Three additional points related to the accounting for the settlement of a preexisting *contractual* relationship include: (1) if the contractual settlement amount available to the party for whom the contract is unfavorable is less than the amount by which the contract is favorable or unfavorable from the buyer's perspective, then the difference is implicitly reflected in the accounting for the business combination (see Example 13-4), (2) a loss contract and an unfavorable contract are not necessarily the same and (3) if there is no settlement amount specified in the contract, the gain or loss is based solely on the amount by which the contract is favorable or unfavorable from the buyer's perspective. As it relates to the second point, an unfavorable contract is based on determining the degree to which the contract terms are unfavorable compared to current market terms for similar contracts. However, a loss contract commonly refers to the degree to which the contract terms are likely to result in the unavoidable costs under the contract exceeding the economic benefits of the contract.

The buyer must also consider whether it has already recognized an asset or liability related to either a contractual or noncontractual preexisting relationship between the buyer and the target. If so, the asset or liability should be factored into the accounting for the gain or loss.

Specific information about the settlement of preexisting relationships between the buyer and the target must be disclosed by the buyer in its financial statements (see Section 14.2.8).

**Example 13-1: Settlement of preexisting noncontractual relationship for which an asset or liability had not been recognized by the buyer**

Buyer enters into a business combination to purchase 100% of Target. Buyer did not previously own any interest in Target. In connection with the business combination, Buyer transfers consideration of $10 million. In return, Buyer receives net assets of $8 million measured predominantly at fair value, which consists of $12 million of identifiable assets acquired and $4 million of liabilities assumed. Buyer and Target have a relationship that predates any contemplation of the business combination. That relationship centers on a lawsuit in which Target is suing Buyer for patent infringement. Based on an analysis of the lawsuit under ASC 450, Buyer has not previously recognized a liability for the contingent loss. The fair value of that contingent liability just prior to the execution of the business combination is $600,000.

Buyer has a preexisting relationship with Target that is effectively being settled by the business combination. As such, a loss related to the settlement of that preexisting relationship must be recognized by Buyer separate from the accounting for the business combination. Given that the contingent liability is noncontractual, measurement of that loss is based on the fair value of the contingent liability.

A summary journal entry representing the loss recognition and the effects of the accounting for the business combination on the consolidated financial statements as of the acquisition date is as follows:

| | Debit | Credit |
|---|---|---|
| Identifiable assets | $12,000,000 | |
| Goodwill | 1,400,000 | |
| Loss on settlement of lawsuit | 600,000 | |
| Liabilities | | $ 4,000,000 |
| Cash | | 10,000,000 |

**Example 13-2: Settlement of preexisting noncontractual relationship for which an asset or liability had been recognized by the buyer**

Assume the same facts as Example 13-1, except Buyer had previously recognized a contingent liability in the amount of $400,000 based on the application of the guidance in ASC 450.

Buyer has a preexisting relationship with Target that is effectively being settled by the business combination. As such, Buyer must reverse the previously recorded contingent liability and determine whether it needs to recognize any incremental loss or a gain related to the settlement of its preexisting noncontractual relationship with Target. Because the fair value of the contingent liability is more than the carrying amount of the contingent liability, Buyer must recognize an incremental loss of $200,000 outside the accounting for the business combination. Measurement of that loss is based on the fair value of the contingent liability ($600,000), given that it is noncontractual, and on the amount of the liability previously recognized by Buyer ($400,000). A summary journal entry representing the recognition of the incremental loss and the effects of the accounting for the business combination on the consolidated financial statements as of the acquisition date is as follows:

| | Debit | Credit |
|---|---|---|
| Identifiable assets | $12,000,000 | |
| Goodwill | 1,400,000 | |
| Loss on settlement of lawsuit | 200,000 | |
| Contingent liability for lawsuit | 400,000 | |
| Liabilities | | $4,000,000 |
| Cash | | 10,000,000 |

**Example 13-3: Settlement of preexisting supply agreement (loss for unfavorable amount)**

Buyer enters into a business combination to purchase 100% of Target. Buyer did not previously own any interest in Target. In connection with the business combination, Buyer transfers consideration of $15 million. In return, Buyer receives net assets of $13 million, which consists of $18 million of identifiable assets acquired and $5 million of liabilities assumed. Buyer and Target have a relationship that predates the business combination. The relationship centers on a 3-year contract in which Target supplies Buyer with some of the raw materials used in Buyer's production process. At the acquisition date, half of the contract term has elapsed. The supply contract is unfavorable to Buyer because the overall market for the raw materials has become depressed. As a result, Target is selling the same raw materials to other customers at a fraction of what Buyer is paying. Buyer is able to cancel the contract at any time by making a payment of $200,000 to Target. Buyer has not previously recognized a contingent liability for the unfavorable supply contract. The amount by which the supply contract is unfavorable to Buyer just prior to the execution of the business combination is $150,000.

Buyer has a preexisting contractual relationship with Target that is effectively being settled by the business combination. Given the unfavorable nature of that relationship to Buyer, a loss related to the settlement of that preexisting relationship must be recognized by Buyer separate from the accounting for the business combination. The amount of that loss is based on the amount by which the supply contract is unfavorable to Buyer ($150,000) as that amount is less than the amount Buyer would have to pay to cancel (i.e., settle) the contract ($200,000). A summary journal entry representing the loss recognition and the effects of the accounting for the business combination on the consolidated financial statements as of the acquisition date is as follows:

| | Debit | Credit |
|---|---|---|
| Identifiable assets | $18,000,000 | |
| Goodwill | 1,850,000 | |
| Loss on settlement of supply contract | 150,000 | |
| Liabilities | | $ 5,000,000 |
| Cash | | 15,000,000 |

**Example 13-4: Settlement of preexisting supply agreement (loss for contract cancellation fee)**

Assume the same facts as Example 13-3, except that the amount by which the contract is unfavorable to Buyer just prior to the execution of the business combination is $300,000.

Buyer has a preexisting contractual relationship with Target that is effectively being settled by the business combination. Given the unfavorable nature of that relationship to Buyer, a loss related to the settlement of the preexisting relationship must be recognized by Buyer separate from the accounting for the business combination. The amount of that loss is based on the amount Buyer would have to pay to cancel (i.e., settle) the contract ($200,000) as that amount is less than the amount by which the supply contract is unfavorable to Buyer ($300,000). A summary journal entry representing the loss recognition and the effects of the accounting for the business combination on the consolidated financial statements as of the acquisition date is as follows:

| | Debit | Credit |
|---|---|---|
| Identifiable assets | $18,000,000 | |
| Goodwill | 1,800,000 | |
| Loss on settlement of supply contract | 200,000 | |
| Liabilities | | $ 5,000,000 |
| Cash | | 15,000,000 |

**Note**: The $100,000 difference between the amount by which the supply contract is unfavorable and the amount Buyer would have to pay to settle the contract has implicitly been included in goodwill.

## 13.3 Arrangements with employees or sellers of target

### 13.3.1 General

As discussed in Section 13.1, the buyer may enter into or modify an arrangement with employees or sellers of the target concurrent with the negotiations to acquire a business. There may also be preexisting arrangements between the target and its employees that the buyer will assume in the business combination. To the extent one of these types of arrangements arises or exists, the buyer must determine whether any payments to be made in conjunction with the arrangement should be: (a) included *within* the accounting for the business combination (possibly as consideration transferred or an assumed liability) or (b) accounted for *separate* from the business combination (possibly as compensation or another cost). For guidance on this subject that is specific to:

- Replacement share-based payment awards (see Section 13.4)
- Settlement of preexisting contractual and noncontractual relationships (see Section 13.2)
- Transaction costs (see Section 13.5)
- Restructuring activities (see Section 13.6)

Guidance on other types of arrangements entered into by the buyer and employees or sellers of the target is provided in this section.

In determining whether arrangements that will or may result in payments to employees or shareholders should be accounted for within or separate from the business combination, the buyer should first consider whether the payments are forfeited upon termination of employment (i.e., whether the payments are contingent upon employment). Section 13.3.1.1 discusses the accounting implications when payment is forfeited upon termination of employment and Section 13.3.1.2 discusses the accounting implications when payment is not forfeited upon termination of employment.

#### 13.3.1.1 Payment is forfeited upon termination of employment

If a payment is forfeited by a recipient upon termination of employment, then the payment should be accounted for separate from the business combination as compensation (see Scenario C in Example 13-5). In other words, forfeit of payment by the recipient upon termination of employment is a determinative factor that results in accounting for the payment separate from the business combination as compensation.

There are situations in which the required continuing employment of one individual affects not only his or her right to receive a payment from the buyer, but also affects the right of one or more other individuals to receive a payment (see Example 13-6). The payment to the employee whose continuing employment is required after the acquisition date should be accounted for separate from the business combination as compensation. We also believe the payment to the other individuals whose rights to payment from the buyer are contingent upon the employee's continuing employment should generally be accounted for separate from the business combination as compensation. We believe the only potential exception to this accounting treatment would be the rare circumstance in which there is no prior relationship between the employee and the other individuals (i.e., they are independent of each other). However, the facts and circumstances would need to be carefully evaluated to understand why the other individuals would agree to a payment being contingent on something they cannot control (i.e., continued employment of unrelated employee).

There are also situations, often referred to as last-man-standing arrangements, in which the cash to be paid, or shares to be issued, to sellers that will continue as employees after the business combination is held in an irrevocable trust only to be distributed to the seller-employees at a future point in time (i.e., vesting date) provided they continue to be employees at that date (i.e., their employment was not terminated before the vesting date). To the extent seller-employees are terminated prior to the vesting date, they forfeit their right to a distribution from the trust. However, the forfeited distribution remains in the irrevocable trust and is reallocated to those seller-employees that continue to be employees on the vesting date. The question that arises in these situations is whether the cash to be paid, or shares to be issued, to seller-employees should be accounted for as compensation separate from the business combination or consideration transferred. We believe the cash to be paid, or shares to be issued, in these situations should be accounted for as compensation based on a speech about a last-man-standing arrangement given by SEC staff member R. Scott Blackley in 2000 at the AICPA's Twenty-Eighth National Conference on Current SEC Developments. Based on the guidance in EITF 95-8, the SEC staff concluded that the shares to be distributed to seller-employees under a last-man-standing arrangement should be accounted for as compensation separate from the business combination, despite use of an irrevocable trust and redistribution of forfeited amounts to other seller-employees that continue to be employed at the vesting date. While EITF 95-8 was superseded by Statement 141R (see Section 1.2), the guidance included in Statement 141R related to accounting for arrangements with seller-employees was based on the guidance in EITF 95-8. In fact, EITF 95-8 included less stringent guidance than the guidance in Statement 141R with respect to accounting for payments to seller-employees that are forfeited upon termination of employment—EITF 95-8 only indicated that such forfeiture was a *strong indicator* that the payment should be accounted for as compensation, while Statement 141R made forfeiture upon termination of employment a determinative factor resulting in accounting for that payment as compensation. As such, we believe the conclusion in the SEC staff speech continues to be relevant.

#### 13.3.1.2 Payment is not forfeited upon termination of employment

For those arrangements with employees in which the payments that will or may be made by the buyer are not forfeited upon termination of employment along with those arrangements with sellers that will or may result in the buyer making payments to the sellers, the buyer should consider the following questions (which were introduced in Section 13.1) to understand the effects those arrangements may have on the accounting for the business combination, if any:

- Why did the parties enter into or modify the arrangement?
- Who initiated the arrangement?
- When was the arrangement entered into or modified?

When considering these questions, the buyer is determining whether it or the combined entity receives the primary benefit from the arrangement. If it is the buyer or the combined entity that receives the primary benefit from the arrangement, then that suggests the arrangement should be accounted for separate from the business combination (e.g., as compensation).

One of the questions considered when determining the accounting implications of an arrangement between the buyer and the sellers (other than the acquisition agreement) focuses on when the parties entered into or modified the arrangement. If the buyer and the sellers enter into or modify another arrangement, such as a supply agreement, at the same time as (or in contemplation of) the business combination, the buyer should determine whether the terms of the arrangement are favorable or unfavorable from its perspective. If the terms are neither favorable nor unfavorable to the buyer, then it is likely that no special accounting considerations arise for the buyer solely as a result of the other arrangement being entered into or modified at the same time as (or in contemplation of) the business combination. However, if the terms of the other arrangement are favorable or unfavorable, the buyer should determine the accounting implications of this on the accounting for the business combination and the other arrangement. For example, if the other arrangement requires the buyer to pay the sellers less in the future for a product or a raw material than the buyer would have paid absent the business combination, then it may be necessary for the buyer to treat some of the amounts paid to the sellers for the target as something other than consideration transferred in the accounting for the business combination. In other words, the buyer needs to determine whether it should treat some of the amounts paid to the sellers for the target as payments for products or raw materials. This example illustrates the importance of the buyer ensuring that it has considered the potential accounting implications of an arrangement it entered into or modified with the sellers at the same time as (or in contemplation of) the business combination.

In many cases involving a contingent payment arrangement between the buyer and employees or sellers of the target, it will be difficult to reach a conclusion about who receives the primary benefit from the arrangement without considering many other factors, such as those included in the following table:

| Factor | The factor indicates the contingent payment *may* need to be... |
| --- | --- |
| Level of compensation | *Accounted for within the business combination (e.g., as consideration)*, if the other amounts being paid to sellers who are employees (i.e., not the contingent payments being analyzed) are comparable to amounts being paid to other employees in the same position. |
| Incremental payments to employees | *Accounted for separate from the business combination (e.g., as compensation)*, to the extent that the sellers who become employees are entitled to more contingent payments per share under the arrangement than the sellers who do not become employees (the amount of compensation would be based on the incremental amount received by the sellers who become employees). |
| Number of shares owned (including those held by sellers that will not be employees, but that are related parties to sellers that will be employees) | *Accounted for separate from the business combination (e.g., as compensation)*, if the sellers who owned substantially all of the shares in the target continue as employees, because those contingent payments may essentially represent profit-sharing payments. |

| Factor | The factor indicates the contingent payment *may* need to be... |
|---|---|
| | *Accounted for within the business combination (e.g., as consideration)*, if only a small number of sellers become employees of the target after the business combination and all sellers are entitled to the same contingent payments per share. |
| Linkage to the valuation | *Accounted for within the business combination (e.g., as consideration)*, if the contingent payments under the arrangement are linked to (or based on) the approach or formula that was used to determine the value of the target and the initial amount of consideration to be transferred.<br><br>*Accounted for separate from the business combination (e.g., as compensation)*, if the contingent payments under the arrangement are linked to (or based on) an approach or formula that has been used by the buyer in the past to determine payment amounts under a profit-sharing arrangement. |
| Formula for determining consideration | *Accounted for within the business combination (e.g., as consideration)*, if the formula used to determine the amount of the contingent payment under the arrangement is based on a multiple of earnings (because a multiple of earnings is sometimes used to value a target).<br><br>*Accounted for separate from the business combination (e.g., as compensation)*, if the formula used to determine the amount of the contingent payment under the arrangement is based on a specified percentage of earnings (because payment under a profit-sharing arrangement is sometimes based on a specified percentage of earnings). |
| Tax treatment | *Accounted for separate from the business combination (e.g., as compensation)*, if the contingent payments are documented to support their use as a compensation deduction for tax purposes. |
| Other agreements with the sellers | *Accounted for either within or separate from the business combination, depending on the facts and circumstances, including whether the terms of the other agreement are favorable, unfavorable or at market* (refer to the earlier discussion in this section on the accounting implications of the buyer entering into or modifying another agreement with the seller at the same time as [or in contemplation of] the business combination that is favorable or unfavorable). |

None of these factors are individually conclusive. In other words, all of the relevant facts and circumstances involved in a contingent payment arrangement between the buyer and employees or sellers of the target should be considered in analyzing each one of the factors listed in the preceding table. After performing this analysis, the conclusion as to whether the contingent payment arrangement should be accounted for within or separate from the accounting for the business combination should be based on the weight of the evidence.

**Example 13-5: Payments to employee in connection with acquisition**

CEO was hired as the Chief Executive Officer of Target on January 1, 20X1. Buyer acquires 100% of Target on December 31, 20X4. On the acquisition date, Buyer transfers $500 million to the sellers.

*Scenario A – Preexisting arrangement with no continuing employment required*

Target enters into an arrangement with CEO on January 1, 20X1. The arrangement specifies that if Target is acquired while CEO is employed by Target, then CEO is entitled to a payment of $2 million upon the acquisition closing. Such payment would be payable one day after the acquisition date. Buyer's purchase of Target was not contemplated at January 1, 20X1 (i.e., the point in time CEO and Target entered into the arrangement).

If CEO is employed by Target upon the acquisition closing, CEO is entitled to the $2 million payment. In other words, the $2 million payment to CEO is not forfeited if CEO's employment is terminated after the acquisition. Because the payment is not forfeited upon termination, Buyer must next consider the following questions:

- *Why did the parties enter into or modify the arrangement?* It was in CEO's best interests to enter into the arrangement because it would provide him with financial protection in the event Target was acquired at any point during his employment. It was in Target's best interests to enter into the arrangement because CEO was their first choice to fill the Chief Executive Officer position and CEO would not agree to fill the position unless Target agreed to the arrangement.
- *Who initiated the arrangement?* CEO initiated the arrangement.
- *When was the arrangement entered into or modified?* The arrangement was entered into on January 1, 20X1, which was before Buyer contemplated acquiring Target.

Based on the answers to these questions, among other factors, Buyer must determine who receives the primary benefit from this arrangement. Buyer concludes that the arrangement primarily benefits Target and its owners (and not Buyer) because the arrangement facilitated the hiring of CEO, which took place well before Buyer and Target's owners entered into negotiations for Buyer's purchase of Target, and the payment owed as a result of this arrangement is unavoidable to Buyer .

Because the arrangement between Target and CEO primarily benefits Target and its owners, the $2 million due to CEO represents a payment for precombination services that should be included within Buyer's accounting for the business combination as an assumed liability.

This scenario is similar to the example included in ASC 805-10-55-34 to 55-35.

*Scenario B – Preexisting arrangement with multiple triggers*

Target enters into an arrangement with CEO on January 1, 20X1. The arrangement specifies that if Target is acquired while CEO is employed by Target, then CEO would be entitled to a payment of $2 million only if Buyer terminates CEO's employment within one year after the acquisition date. As a result, similar to Scenario A, the $2 million payment to CEO is not forfeited if CEO's employment is terminated after the acquisition. However, unlike Scenario A, payment is not automatically made to CEO on change of control of the Target as there is an additional trigger for payment to be made (employment termination by Buyer within one year).

Because the payment is not forfeited upon termination, Buyer must next consider the following questions:

- *Why did the parties enter into or modify the arrangement?* It was in CEO's best interests to enter into the arrangement because it would provide him with financial protection in the event Target was acquired at any point during his employment and his employment was subsequently terminated within one year. It was in Target's best interests to enter into the arrangement because CEO was their first choice to fill the Chief Executive Officer position and CEO would not agree to fill the position unless Target agreed to the arrangement.

- *Who initiated the arrangement?* CEO initiated the arrangement.
- *When was the arrangement entered into or modified?* The arrangement was entered into on January 1, 20X1, which was before Buyer contemplated acquiring Target.

Based on the answers to these questions, among other factors, Buyer must determine who receives the primary benefit from this arrangement. Although Target receives some benefit from this arrangement based on the answers to the questions above, since payment from the arrangement would only occur as a result of activities within Buyer's control (i.e., Buyer terminates the CEO's employment within one year of the acquisition), Buyer would receive the primary benefit (e.g., future costs avoided). As a result, we believe the arrangement should be accounted for separate from the business combination.

*Scenario C – Continuing employment required*

Buyer enters into an arrangement with CEO on December 31, 20X4 (i.e., the acquisition date). The arrangement specifies that if CEO is employed by the combined entity one year after the acquisition date, then CEO is entitled to a payment of $2 million at that point in time. Because payment is due to CEO only if CEO is employed by the combined entity one year after the acquisition date, the arrangement should be accounted for separate from the business combination as compensation using other applicable U.S. GAAP. Absent extenuating circumstances, other applicable U.S. GAAP would call for the arrangement to be accounted for as compensation for postcombination services over the service period. This is the case even if there are other indicators that the payment represents compensation for precombination services.

*Scenario D – Continuing employment required except in limited circumstances*

Buyer enters into an arrangement with CEO on December 31, 20X4 (i.e., the acquisition date). The arrangement specifies that if CEO is employed by the combined entity one year after the acquisition date, then CEO is entitled to a payment of $2 million at that point in time. CEO is also entitled to receive this payment if no longer employed by the combined entity one year after the acquisition date due to either being terminated by the Buyer or resigning due to a significant reduction in pay or responsibilities. However, if CEO voluntarily resigns for other reasons or is terminated for cause within one year, CEO will not receive this payment. Although payment may be made to CEO even if CEO is no longer employed by the combined entity one year after the acquisition date, this would only occur as a result of activities within Buyer's control (e.g., Buyer either terminates the CEO or significantly reduces the CEO's pay or responsibilities) for which Buyer would receive the primary benefit. As a result, consistent with Scenario C, we believe the arrangement should be accounted for separate from the business combination as compensation using other applicable U.S. GAAP.

**Example 13-6: Payments to employee and other shareholders in connection with acquisition**

CEO was hired as the Chief Executive Officer of Target on January 1, 20X1. Buyer acquires 100% of Target on December 31, 20X4. On the acquisition date, Buyer transfers $500 million to the sellers. Buyer enters into an arrangement with CEO and two other officers of the Target on December 31, 20X4 (i.e., the acquisition date). The arrangement specifies that if CEO is employed by the combined entity one year after the acquisition date, then CEO and the two other officers of Target (who will not be employees of the combined entity) are entitled to a payment of $2 million each at that point in time.

With respect to the payment due to CEO only if CEO is employed by the combined entity one year after the acquisition date, the arrangement should be accounted for separate from the business combination as compensation using other applicable U.S. GAAP. In addition, we believe the payments due to the other two officers of Target if CEO is employed by the combined entity one year after the acquisition date should also be accounted for separate from the business combination as compensation using other applicable U.S. GAAP, which is consistent with the accounting for the payment due to CEO under the same circumstances. This is because the CEO would not be considered independent of the other officers of the company.

**Example 13-7: Sales agreement entered into with sellers on the acquisition date**

Buyer acquires 100% of Target on December 31, 20X4 from Sellers. The business acquisition agreement requires Buyer to pay Sellers $100 million for Target. The net assets acquired by Buyer (measured in accordance with ASC 805) amount to $65 million. Also on December 31, 20X4, Buyer (on behalf of the combined entity) enters into an agreement to sell 10,000 kilograms of a specialized manufacturing compound to Sellers over the course of the next year for $1,000 per kilogram. Historically, Target has sold this manufacturing compound to Sellers' other subsidiaries. If Sellers were to buy this manufacturing compound from other suppliers, Sellers would have to pay $700 per kilogram.

Because Buyer and Sellers entered into the supply agreement at the same time Buyer bought Target from Sellers, Buyer must determine whether the terms of the supply agreement are favorable or unfavorable from its perspective. Buyer concludes that the supply agreement is favorable from its perspective because it will result in Sellers paying Buyer more for the specialized manufacturing compound than it would have to pay absent the business combination. Because the agreement is favorable to Buyer, a portion of the amount to be received from Sellers over the course of the next year for the specialized manufacturing compound should be used to reduce the consideration transferred to acquire Target. The amount by which the supply agreement is favorable to Buyer is $3 million (10,000 kilograms at $300 per kilogram). As a result, the amount of consideration transferred in the accounting for the business combination is reduced by $3 million (from $100 million to $97 million), which reduces goodwill by $3 million (from $35 million to $32 million). In addition, a separate asset in the amount of $3 million should be recorded for the favorable supply agreement outside of the accounting for the business combination. This asset would be derecognized as a reduction to revenue as Buyer otherwise recognizes revenue for the sales agreement in accordance with ASC 606.

The same accounting should result if the supply terms were included in the business acquisition agreement instead of being executed as a separate agreement.

### 13.3.2 Disclosures

Specific information about arrangements between the buyer and employees or sellers of the target that are accounted for separate from the business combination (e.g., accounted for as compensation in the postcombination period) must be disclosed by the buyer in its financial statements (see Section 14.2.8).

## 13.4 Apportioning replacement awards between consideration transferred and compensation and other costs for goods or services

As discussed in Section 11.7, the buyer in a business combination may issue replacement share-based payment awards to grantees (which may include employees and nonemployees) of the target. Also as discussed in Section 11.7, the buyer should use ASC 718 to measure these awards. Some or all of the amount measured for these awards under ASC 718 (the ASC 718 value) may be treated as part of the consideration transferred in the business combination (see Section 12.3). Section 13.4.1 discusses the accounting when the grantee is an employee and Section 13.4.2 discusses the accounting when the grantee is a nonemployee.

### 13.4.1 Grantee is an employee

When the buyer is obligated to issue a replacement award to an employee, some or all of that award should be treated as consideration transferred in the accounting for the business combination (because some or all relates to precombination employee service [or vesting]). In addition, if only some of the replacement award is attributed to precombination employee service, the remainder of the award is attributed to postcombination employee service (or vesting) and should be treated as compensation after the acquisition. The following are steps that capture how to determine the portion of a replacement award (that the buyer is obligated to issue) that should be attributed to consideration transferred and postcombination compensation:

1. Measure both the replacement awards and the awards being replaced (i.e., the target's awards) in accordance with ASC 718 as of the acquisition date using assumptions that reflect the conditions (e.g., volatility, expected terminations or forfeitures) at the acquisition date, not the conditions at the date the original award was granted
2. Determine which of the following employee service periods is longer: (a) the total employee service period (the sum of the requisite employee service period for the target's awards completed prior to the acquisition date and the requisite employee service period [if any] for the replacement awards to be completed after the acquisition date) or (b) the employee service period of the target's award
3. Determine the ratio of the precombination employee service period (the portion of the target's awards' requisite employee service period completed prior to the acquisition date) to the longer of the employee service periods identified in (2)
4. Multiply the ASC 718 value of the target's awards by the ratio determined in (3) to identify the portion of the replacement awards' ASC 718 value attributable to precombination employee service (see Section 13.4.3 regarding the treatment of forfeitures)
5. Calculate the excess of the replacement awards' ASC 718 value over the amount calculated in (4) to identify the portion of the replacement awards' ASC 718 value attributable to postcombination employee service
6. Treat the amount determined in (4) as part of the consideration transferred in the business combination (because it relates to precombination employee service) and the amount determined in (5) as postacquisition-date employee compensation (because it relates to postcombination employee service)

To the extent the business combination causes the target's awards to expire and the buyer is not obligated to replace those awards, any share-based payment awards the buyer chooses to grant to the target's employees should be accounted for separate from the business combination, and the ASC 718 value of those awards should be attributed to the postcombination financial statements.

Additional guidance to keep in mind when applying the steps or otherwise accounting for a replacement award includes:

- Requisite service period in the context of these steps has the same meaning as it does in the context of ASC 718. As such, it includes explicit, implicit and derived employee service periods required to vest in the award.
- The steps are the same regardless of whether the replacement award should be classified as a liability or equity based on the provisions in ASC 718. For those awards classified as a liability, any postacquisition-date changes in their value, and the related income tax effects, are recognized by the buyer in its postacquisition-date financial statements (i.e., the changes do not

affect the accounting for the business combination). Accounting for the income tax effects of replacement awards classified as equity presents additional challenges. These challenges are discussed in ASC 805-740-25-10 and 25-11 and 805-740-45-5 and 45-6.

- To the extent the employee has rendered all requisite service related to the target's awards by the acquisition date and the replacement awards do not include a requisite employee service period, the buyer may ultimately recognize compensation immediately after the acquisition occurs if the ASC 718 value of the replacement awards exceeds the portion of that amount attributed to precombination employee services (the amount determined in the fourth step) (see Case 1 in Example 13-8).
- If the replacement award has a graded vesting schedule, the buyer must take into consideration its policy election for other awards with graded vesting. ASC 718-10-35-8 discusses this policy election.
- After the acquisition date, the amount of the replacement awards' ASC 718 value attributed to postcombination employee service is accounted for under the provisions of ASC 718.

**Example 13-8: Various replacement awards granted to employees**

ASC 805-30-55-17 to 55-24 provide four cases focused on determining the portion of the replacement awards' ASC 718 value attributable to: (a) precombination employee service (and therefore, included in consideration transferred for purposes of accounting for the business combination) and (b) postcombination employee service (and therefore, accounted for as compensation after the acquisition date and not reflected in the accounting for the business combination). The buyer was obligated to issue replacement awards in all cases and all of the replacement awards involved in the four cases are classified as equity. There is also an implicit assumption of no forfeitures in each of the cases. Other key facts from those cases (which are included in rows A, B, C, D and F) and the conclusions are summarized in the following table to illustrate the way in which the accounting for replacement awards varies based on changes in certain facts. For additional information on and discussion of this example, refer to ASC 805-30-55-17 to 55-24.

| | | Case 1 | Case 2 | Case 3 | Case 4 |
|---|---|---|---|---|---|
| | | **(dollar amounts in 000s)** | | | |
| **Step 1:** | | | | | |
| • ASC 718 value of buyer's replacement awards at acquisition date | A | $110 | $100 | $100 | $100 |
| • ASC 718 value of target's awards at acquisition date | B | $100 | $100 | $100 | $100 |
| **Step 2:** | | | | | |
| • Precombination employee service period (i.e., the portion of the target's awards' requisite employee service period completed prior to the acquisition date) | C | All (Note 1) | 4 years | 2 years | 2 years |
| • Length of the replacement awards' requisite employee service period | D | None (Note 1) | 1 year | 1 year | None |
| • Total employee service period (C + D) | E | Note 1 | 5 years | 3 years | 2 years |
| • Target's awards' employee service period | F | Note 1 | 4 years | 4 years | 4 years |
| • Longer of total employee service period and the target's awards' employee service period (if E > F, use E; if F > E, use F) | G | Note 1 | 5 years | 4 years | 4 years |
| **Step 3:** | | | | | |
| • Ratio of the precombination employee service period to the longer of the total employee service period and the target's awards' employee service period (C ÷ G) | H | Note 1 | 4/5 or 80% | 2/4 or 50% | 2/4 or 50% |
| **Steps 4 and 6:** | | | | | |
| • Amount attributable to precombination employee service and included in consideration transferred (H × B) | J | $100 (Note 1) | $80 ($100 × 80%) | $50 ($100 × 50%) | $50 ($100 × 50%) |
| **Steps 5 and 6:** | | | | | |
| • Amount attributable to postcombination employee service and treated as compensation (A – J) | | $10 (Notes 1 and 2) | $20 (Note 3) | $50 (Note 3) | $50 (Note 2) |

**Note 1**: The facts for Case 1 indicate that 100% of the target's awards' requisite employee service period had been completed prior to the acquisition date and that there was no requisite employee service period for the replacement awards. Based on these facts: (a) 100% of the target's awards' ASC 718 value should be attributed to precombination employee service and included in consideration transferred and (b) the difference between the replacement awards' ASC 718 value and the target's awards' ASC 718 value should be attributed to postcombination employee service and treated as compensation.
**Note 2:** Because no postcombination employee service is required of the employees in this case, the amount attributable to postcombination employee service should be recognized as compensation immediately after the acquisition takes effect.
**Note 3:** After the acquisition date, these amounts should be accounted for in accordance with ASC 718.

### 13.4.2 Grantee is a nonemployee

When the buyer is obligated to issue a replacement award to a nonemployee, some or all of that award should be treated as consideration transferred in the accounting for the business combination (because it relates to precombination vesting). In addition, if only some of the replacement award is attributed to precombination vesting, the remainder of the award is attributed to postcombination vesting and does not affect the accounting for the business combination. The following are steps that capture how to determine the portion of a replacement award (that the buyer was obligated to issue) that should be attributed to precombination vesting and postcombination vesting:

1. Measure both the replacement award and the award being replaced (i.e., the target's award) in accordance with ASC 718 as of the acquisition date using assumptions that reflect the conditions (e.g., volatility, expected terminations or forfeitures) at the acquisition date, not the conditions at the date the original award was granted
2. Determine the effective vesting requirement of the replacement award by adding together the portion of the target's award that has vested as of the acquisition date and the incremental vesting requirements in the replacement award
3. Calculate the percentage of the target's award that vested as of the acquisition date using the vesting requirement in the target's award
4. Calculate the percentage of the target's award that would have vested as of the acquisition date using the effective vesting requirement in (2)
5. Determine the percentage of the target's award that would have been recognized by selecting the lower of the two percentages calculated in (3) and (4)
6. Multiply the ASC 718 value of the target's award by the percentage that would have been recognized in (5) to identify the portion of the replacement award's ASC 718 value attributable to precombination vesting and treat that amount as part of the consideration transferred in the business combination (see Section 13.4.3 regarding the treatment of forfeitures)
7. Calculate the excess of the replacement award's ASC 718 value over the amount calculated in (6) to identify the portion of the replacement award's ASC 718 value attributable to postcombination vesting and account for that amount as postacquisition-date compensation cost in accordance with ASC 718-10-25-2C

To the extent the business combination causes the target's awards to expire and the buyer is not obligated to replace those awards, any awards the buyer chooses to grant to the target's nonemployees should be accounted for separate from the business combination, and the ASC 718 value of those awards should be attributed to the postcombination financial statements. In addition, to the extent the nonemployee has vested in the award (i.e., rendered all required services and [or] delivered all required goods) by the acquisition date and the replacement awards do not include additional vesting requirements (i.e., rendering additional services or delivering additional goods), the buyer may ultimately recognize compensation cost immediately after the acquisition occurs if the ASC 718 value of the replacement awards exceeds the portion of that amount attributed to precombination vesting (the amount determined in the sixth step presented earlier) (see Case 1 in Example 13-9).

Determining the portion of a replacement award (that the buyer was obligated to issue) that should be attributed to precombination vesting and postcombination vesting (which is captured in the seven steps listed earlier) is the same regardless of whether the replacement award should be classified as a liability or equity based on the provisions in ASC 718. For those awards classified as a liability, any postacquisition-date changes in their value, and the related income tax effects, are recognized by the buyer in its postacquisition-date financial statements (i.e., the changes do not affect the accounting for the business combination). Accounting for the income tax effects of replacement awards classified as equity presents additional challenges. These challenges are discussed in ASC 805-740-25-10 and 25-11 and 805-740-45-5 and 45-6.

**Example 13-9: Various replacement awards granted to nonemployees**

ASC 805-30-55-25 to 55-35 provide four cases focused on determining the portion of the replacement awards' ASC 718 value attributable to: (a) precombination vesting (and therefore, included in consideration transferred for purposes of accounting for the business combination) and (b) postcombination vesting (and therefore, accounted for outside of the business combination after the acquisition date and not reflected in the accounting for the business combination). The buyer was obligated to issue replacement awards in all cases and all of the awards are classified as equity. There is also an implicit assumption of no forfeitures in each of the cases. Other key facts from those cases (which are included in rows A, B, C, D and G) and the conclusions are summarized in the following table to illustrate the way in which the accounting for replacement awards varies based on changes in certain facts. For additional information on and discussion of this example, refer to ASC 805-30-55-25 to 55-35.

| | | Case 1 | Case 2 | Case 3 | Case 4 |
|---|---|---|---|---|---|
| | | **(dollar amounts in 000s)** | | | |
| **Step 1:** | | | | | |
| • ASC 718 value of buyer's replacement awards at acquisition date | A | $110 | $100 | $100 | $100 |
| • ASC 718 value of target's awards at acquisition date | B | $100 | $100 | $100 | $100 |
| **Step 2:** | | | | | |
| • Precombination vesting requirement for Target's awards completed prior to the acquisition date | C | All (Note 1) | 40 engines | 20 engines | 20 engines |
| • Postcombination vesting requirement for the replacement awards | D | None (Note 1) | 10 engines | 10 engines | None |
| • Effective vesting requirement (C + D) | E | Note 1 | 50 engines | 30 engines | 20 engines |
| **Step 3:** | | | | | |
| • Percentage of effective vesting requirements satisfied (C ÷ E) | F | Note 1 | 80% | 66.67% | 100% |
| **Step 4:** | | | | | |

| | | | | | |
|---|---|---|---|---|---|
| • Vesting requirement for the target's award | G | Note 1 | 40 engines | 40 engines | 40 engines |
| | | **Case 1** | **Case 2** | **Case 3** | **Case 4** |
| • Percentage of vesting requirement for the target's awards satisfied (C ÷ G) | H | Note 1 | 100% | 50% | 50% |
| **Step 5:** | | | | | |
| • Lower of the following: (a) percentage of effective vesting requirements satisfied and (b) percentage of target's award's vesting requirement satisfied (if F < H, use F; if H < F, use H) | I | Note 1 | 80% | 50% | 50% |
| **Step 6:** | | | | | |
| • Amount attributable to precombination vesting and included in consideration transferred (I × B) | J | $100 (Note 1) | $80 ($100 × 80%) | $50 ($100 × 50%) | $50 ($100 × 50%) |
| **Step 7:** | | | | | |
| • Amount attributable to postcombination vesting and accounted for as compensation costs after the acquisition date (A – J) | K | $10 (Notes 1 and 2) | $20 (Note 3) | $50 (Note 3) | $50 (Note 2) |

**Note 1**: The facts for Case 1 indicate that 100% of the target's award's precombination vesting requirements have been satisfied (i.e., all engines had been delivered by the nonemployee) prior to the acquisition date and that there was no postcombination vesting requirements for the replacement awards. Based on these facts: (a) 100% of the target's award's ASC 718 value should be attributed to precombination vesting requirements and included in consideration transferred and (b) the difference between the replacement award's ASC 718 value and the target's award's ASC 718 value should be attributed to postcombination vesting and accounted for as compensation costs.

**Note 2:** Because no postcombination vesting is required in this case, the amount attributable to postcombination vesting should be recognized as compensation cost immediately after the acquisition takes effect.

**Note 3:** After the acquisition date, these amounts should be accounted for as compensation cost based on the guidance in ASC 718-10-25-2C.

### 13.4.3 Treatment of forfeitures in replacement share-based payment awards

When determining the portion of a replacement share-based payment award's ASC 718 value that should be attributed to precombination vesting (i.e., consideration transferred), the buyer should take into consideration its expectations about:

- For employee awards, the number of awards for which the requisite employee service will be rendered
- For nonemployee awards, the service that will be rendered or goods that will be delivered by the nonemployee

In other words, the portion of the replacement award's ASC 718 value attributed to precombination service should reflect expected forfeitures. This is the case even when the buyer has elected an accounting policy in accordance with ASC 718-10-35-3 (for employee awards) and ASC 718-10-35-1D (for nonemployee awards) to account for forfeitures in normal course as they occur. When that accounting policy has been elected, the amount related to forfeitures that is excluded from the portion of the replacement award's ASC 718 value attributed to precombination vesting (i.e., consideration transferred) should be included in the portion of the replacement award's ASC 718 value attributed to:

- Compensation recognized over the postcombination requisite employee service period for employee awards
- The cost of goods or services recognized in the postcombination period for nonemployee awards

Treating forfeitures in this manner will offset the accounting for the forfeitures as they occur.

Consider a situation in which the buyer, prior to considering forfeitures, has determined that the portion of an employee replacement award's ASC 718 value that should be attributed to: (a) consideration transferred is $200 and (b) postcombination compensation cost is $100. In considering forfeitures, the buyer expects the employee to render services for only 90% of the award. In this situation, regardless of the forfeiture accounting policy elected by the buyer, $180 ($200 × 90%) should be attributed to consideration transferred. The amount attributed to postcombination compensation cost depends on the buyer's accounting policy election related to forfeitures:

- If the buyer elects to estimate forfeitures, $90 ($100 × 90%) should be attributed to postcombination compensation cost.
- If the buyer elects to record forfeitures when they occur, $120 ($100 + $20 for forfeitures related to the consideration transferred) should be attributed to postcombination compensation cost, which will be offset in the postcombination period as the buyer accounts for forfeitures when they occur. If actual forfeitures match expected forfeitures, the $120 attributed to postcombination compensation cost will be offset by $30 in forfeitures ([$200 + $100] × 10%), bringing the net postcombination compensation cost to $90.

Regardless of the buyer's accounting policy for forfeitures, any changes in estimated forfeitures are recognized in the postcombination period and do not affect the business combination accounting.

## 13.5 Transaction costs

### 13.5.1 General

The following are types of costs that the buyer in a business combination may incur in conjunction with the business combination:

- Finder's fees
- Professional or consulting fees for advisory, legal, accounting, valuation and other services
- Internal costs, such as those related to an internal acquisitions or corporate development group

These and similar costs should be expensed when incurred and when the related services have been received by the buyer. These transaction costs generally do not represent assets, and they result from transactions that should be accounted for separate from the business combination.

Transaction costs should be reflected as an operating expense on the income statement. Recognizing these costs in earnings may create volatility in the buyer's preacquisition-date earnings.

Cash payments for transaction costs should be classified within operating activities on the cash flow statement. Classifying the cash payments in this manner on the cash flow statement is consistent with classifying the expense related to the transaction costs within operating expenses on the income statement.

The income tax effects of transaction costs are discussed in Section 11.4.6.

Transaction costs incurred in connection with acquisitions that are not accounted for as business combinations in accordance with ASC 805 are treated as part of the purchase price (see Section 15.2.5).

Debt or equity issuance and registration costs incurred by the buyer in conjunction with effecting a business combination should be accounted for in accordance with other applicable U.S. GAAP. Application of other relevant U.S. GAAP typically results in the issuance and registration costs for debt or equity securities issued to effect a business combination being treated as follows:

- For debt securities, the costs are deferred and amortized as required by the applicable U.S. GAAP. Issuance costs related to term debt should be presented as a reduction of the related debt's carrying amount on the balance sheet.
- For equity securities, the costs are included in the appropriate paid-in capital account.

Specific information about transaction costs must be disclosed by the buyer in its financial statements (see Section 14.2.8).

### 13.5.2 Transaction costs paid by the seller or target

As indicated previously, transaction costs incurred to effect a business combination should be accounted for separate from the business combination as an expense when incurred and when the related services have been received by the buyer. This is the case if the buyer is paying the service provider directly, as well as if the buyer arranges to have the seller or target pay the service providers, and in return, the buyer reimburses the seller for those payments through an increase in the consideration transferred in conjunction with the business combination. In this latter situation, the fact that the seller has paid the service providers for the transaction costs does not change the substance of those costs or how they should be accounted for. In other words, those costs are still transaction costs that should be expensed by the buyer separate from the business combination and not additional consideration for purposes of accounting for the business combination. To treat such costs as consideration would effectively circumvent the requirement to account for them separate from the business combination because it would result in an increase to the goodwill (or a decrease in the gain from a bargain purchase) that would otherwise be recognized by the buyer in the accounting for the business combination. For additional information on determining what should and should not be included in the accounting for a business combination, see Section 13.1.

### 13.5.3 Transaction costs paid by related party

In general, transaction costs paid by related parties (e.g., the buyer's shareholder) should be evaluated to ensure that the expense is reflected in the buyer's financial statements. Consider a situation in which a PEG pays the transaction costs related to the acquisition of an operating company by one of the PEG-created acquisition entities (NewCo). Those transaction costs should be reflected as an expense of the NewCo even though they were paid by the PEG. To do so, the NewCo would likely have to make an entry to debit an expense account and credit an equity account (e.g., additional paid-in capital). Consider the following example.

**Example 13-10: Transaction costs paid by buyer and transaction costs paid by seller**

Buyer entered into a business combination to acquire Target. Buyer transferred $15 million of cash consideration in the acquisition, and in return, received a 100% ownership interest in Target. Buyer did not previously own any interest in Target. The net assets acquired by Buyer, as measured in accordance with ASC 805, amounted to $13.8 million, which consisted of $20 million of identifiable assets acquired and $6.2 million of liabilities assumed. Under Scenario 1, assume that in connection with the acquisition, Buyer incurred $500,000 of transaction costs directly with various service providers. Under Scenario 2, assume that Target agreed to transact with and pay Buyer's various service providers for the acquisition fees due them in connection with Buyer's acquisition of Target. In return for doing so, Buyer agrees to transfer another $500,000 of cash consideration to the sellers in connection with the acquisition. The following table includes summary journal entries representing the overall effects of the business combination on Buyer's consolidated financial statements at the acquisition date for both Scenarios 1 and 2. An additional summary journal entry is provided to illustrate the incorrect accounting that would result from treating the $500,000 reimbursement of transaction costs by Buyer to Target as additional consideration.

| | (in 000s) | | | | | |
|---|---|---|---|---|---|---|
| | Scenario 1 | | Scenario 2 correct | | Scenario 2 incorrect | |
| | Debit | Credit | Debit | Credit | ~~Debit~~ | ~~Credit~~ |
| Acquisition expenses | $500 | | $500 | | | |
| Payables to service providers | | $500 | | | | |
| Payable to Target | | | | $500 | | |
| | | | | | | |
| Identifiable assets | $20,000 | | $20,000 | | ~~$20,000~~ | |
| Goodwill | 1,200 | | 1,200 | | ~~1,700~~ | |
| Payable to Target | | | 500 | | | |
| Cash | | $15,000 | | $15,500 | | ~~$15,500~~ |
| Liabilities | | 6,200 | | 6,200 | | ~~6,200~~ |

Note that the amount of goodwill recognized does not change between Scenario 1 and the correct Scenario 2. This is because the arrangement between Buyer and Target on how the payment for transaction costs should be handled in Scenario 2 was accounted for in accordance with its substance rather than its form.

### 13.5.4 Fees for multiple services

The buyer in a business combination may hire a service provider, such as a law firm or investment banking firm, to provide a variety of services in connection with its acquisition of the target. In many cases, the nature of the services provided may vary depending on how the buyer is financing its purchase of the target. For example, assume that the buyer is going to issue equity and enter into a loan agreement to finance its purchase of the target. The legal services or investment banking services the buyer may need in that situation would be different from the services they would need if they were just paying cash for the target.

When a service provider is providing a variety of services in connection with the buyer's acquisition of the target, the buyer must be able to determine how much of the service provider's fees relate to each of the services being provided. Making this determination is critical to the proper accounting for those fees as different accounting models are applied to different types of fees.

Continuing with the example provided earlier, if the buyer hires one law firm to provide legal advice and assistance in drafting documents related to the buyer's purchase of the target, issuance of equity and entering into a loan agreement, the buyer must determine how much of the fees charged by the law firm are: (a) transaction costs that should be expensed as incurred, (b) equity issuance costs that should reduce additional paid-in-capital and (c) debt issuance costs that should be deferred as a contra-liability and amortized. Allocating the service provider's total fees among the different services provided is consistent with the discussion in SAB Topic 2.A.6 (which is included in ASC 340-10-S99-2). The buyer should allocate the service provider's total fees among the different services provided on a relative fair value basis.

At the same time a service provider is providing a variety of services in connection with the buyer's acquisition of the target, the service provider may also be providing other unrelated services to the buyer. For example, the law firm providing legal services in connection with the buyer's acquisition of the target may also be providing the buyer legal services in connection with outstanding litigation completely unrelated to the acquisition. These litigation-related services are another category of legal services the buyer should take into consideration when allocating the law firm's total fees among the different legal services provided. The fees allocated to the litigation-related services on a relative fair value basis should be accounted for the same way as other legal fees incurred by the buyer in connection with litigation.

Discussions should be held with a service provider upfront about the service provider supplying billings that enable the buyer to sort the service provider's fees into different service groupings based on the accounting model that should be applied to each particular grouping. The ultimate objective is to have the total fees charged by the service provider allocated to the service groupings based on the relative fair values of the different services provided. However, the buyer cannot solely rely on the billing breakdown provided by the service provider. Instead, the buyer must satisfy itself that the billing breakdown represents the relative fair values of the different service groupings provided.

When services related to the issuance of debt are one of the services being provided by the service provider, the buyer should assess whether the effective debt service cost (which includes interest and the allocated debt issuance costs) is reasonable when compared to what the effective debt service cost has been or would be for similar debt issuances.

**Example 13-11: Fees for multiple services**

Buyer hired Law Firm to provide legal advice and assistance in drafting documents related to: (a) Buyer's purchase of Target, (b) Buyer's issuance of $50 million in equity to the sellers in connection with its purchase of Target and (c) Buyer's borrowing of $100 million from a syndicated loan group in connection with its purchase of Target. Buyer has received invoices from Law Firm that total $650,000. The bills from Law Firm indicate that the charges are for the full complement of services provided by them in connection with the acquisition, equity issuance and borrowing. No additional breakdown of the services and fees was provided by Law Firm.

Buyer also hired Investment Banking Firm (IBF) to provide services in connection with its purchase of Target and its borrowing of $100 million from a syndicated loan group identified by IBF. Buyer has received invoices from IBF that total $900,000. The bills from IBF indicate that the charges are for both the acquisition and syndicated loan services provided. No additional breakdown of the services and fees was provided by IBF.

Buyer contacts Law Firm and IBF and asks them to break down their billings to indicate how much relates to the acquisition, the issuance of equity and the borrowing. The information Buyer receives is summarized as follows:

| | Law Firm | IBF |
|---|---|---|
| Acquisition | $200,000 | $300,000 |
| Equity issuance | 50,000 | |
| Borrowing | 400,000 | 600,000 |
| Total | $650,000 | $900,000 |

If Buyer is able to support that the breakdowns provided by Law Firm and IBF represent the relative fair values of the services provided, it would record the following journal entry to account for the services provided by these entities:

| | Debit | Credit |
|---|---|---|
| Additional paid-in capital | $50,000 | |
| Deferred debt issuance costs (Note 1) | 1,000,000 | |
| Acquisition expenses | 500,000 | |
| Payable to Law Firm | | $650,000 |
| Payable to Investment Banking Firm | | 900,000 |

**Note 1:** As discussed in Section 13.5.1, deferred debt issuance costs related to term debt are presented as a reduction of the related debt's carrying amount.

In considering whether the breakdowns provided by Law Firm and IBF represent the relative fair values of the services provided, Buyer should consider the following questions:

- What would another law firm or investment banking firm charge to provide services (e.g., legal advice, assistance in drafting documents) solely related to Buyer's purchase of Target?
- What would another law firm charge to provide legal advice and assistance in drafting documents solely related to Buyer's issuance of $50 million in equity to the sellers in connection with its purchase of Target?
- What would another law firm or investment banking firm charge to provide services (e.g., legal advice, assistance in drafting documents) solely related to Buyer's borrowing of $100 million from a syndicated loan group in connection with its purchase of Target?

In addition, Buyer should consider whether the effective debt service cost of the $100 million borrowing (which includes interest and the allocated debt issuance costs) is reasonable when compared to the effective debt service cost for similar debt issuances.

### 13.5.5 Acquisition services provided by related party

To the extent the party providing the acquisition services is a related party, particular scrutiny of the total billings and billing breakdown is warranted. In that situation, the buyer needs to assess whether the transactions between it and the related party are occurring on an arm's length basis and whether all of those transactions have been recorded by the buyer. In other words, are the related party's charges to the buyer for services provided complete, reasonable and customary for the services provided? Determining whether transactions between the buyer and the related party are occurring on an arm's length basis is important because there are often significant accounting repercussions when those transactions are not on an arm's length basis. In other words, there are significant accounting consequences to concluding that part of the billing represents a dividend or return of capital instead of fees for services provided.

For example, if the service provider is the buyer's parent and the billings from the service provider are higher than market prices for the services being provided by the parent (i.e., higher than what is reasonable and customary for those services), it is possible that part of the billing from the parent represents a dividend or return of capital to the parent instead of fees for services provided. This situation may arise when a PEG provides services in connection with a business acquisition and issuance of debt undertaken by one of its portfolio companies and the PEG charges fees for those services that are in excess of what a typical service provider would charge for those services. Consideration should also be given to whether these fees actually represent payments for the ongoing management services provided by the PEG to the portfolio company.

For another example, if the service provider is the buyer's parent and has not yet billed the buyer by the end of the reporting period for the services provided in connection with a business combination, the buyer still needs to recognize the costs for those services in the period end they were incurred. In addition to working with its parent to determine an appropriate estimate of the costs that should be recognized in the period end, the buyer will need to understand whether or not it will have to repay its parent. If repayment will be required, a payable to the parent should be recognized when the costs are recognized. If not, an equity contribution from the parent should likely be recognized when the costs are recognized.

**Example 13-12: Parent pays subsidiary's transaction costs**

NewCo entered into a business combination on December 1, 20X4 to acquire OpCo. NewCo transferred $123 million of cash consideration in the acquisition, and in return, received a 100% ownership interest in OpCo. NewCo did not previously own any interest in OpCo. PEG is NewCo's parent and provides any necessary transaction advisory services to NewCo. PEG plans to bill NewCo $1.5 million for the transaction advisory services it provided to NewCo related to its acquisition of OpCo, but does not do so before NewCo issues its financial statements. NewCo has a calendar year end and must issue standalone financial statements within 90 days of its year end.

In preparing its financial statements for December 31, 20X4, NewCo realizes that it has not recognized any transaction costs in connection with its acquisition of OpCo. NewCo follows up with PEG and learns that PEG plans to bill NewCo $1.5 million for the transaction advisory services provided by PEG in connection with its acquisition of OpCo.

NewCo next considers whether the $1.5 million is representative of the fair value of the transaction advisory services it received from PEG and determines that the fair value of those services was $1 million. As such, NewCo concludes that it should only recognize $1 million of transaction costs as an expense and treats the excess amount as a reduction to equity when paid or declared.

Two important takeaways from this example include the following:

- If NewCo had issued its financial statements for December 31, 20X4 without including transaction costs, its financial statements would have been in error.
- If NewCo had recognized $1.5 million of transaction costs, its financial statements for December 31, 20X4 would have been in error.

As such, in these and similar situations, it is imperative for NewCo to ensure it has recognized all necessary transaction costs in the appropriate accounting period, and that it recognizes the appropriate amount of transaction costs.

### 13.5.6 Buyer pays sellers' transaction costs

Only the transaction costs incurred for the buyer's benefit in the business combination should be recognized by the buyer when incurred and when the related services have been received by the buyer. If the buyer agrees to pay the sellers' transaction costs on the sellers' behalf, those costs were not incurred for the buyer's benefit and should not be recognized as an expense by the buyer. Instead, amounts the buyer agrees to pay the sellers' service providers on the sellers' behalf should be treated as additional consideration transferred. The fact that the buyer is paying the sellers' service providers directly is a convenience to the sellers, instead of the buyer paying the sellers and then the sellers paying their service providers. This convenience does not change the character of, or necessary accounting for, the costs.

**Example 13-13: Buyer pays Sellers' transaction costs**

Buyer enters into a business combination to purchase 100% of Target. Buyer did not previously own any interest in Target. In connection with the business combination, Buyer transfers consideration of $10 million. Buyer also agrees to pay Sellers' service providers for the costs Sellers incurred in connection with the business combination. As such, Buyer also transfers $500,000 to those service providers. Buyer receives net assets of $8 million measured predominantly at fair value, which consists of $12 million of identifiable assets acquired and $4 million of liabilities assumed.

Buyer concludes that the $500,000 transferred to Sellers' services providers should be included in the consideration transferred when determining the amount of goodwill to recognize. Using total consideration transferred of $10.5 million and net assets acquired of $8 million, Buyer determines it should recognize $2.5 million of goodwill in the accounting for the business combination.

### 13.5.7 Insurance-related costs

The buyer in a business combination may incur insurance costs for various matters related to the transaction, including for directors and officers liability as well as representations and warranties included in the acquisition agreement. Directors and officers liability insurance may be obtained by a buyer to cover potential losses from litigation claims made against directors and officers of the acquiree for any actions that occurred prior to the acquisition date for which claims are made subsequent to the acquisition. Insurance for general representations and warranties made in a business combination may be obtained by a buyer to cover potential losses from incorrect representations or warranties made by a seller in the acquisition agreement. This insurance may be obtained in cases in which amounts aren't held in escrow related to the seller satisfying general representations and warranties as discussed in Section 12.3.1.2. As both of these types of insurance coverage are for events that either occurred prior to or as of the acquisition date, any costs should be expensed as incurred.

Furthermore, insurance costs may be shared between the buyer and the seller. In such cases, consideration should be given to which party receives the primary benefit from the insurance to appropriately account for the costs. See Section 13.1 for additional information on evaluating which party or parties primarily benefit from a transaction. Judgment may be required in arriving at an appropriate conclusion; therefore, we recommend consultation with a subject matter expert when evaluating significant shared costs.

## 13.6 Determining whether a restructuring is part of a business combination

The target may have ongoing restructuring activities on the acquisition date for which it has recognized a restructuring liability in its preacquisition-date financial statements. If the criteria in the Codification related to recognizing a restructuring liability are met on the acquisition date, the buyer must determine whether the restructuring liability should be: (a) recognized within the accounting for the business combination (i.e., as an assumed liability) or (b) recognized separate from the business combination (i.e., as an expense). As discussed in Section 13.1, the questions the buyer should consider in this regard are:

- *Who received the primary benefit from the restructuring activities (i.e., why were the restructuring activities undertaken)?* If the target undertook the restructuring activities primarily for the benefit of the buyer or combined entity, then that is an indication that the restructuring activities should be accounted for separate from the business combination.
- *Who initiated the restructuring activities?* If the buyer initiated the restructuring activities, then that may be an indication that the restructuring activities should be accounted for separate from the business combination.
- *When was the restructuring entered into?* If the restructuring was entered into in contemplation of the business combination, then that may be an indication that the restructuring should be accounted for separate from the business combination.

A restructuring liability recognized within the accounting for a business combination is measured at its fair value on the acquisition date. A restructuring liability recognized separate from the accounting for a business combination is measured in accordance with ASC 420-10-30.

**Example 13-14: Restructuring activities in three scenarios**

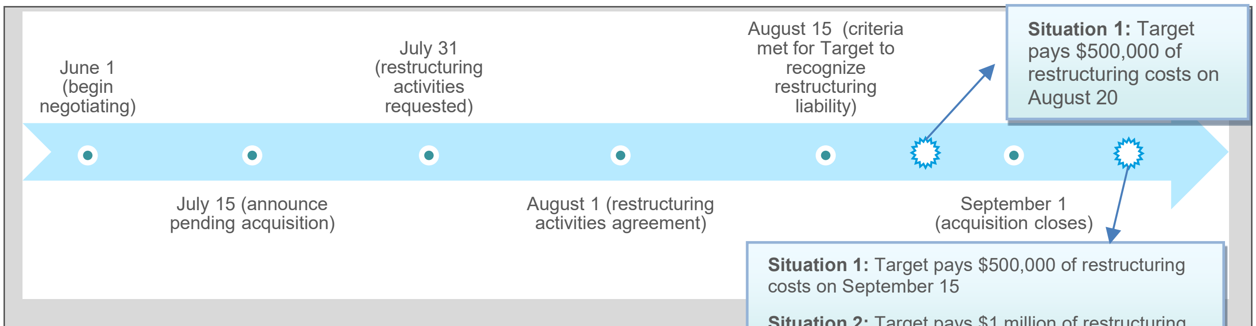
| **Common facts:** | | |
|---|---|---|
| On June 1, 20X2, Buyer enters into negotiations to purchase Target from Sellers. On July 15, 20X2, Buyer and Seller announce that the business combination is expected to occur and that it is expected to close on September 1, 20X2. On September 1, 20X2, the business combination closes and Target becomes a wholly owned subsidiary of Buyer. | | |
| **Additional facts:** | | |
| **Scenario A** | **Scenario B** | **Scenario C** |
| On July 31, 20X2, Buyer requests that Target undertake certain restructuring activities that would support Buyer's plans to close certain of Target's locations after the acquisition is closed. On August 1, 20X2, Target agrees to undertake these activities only if Buyer agrees to compensate Target for the full cost of the restructuring activities regardless of whether the business combination closes. Buyer agrees to these terms. On August 15, 20X2, Target announces the restructuring activities. Also on that date, Target meets the criteria to recognize a restructuring liability. As of September 1, 20X2, Target has not completed all of the restructuring activities. | On October 1, 20X1, Target announces and begins to undertake certain restructuring activities to streamline its business. Also on that date, Target meets the criteria to recognize a restructuring liability. As of September 1, 20X2, Target has not completed all of the restructuring activities. | On August 15, 20X2, Buyer announces the restructuring activities it plans on undertaking upon its acquisition of Target. |

| Should a restructuring liability be recognized within or separate from the business combination? | | |
|---|---|---|
| **Scenario A** | **Scenario B** | **Scenario C** |
| A restructuring liability would likely be recognized separate from the accounting for the business combination because: (a) Target undertook the restructuring activities primarily for the benefit of Buyer and the combined entity, (b) Buyer initiated the restructuring activities (i.e., Target undertook the restructuring activities at Buyer's request) and (c) the restructuring activities were undertaken in contemplation of the business combination (i.e., between the announcement date and the acquisition date). | A restructuring liability would likely be recognized within the accounting for the business combination (i.e., as an assumed liability) because: (a) Target undertook the restructuring activities primarily for its own benefit (and the benefit of its owners), (b) Target initiated the restructuring activities and (c) the restructuring activities were not undertaken in contemplation of the acquisition (i.e., they were undertaken well before Buyer and Seller entered into negotiations for Buyer's acquisition of Target). | A restructuring liability should not be recognized within or separate from the business combination on the acquisition date because the criteria in ASC 420 related to recognizing a restructuring liability are not met on the acquisition date. In other words, a liability has not been incurred merely because Buyer has announced its planned restructuring activities. If Buyer meets the criteria in the Codification at some point after the acquisition date, it would account for the restructuring activities separate from the business combination. Refer to Section 10.15 for additional information. |

Depending on the facts and circumstances, the accounting for Scenario A can be complex. Consider these additional facts related to Scenario A:

- The amount of the liability recognized by Target on August 15, 20X2 is $1 million.
- On September 1, 20X2, the business combination closes and Target becomes a wholly owned subsidiary of Buyer.
- The amount Buyer agrees to pay is $20 million plus any amount spent by Target on the restructuring activities prior to September 1, 20X2 (i.e., the acquisition date).
- The amount of net assets acquired by Buyer, measured in accordance with ASC 805, is $18 million. (Note that this amount does not include a liability for the restructuring activities undertaken at Buyer's request.)
- Buyer did not have a PHEI in Target.
- With respect to the restructuring activities, consider the following two situations: (1) Target pays $500,000 of the restructuring costs on August 20, 20X2 and the remaining $500,000 of the restructuring costs on September 15, 20X2 and (2) Target makes a $1 million payment on September 15, 20X2 for all of the restructuring costs. With respect to Situation 1, Buyer pays an additional $500,000 to Sellers on September 1, 20X2 (i.e., the acquisition date).

Following is a timeline of the events for both situations under Scenario A, as well as the journal entries that would be recorded by Buyer for both situations:




*Buyer's journal entries under Scenario A*

*August 15*

| | Situation 1 | | Situation 2 | |
|---|---|---|---|---|
| | **Debit** | **Credit** | **Debit** | **Credit** |
| Expense | $1,000,000 | | $1,000,000 | |
| Liability to Target | | $1,000,000 | | $1,000,000 |

**Note:** The expense and liability to Target recognized in this journal entry represent the restructuring expense and liability that Buyer should record prior to the acquisition based on the agreement it has reached with Target. After the acquisition, it may be appropriate to refer to the liability as a restructuring liability in the Buyer's financial statements. Whether that is the case depends on the arrangement between Buyer and Target, how the liability will be settled and any intercompany accounting activity between Buyer and Target. For ease of illustration, we have used the Liability to Target caption throughout the journal entries reflected in this example.

*September 1*

| | Situation 1 | | Situation 2 | |
|---|---|---|---|---|
| | **Debit** | **Credit** | **Debit** | **Credit** |
| Net assets acquired (Note 1) | $18,000,000 | | $18,000,000 | |
| Goodwill (Note 1) | 2,000,000 | | 2,000,000 | |
| Liability to Target | 500,000 | | | |
| Cash | | $20,500,000 | | $20,000,000 |

**Note 1:** As mentioned earlier, the amount of net assets acquired does not include a liability for the restructuring activities undertaken by Target at Buyer's request. Had that liability been included in the accounting for the business combination (i.e., if the restructuring activities were determined to be for the primary benefit of Target and Sellers), and no expenditures related to the restructuring activities had been made by September 1, the net assets acquired would have amounted to $17 million and the amount of goodwill recognized would have amounted to $3 million. In addition, Buyer would not have previously recognized a restructuring charge or liability in its financial statements for $1 million.

*September 15*

| | Situation 1 | | Situation 2 | |
|---|---|---|---|---|
| | **Debit** | **Credit** | **Debit** | **Credit** |
| Liability to Target | $500,000 | | $1,000,000 | |
| Cash | | $500,000 | | $1,000,000 |

# 14. Disclosures

## 14.1 Disclosure principles

The buyer in a business combination must provide disclosures that satisfy the following two objectives: (1) users of the buyer's financial statements are able to evaluate the *nature* of the business combination and (2) users of the buyer's financial statements are able to evaluate the *financial effects* of the business combination. The business combinations for which these objectives must be satisfied include: (a) those that occur during the current reporting period and (b) those that occur after the end of the current reporting period, but before the buyer issues its financial statements for the current reporting period (or before the buyer's financial statements for the current reporting period are available to be issued).

Another disclosure objective arises to the extent adjustments are recorded in the current reporting period to the accounting for a business combination that occurred in either the current or a previous reporting period. To satisfy that objective, the buyer must provide disclosures that enable the users of its financial statements to evaluate the financial effects of those adjustments.

ASC 805 requires specific information to be disclosed to satisfy these objectives. Those specific disclosures are discussed in the following sections and included in the disclosure checklist in Section 1 of Appendix B:

- Section 14.2, which focuses on specific information the buyer must disclose in its financial statements about a business combination that occurs during the reporting period covered by the financial statements
- Section 14.3, which focuses on specific information the buyer must disclose in its financial statements about a business combination that occurs after the end of the current reporting period, but before the financial statements for the current reporting period are issued or available to be issued
- Section 14.4, which focuses on specific information the buyer must disclose in its financial statements about adjustments made in the current reporting period that relate to a business combination that occurred in the current or a prior reporting period

The disclosure requirements discussed in these sections must be satisfied for both interim and annual reporting periods. In addition, the vast majority of the disclosure requirements discussed in these sections are only those included in ASC 805. There are other disclosure requirements in U.S. GAAP that apply to items recognized in a business combination. For example, consider the disclosure requirements related to employee benefits such as pension benefits and other postretirement benefits. If the buyer assumes the obligation to provide these benefits as part of a business combination, and as such, includes them in the accounting for the business combination, the buyer must also provide all of the disclosures related to these employee benefit obligations that are required under the applicable U.S. GAAP. This is but one illustration of the necessity for the buyer to apply other disclosure requirements in U.S. GAAP to assets acquired and liabilities assumed in a business combination.

## 14.2 Disclosures for business combinations occurring during the reporting period

### 14.2.1 Overview

The buyer in a business combination must disclose specific information in its financial statements about a business combination that occurs during the reporting period covered by the financial statements (as discussed in Section 14.1, the reporting period could be an interim or annual period). This specific information is designed to satisfy the overall disclosure objectives included in ASC 805 (see Section 14.1). However, if providing the specific information required by ASC 805 and other U.S. GAAP does not satisfy those objectives, the buyer must provide the incremental information that would ensure that those objectives are met.

The specific information that must be disclosed in the financial statements for the period in which a business combination occurs can broadly be categorized as follows:

- General information about the business combination (see Section 14.2.2)
- Information about goodwill or a gain from a bargain purchase(*) (see Section 14.2.3)
- Nature, terms and fair value of consideration transferred(*) (see Section 14.2.4)
- Details about specific assets, liabilities and any NCI recognized(*) (see Section 14.2.5)
- Information about the provisional amounts recognized and why recognizing provisional amounts was necessary(*) (see Section 14.2.6)
- Reduction in buyer's preexisting deferred tax asset valuation allowance (see Section 14.2.7)
- Information about transactions accounted for separately from the business combination(*) (see Section 14.2.8)
- Information relevant to step acquisitions(*) (see Section 14.2.9)
- Incremental information required to be provided by a buyer that is a public entity(*) (see Section 14.2.10)

The specific disclosures in each of the listed categories should be provided separately for each business combination that occurs during the period. However, if there are individually immaterial business combinations that occurred during the period that are collectively material, then the disclosures for those categories marked with an (*) should be provided in the aggregate for that collective group of individually immaterial business combinations.

Additional discussion about the specific disclosures for items within each of the categories listed earlier is provided in the sections that follow.

### 14.2.2 General information

The buyer in a business combination must disclose the following general information regarding the business combination:

- The name of the target
- A description of the target
- The acquisition date (see Chapter 6)
- The portion of the target's voting equity interests acquired by the buyer
- The buyer's reasons for entering into the business combination
- How the buyer obtained control of the target

### 14.2.3 Goodwill or a gain from a bargain purchase

As discussed in Section 12.1, goodwill can result from a number of factors. To the extent the accounting for a business combination results in goodwill, the buyer must provide a qualitative description of the factors that gave rise to the goodwill. For example, if the goodwill is partially or wholly attributable to the synergies that are expected to result from combining the operations of the buyer and the target, then that factor should be disclosed and discussed by the buyer. In addition, if the buyer elected the private-company intangible asset alternative (see Chapter 17), another factor that may give rise to goodwill is any intangible assets that were not separately recognized as a result of electing the alternative. Additional information about providing this disclosure is included in Section 17.5.

The buyer must also disclose the amount of goodwill that it expects to deduct for tax purposes, and if applicable, the amount of goodwill in each reportable segment. If the buyer has not yet determined the amount of goodwill to be assigned to each reportable segment at the time the financial statements are issued or available to be issued, then the buyer must disclose that fact.

If the accounting for a business combination results in a bargain purchase, then the following information must be disclosed: (a) the amount of the gain recognized, (b) the line item in the income statement in which the gain has been reflected and (c) an explanation of the factors that gave rise to the gain (see Section 12.2). In providing an explanation of the factors that gave rise to the gain, the buyer should keep the following in mind:

- Disclosing that the bargain purchase resulted from the fair value of the identifiable net assets acquired exceeding the consideration transferred only provides an explanation of the mathematics that gave rise to the gain from a bargain purchase and does not explain the factors that gave rise to the bargain purchase.
- Disclosing that the bargain purchase resulted from a depressed economy, market or industry segment does not explain the factors that gave rise to the bargain purchase in the buyer's specific facts and circumstances. Disclosing only that the bargain purchase resulted from a depressed economy suggests that all purchases that occur in a depressed economy are bargain purchases, which is not the case.

In preparing the disclosures that will explain the factors that gave rise to the bargain purchase, the buyer should focus on the facts and circumstances specific to *its* business combination that contributed to the bargain purchase. For example, if the buyer bought the target out of bankruptcy, that would be a fact specific to the buyer's business combination that may have contributed to the bargain purchase. If the buyer cannot identify the specific factors that gave rise to the bargain purchase in its situation, it may need to review its accounting for the business combination to determine whether a bargain purchase has, in fact, occurred (see Section 12.2).

#### 14.2.4 Consideration transferred

The buyer in a business combination must provide the following information about the consideration transferred:

- Acquisition-date fair value of each major class of consideration transferred (classes of consideration typically include cash, other tangible or intangible assets, liabilities incurred and equity interests of the buyer)
- Acquisition-date fair value of the aggregate amount of consideration transferred
- If equity interests of the buyer are part of the consideration transferred, the number of instruments or interests issued or issuable and how the fair value of the equity interests was determined (i.e., the method used)

A business or subsidiary transferred by the buyer as consideration to purchase the target is part of the class of consideration that includes other tangible or intangible assets.

We believe all cash transferred in the business combination should be included in the consideration transferred. In other words, acquired cash should be treated the same as all other assets acquired and not netted against cash consideration transferred. For example, if an entity acquires 100% of Target for $15 million in cash and the total identifiable net assets acquired measured in accordance with ASC 805 is $12.5 million (which includes acquired cash of $1.2 million), the acquirer should disclose consideration transferred of $15 million and acquired cash of $1.2 million (rather than consideration transferred of $13.8 million).

Additional information must be provided for contingent consideration. This information includes:

- The amount of contingent consideration recognized by the buyer as of the acquisition date
- A description of the contingent consideration arrangement
- The manner in which the contingent payment is determined
- If determinable, a range of estimated outcomes (undiscounted)
- If a range of estimated outcomes is not determinable, that fact and the reason why
- If there is no upper limit on the range of estimated outcomes (i.e., an unlimited maximum payment), that fact

In addition, for share-based contingent consideration, the disclosure requirements in: (a) ASC 480-10-50 and ASC 815-40-50 should be considered when that consideration is classified as an asset or liability and (b) ASC 505-10-50 and ASC 815-40-50 should be considered when that consideration is classified as equity.

For additional information about consideration transferred and contingent consideration, see Section 12.3 and Section 12.4, respectively.

### 14.2.5 Specific assets, liabilities and any NCI

ASC 805 requires the buyer to disclose details about specific assets acquired, liabilities assumed and any NCI recognized in connection with a business combination. In addition, ASC 350-30-50-1 to 50-5 require the disclosure of specific information about intangible assets acquired in a business combination. The assets, liabilities and NCI for which additional information must be disclosed, along with the additional information to be provided, are listed in the following table:

| Asset, liability or NCI | Additional discussion | Required disclosures |
|---|---|---|
| Indemnification assets | Section 11.3 | • The amount recognized by the buyer as of the acquisition date<br>• A description of the indemnification<br>• The manner in which the indemnified amount is determined<br>• If determinable, a range of estimated outcomes (undiscounted)<br>• If a range of estimated outcomes is not determinable, that fact and the reason why<br>• If there is no upper limit on the range of estimated outcomes (i.e., an unlimited maximum indemnification), that fact |
| Receivables (excluding those that fall within the scope of ASC 310-30 before the adoption of ASC 326 or excluding those that meet the definition of PCD assets [see Section 10.3.4] after the adoption of ASC 326) (see Section 10.3.2 | Section 10.3 | • For each major class of receivable:<br>− Fair value of amounts receivable, except for a lessor's receivables related to sales-type leases and direct financing leases<br>− Recorded amounts receivable for a lessor's receivables related to sales-type leases and direct financing leases<br>− Gross contractual amounts receivable |

| Asset, liability or NCI | Additional discussion | Required disclosures |
|---|---|---|
| for information about ASC 326) | | − Acquisition-date best estimate of the contractual cash flows that are believed to be uncollectible |
| Each major class of assets acquired and liabilities assumed | Chapters 7, 10 and 11 | • Amounts recognized as of the acquisition date, including the amount of acquired cash |
| Contract assets and liabilities (after adoption of ASU 2021-08) | Section 11.9 | • For any of the practical expedients in ASC 805-20-30-29 that an acquirer uses:<br>− A description of the expedients used<br>− To the extent reasonably possible, a qualitative assessment of the estimated effect of applying each of those expedients |
| Intangible assets | Sections 10.6, 10.8, 10.9, 10.10, 10.12 and 10.13 | • For amortizable intangible assets, in the period of acquisition (Note 1):<br>− Total amount<br>− Amount by major class<br>− Total residual value<br>− Residual value by major class<br>− Weighted average amortization period in total<br>− Weighted average amortization period by major class<br>• For amortizable intangible assets, for each period for which a balance sheet is presented:<br>− Total gross carrying amount<br>− Carrying amount by major class<br>− Total accumulated amortization<br>− Accumulated amortization by major class<br>− Aggregate amortization expense for the period<br>− Aggregate amortization expense estimated for the next five fiscal years<br>• For nonamortizable intangible assets, in the period of acquisition (Note 1):<br>− Total amount<br>− Amount by major class<br>• For nonamortizable intangible assets, for each period for which a balance sheet is presented:<br>− Total carrying amount<br>− Carrying amount by major class<br>• For intangible assets that meet certain criteria, in the period of acquisition and for each period for |

| Asset, liability or NCI | Additional discussion | Required disclosures |
|---|---|---|
| | | which a balance sheet is presented, information about the intangible assets' estimated useful lives<br>• Specific information regarding intangible assets for which there are renewal or extension provisions, including the accounting policy for the related costs<br>• Specific information regarding any impairments of intangible assets |
| Preacquisition contingencies | Section 11.2 | • For each preacquisition contingency recognized at the acquisition date or for the aggregate of all preacquisition contingencies recognized at the acquisition date that are similar in nature:<br>– The nature of the contingencies giving rise to the assets and liabilities<br>– The amounts recognized at the acquisition date<br>– How the amount recognized was determined (i.e., fair value or reasonably estimable amount)<br>• For each preacquisition contingency that is not recognized at the acquisition date or for the aggregate of all preacquisition contingencies not recognized at the acquisition date that are similar in nature, the information that is required by ASC 450 to be disclosed for other unrecognized contingencies to the extent the conditions requiring disclosure exist<br>(Note that this information should be included with the other disclosures related to the business combination and not with the other disclosures related to contingencies.) |
| NCI | Section 10.19 | • Acquisition-date fair value of the NCI<br>• Valuation techniques used to estimate the fair value of the NCI<br>• Significant inputs used in estimating the NCI's fair value |

**Note 1:** If the aggregate fair values of intangible assets (other than goodwill) acquired in a business combination are significant, then this information should be disclosed.

### 14.2.6 Provisional amounts

As discussed in Section 12.7.1, the buyer in a business combination may, under certain circumstances, recognize provisional amounts in the initial accounting for the business combination and subsequently adjust these provisional amounts during the measurement period. The items in a business combination for which provisional amounts could be recognized in the initial accounting for the business combination include any part of the four elements involved in determining the amount of goodwill or gain from a bargain purchase recognized as a result of a business combination (and the goodwill or gain from a bargain purchase itself) (see Section 12.1).

To the extent the buyer has not completed its accounting for the business combination, and as a result, has recorded provisional amounts in its financial statements related to the business combination, the buyer must explain why its initial accounting is incomplete (i.e., why it was necessary to record provisional amounts) and the specific items for which provisional amounts have been recorded. Because provisional amounts could be recorded for any part of any of the items involved in the accounting for the business combination, the specific items for which provisional amounts have been recorded could include assets, liabilities, equity interests and items of consideration or any combination thereof. Section 12.7.1 discusses the importance of making sure that disclosures about provisional amounts are complete and accurate.

### 14.2.7 Reduction in the buyer's preexisting deferred tax asset valuation allowance

Disclosure of the effects a business combination has on the buyer's preexisting deferred tax asset valuation allowances must be provided. More specifically, ASC 805-740-50-1 indicates that the buyer must disclose "...any acquisition-date income tax benefits or expenses recognized from changes in the acquirer's valuation allowance for its previously existing deferred tax assets as a result of a business combination."

### 14.2.8 Separate transactions

As discussed in Chapter 13, there are many situations in which the buyer in a business combination may have to account for a transaction or relationship between it and the target or the sellers separate from the business combination. One example involves the effective settlement of a preexisting relationship between the buyer and the target or the sellers as a result of the business combination.

The following information must be disclosed for those transactions and relationships that are accounted for separate from the business combination:

- A description of the transaction or relationship
- How the buyer accounted for the transaction or relationship
- The amounts recognized by the buyer for the transaction or relationship and where these amounts are reflected in the buyer's financial statements

In addition, if the transaction that was separately accounted for was the effective settlement of a preexisting relationship, then the method used to determine the settlement amount must also be disclosed.

As discussed in Section 13.5.1, transaction costs are expensed as incurred and when the related services have been received by the buyer. In other words, such costs are accounted for separate from the business combination. As such, the disclosures for separate transactions should also include information about transaction costs having to do with the business combination, including:

- The amount of such costs
- The amount of such costs recognized as an expense
- The line item in which such costs have been reflected on the income statement

In addition, if the buyer incurred costs to issue debt or equity in conjunction with the business combination, then the amount of such costs, as well as how they were accounted for, should also be disclosed.

#### 14.2.9 Step acquisitions

The accounting for a step acquisition is discussed in Section 12.6. If the buyer obtains control of a target through a step acquisition, the following additional disclosures are required:

- The acquisition-date fair value of the buyer's PHEI in the target immediately before the acquisition, the valuation technique used in the fair value measurement process and information about the inputs used in that process
- The gain or loss recognized in connection with adjusting the carrying amount of the buyer's PHEI in the target to its fair value immediately before the business combination and the line item in which the gain or loss has been reflected on the income statement

#### 14.2.10 Public company

If the buyer in a business combination is a public entity as defined in the Master Glossary of the Codification, then the postacquisition-date revenue and net income included in the consolidated financial statements that are attributable to the target must be disclosed by the buyer. In addition, supplemental pro forma information must also be disclosed for the combined entity. The nature of the supplemental pro forma information depends on whether the buyer presents comparative financial statements. If the buyer does not present comparative financial statements, then it must disclose the pro forma consolidated revenue and net income for the current reporting period as if the business combination had occurred as of the beginning of the fiscal year in which the business combination actually occurred. If the buyer does present comparative financial statements, then it must disclose the pro forma consolidated revenue and net income for the period in which the business combination occurred and the prior period as if the business combination had occurred as of the beginning of the prior period. In either case, for any material, nonrecurring adjustments directly related to the business combination that are included in the supplemental pro forma information, the buyer must also disclose the nature and amount of those adjustments.

ASC 805 provides a practicability exception for these disclosures. In other words, if the buyer finds that providing any of the disclosures discussed in this section to be impracticable, it would instead disclose that fact and the reasons why providing such information is impracticable. The definition of impracticable in ASC 250-10-45-9 is used for this purpose.

## 14.3 Disclosures when a business combination occurs after the end of the reporting period, but before the financial statements are issued or available to be issued

The buyer in a business combination must disclose specific information in its financial statements about a business combination that occurs after the end of the current reporting period, but before the financial statements for that period are issued or available to be issued (as discussed in Section 14.1, the current reporting period could be an interim or annual period). The specific information that should be disclosed is the same information that should be disclosed for a business combination that occurs during the current reporting period (see Section 14.2). An exception to this requirement is provided if the buyer has not yet completed its initial accounting for the business combination at the time the financial statements are otherwise ready to be issued or available to be issued. If the exception applies, the buyer should: (a) make the disclosures it is able to make and (b) describe the disclosures that it could not make and the reasons why.

If these specific disclosures do not allow the users of the buyer's financial statements to evaluate the nature and financial effects of the business combination, then the buyer must disclose the necessary incremental information that would allow for that evaluation.

## 14.4 Disclosures about adjustments made to amounts recorded in the accounting for business combinations

### 14.4.1 General

The buyer in a business combination may make an adjustment in the current reporting period that relates to a business combination that occurred in the current or a prior reporting period (as discussed in Section 14.1, the period referred to could be an interim or annual period). For these types of adjustments, the buyer must disclose information that enables users of its financial statements to evaluate the financial effects of the adjustment. The nature of the information to be disclosed for a particular adjustment depends on the nature of the adjustment or the nature of the item being adjusted. Specific disclosures are required by ASC 805 for: (a) measurement period adjustments (see Section 14.4.2), (b) adjustments to amounts recorded for contingent consideration (see Section 14.4.3) and (c) adjustments to goodwill (see Section 14.4.4). If providing only these specific disclosures does not allow users of the financial statements to evaluate the financial effects of the adjustment, then the buyer must disclose the necessary incremental information that would allow for that evaluation.

The required disclosures should be provided separately for each material business combination. However, if there are immaterial business combinations that are collectively material, then the required disclosures should be provided in the aggregate for that collective group of individually immaterial business combinations. The disclosure requirements discussed in Section 14.4 are primarily only those included in ASC 805. There are additional disclosure requirements included in other U.S. GAAP that cover changes in the balances of assets and liabilities that may have been recognized in the accounting for a business combination.

### 14.4.2 Measurement period adjustments

When a measurement period adjustment is made to a provisional amount (see Section 12.7), the buyer must disclose the nature and amount of the measurement period adjustment recognized during the reporting period. In addition, with respect to the amount (i.e., portion) of a measurement period adjustment made to individual income statement items in the current reporting period that would have been recognized in previous reporting periods if the adjustment had been retrospectively recorded as of the acquisition date, the buyer may either: (a) disclose the amount of the measurement period adjustment related to previous periods or (b) present the amount of the measurement period adjustment related to previous periods in its own line in the income statement. In the context of Example 12-9, the buyer should disclose that $10,000 of the $30,000 measurement period adjustment to depreciation expense in the current reporting period would have been recorded in the previous reporting period if the measurement period adjustment had been retrospectively recorded as of the acquisition date (i.e., November 1, 20X1).

### 14.4.3 Contingent consideration adjustments

As discussed in Section 12.4.2, the buyer in a business combination will most likely have classified contingent consideration included in the accounting for the business combination as an asset or a liability. An asset might be recognized if the seller is obligated to return consideration to the buyer upon a specific event occurring or not occurring. A liability might be recognized if the buyer is obligated to transfer additional consideration upon a specific event occurring or not occurring. Disclosures related to contingent consideration that must be made for the period in which the business combination occurs are discussed in Section 14.2.4.

As discussed in Section 12.4.4.2, if an asset or liability is recognized for contingent consideration, it is remeasured to its fair value at each reporting date until it is derecognized. The information that should be provided when the asset or liability is remeasured or derecognized includes:

- The change to the recognized amount

- Any difference between the recognized amount and the amount received or paid upon settlement of the contingency
- Any changes in the range of outcomes previously disclosed for the contingent consideration and the reason for such changes

In addition, the fair-value-related disclosures required by ASC 820 for recurring fair value measurements should also be provided for contingent consideration remeasured to its fair value at the end of each reporting period (see Section 14.7).

### 14.4.4 Goodwill adjustments

ASC 350-20-50-1 requires a rollforward of goodwill from the beginning of the period to the end of the period. ASC 805-30-50-4(b) requires such a rollforward for the goodwill related to each business combination. The items that must be reflected in the rollforward include the following:

- Beginning balances of:
  - The gross amount of goodwill
  - The accumulated impairment losses recognized
- Amount of the following types of activity in the goodwill balance during the period:
  - Recognition of additional goodwill, except for any portion that is part of a disposal group that is classified as held for sale upon acquisition
  - Recognition of measurement period adjustments attributable to the change in a valuation allowance recorded on acquired deferred tax assets (see ASC 805-740-25-2 to 25-4 and 805-740-45-2)
  - Reclassification of goodwill included in a disposal group that is classified as held for sale
  - Derecognition of goodwill that was not previously reflected as part of a disposal group classified as held for sale
  - Recognition of impairment losses
  - Changes in the net amount of any foreign-currency exchange differences
  - Recognition of any other changes
- Ending balances of:
  - The gross amount of goodwill
  - The accumulated impairment losses recognized

If the buyer reports segment information, this rollforward has to be provided for goodwill in total, as well as for the goodwill assigned to each reportable segment. Any changes in how goodwill was assigned to reportable segments must also be part of the disclosure. If the goodwill has not yet been assigned to reporting units at the reporting date, then the amount not yet assigned must be disclosed along with the reasons why the assignment has not yet occurred.

A buyer must disclose the following when it has reporting units with zero or negative carrying amounts:

- Those reporting units that have assigned goodwill
- The amount of goodwill assigned to each of those reporting units
- The reportable segments that include those reporting units

Specific information regarding any goodwill impairments must be provided, including the facts and circumstances that gave rise to the impairment and the amount of the impairment.

If a buyer has elected the private-company goodwill amortization alternative (see Section 18.3), the disclosure requirements discussed in Section 18.3.8 would apply.

## 14.5 Disclosure illustrations

ASC 805-10-55-37 to 55-50 provide an illustration of the requirements included in ASC 805. Note that this illustration is not comprehensive. In other words, it does not illustrate all of the disclosure requirements included in ASC 805. Nonetheless, it is useful to see one approach used to satisfy many of the disclosure requirements in ASC 805. The illustration in the Codification is included in Appendix B and cross-referenced to the disclosure checklist also included in that appendix.

ASC 350-20-55-24 provides an illustration of the disclosures that must be provided for goodwill when the private-company goodwill amortization alternative has not been elected.

## 14.6 Disclosures upon initial consolidation of a VIE

Upon acquisition of a VIE that is a business, the buyer (which is always the PB when a VIE is being acquired) must provide all of the same disclosures required of the buyer in a business combination. Upon acquisition of a VIE that is not a business, the buyer must disclose the gain or loss recognized upon the initial consolidation of the VIE. For additional discussion of the interaction of accounting for business combinations and accounting for interests in VIEs, see Section 2.1, Section 3.1.3 and Section 5.1.

## 14.7 Fair value disclosures

Given that ASC 805 requires the vast majority of assets and liabilities to be measured at fair value in the accounting for a business combination (see Section 8.1), the disclosure requirements of ASC 820 must also be taken into consideration when preparing financial statements that include a business combination.

The nature and extent of the disclosures required by ASC 820 vary depending on whether the fair value measurement is considered recurring or nonrecurring and whether the reporting entity is a PBE. More extensive disclosures are required for recurring fair value measurements and PBEs.

Whether a fair value measurement recognized in connection with a business combination is recurring or nonrecurring depends on how the underlying asset or liability is accounted for after its initial recognition. If the asset or liability measured at fair value in the accounting for the business combination is remeasured to its fair value at the end of each reporting period, then it is a recurring fair value measurement. Examples of assets and liabilities recognized at fair value in the accounting for a business combination that are remeasured to their fair value at the end of each reporting period are a contingent consideration liability and a debt security classified as trading. These fair value measurements are recurring. Examples of assets and liabilities recognized at fair value in the accounting for a business combination that are *not* remeasured to their fair value at the end of each reporting period are a trademark, an FCC license, a building, a customer relationship intangible asset and accounts payable. These fair value measurements are nonrecurring.

In general, the disclosure requirements in ASC 820 apply to recurring and nonrecurring fair value measurements for assets and liabilities recorded in the financial statements *after the initial recognition* of those assets and liabilities. What does this mean as far as the assets and liabilities recognized at fair value in the accounting for a business combination are concerned? Consider a situation in which a business combination occurs on December 1, and the buyer is analyzing whether the disclosures in ASC 820 are required in its December 31 year-end financial statements for a debt security classified as trading and an FCC license that were acquired in the business combination:

- *Debt security classified as trading:* A debt security classified as trading is initially recognized at fair value in the accounting for a business combination and is subsequently accounted for at fair value (i.e., it is remeasured to its fair value at the end of each reporting period). Because the debt security is measured at fair value on a recurring basis in periods *after its initial recognition*, the recurring fair value measurement disclosures should be provided for it in the December 31 financial statements. Because the fair value reflected in the December 31 financial statements is the fair value of the debt security on December 31, information about the fair value on that date is provided in the disclosures. In addition, because the change in fair value reflected in the December 31 financial statements is based on the change between December 1 and December 31, information about the fair value on December 1 might also be provided in the disclosures. The nature and extent of the required disclosures depends on which level within the fair value hierarchy (Level 1, 2 or 3) the recurring fair value measurement falls and whether the buyer is a PBE.

- *FCC license:* An FCC license is initially recognized at fair value in the accounting for a business combination, but is not subsequently accounted for at fair value. It is only remeasured to its fair value in connection with the recognition of an impairment loss at some point after the acquisition date. As such, the FCC license is measured at fair value on a nonrecurring basis. Are the nonrecurring fair value measurement disclosures in ASC 820 applicable to the fair value of the FCC license on the acquisition date? No. The nonrecurring fair value measurement disclosures are not required for the FCC license in the December 31 financial statements because those disclosures only apply to assets and liabilities measured at fair value on a nonrecurring basis in periods *after their initial recognition*. While the FCC license was measured at fair value on the acquisition date (i.e., its initial recognition), it was not remeasured to its fair value after that (i.e., the FCC license was not written down to its fair value in connection with an impairment charge between the acquisition date [December 1] and the balance-sheet date [December 31]). As a result, the nonrecurring fair value measurement disclosures are not required for the FCC license in this situation.

As it relates to the FCC license, assume instead that it was acquired in a business combination that occurred on June 1 and that it was considered indefinite-lived. In addition, assume the FCC license was written down to its fair value as of December 1 as a result of the buyer's performance of its annual impairment testing of indefinite-lived intangible assets. In this situation, the nonrecurring fair value measurement disclosures should be provided for the FCC license in the December 31 financial statements because those disclosures apply to assets and liabilities measured at fair value on a nonrecurring basis in periods *after their initial recognition*. After its initial recognition, the FCC license was written down to its fair value through an impairment charge in the December 31 year end. The disclosures provided are based on the fair value of the FCC license at December 1 (the date the fair value was measured for purposes of determining the impairment charge) and not the fair value of the FCC license at June 1 (the date of its initial acquisition in the business combination) or December 31 (the balance-sheet date).

Some question why the disclosure requirements in ASC 820 apply only to recurring and nonrecurring fair value measurements for assets and liabilities recorded in the financial statements *after the initial recognition* of those assets and liabilities. In other words, why are ASC 820's disclosures not required for the fair value measurements that are actually included in the accounting for the business combination? We understand that one of the primary purposes of ASC 820's disclosures is to provide the user with information about significant judgments that affect an entity's results of operations. Fair value measurements that are included in the accounting for a business combination do not, in-and-of-themselves, affect the buyer's results of operations at the point in time they are recognized (i.e., at the acquisition date). In the example discussed earlier, recording the FCC license at its fair value on the acquisition date in the accounting for the business combination did not affect the buyer's results of operations. As a result, given that one of the primary purposes of ASC 820's disclosures is to provide the user with information about significant judgments that affect an entity's results of operations, ASC 820's nonrecurring fair value measurement disclosures were not required with respect to the FCC license and its estimated fair value on the acquisition date. In contrast, to the extent the asset or liability recognized at fair value in the accounting for the business combination is subsequently adjusted to reflect its fair value during or at the end of a reporting period, that change in fair value generally does affect the buyer's results of operations. In the example discussed earlier involving the debt security classified as trading, the change in the fair value of the security did affect the buyer's results of operations. As a result, given that one of the primary purposes of ASC 820's disclosures is to provide the user with information about significant judgments that affect an entity's results of operations, ASC 820's recurring fair value measurement disclosures were required. In addition, in the example involving the indefinite-lived FCC license in which an impairment loss was recognized, the change in the fair value of the license did affect the buyer's results of operations. As a result, ASC 820's nonrecurring fair value measurement disclosures were required.

# 15. Asset acquisitions

## 15.1 Overview

As discussed in Section 3.1.1, purchases of assets (or assets and liabilities [net assets]) that do not constitute a business (and are not VIEs) are accounted for as asset acquisitions in accordance with ASC 805-50 and not business combinations using the acquisition method in ASC 805. As discussed in Section 4.3, reaching a conclusion on the accounting model that should be applied to a transaction as early in the acquisition process as possible is important because there are significant differences between the accounting for a business combination and the accounting for an asset acquisition (many of which are discussed later in this section).

The buyer in a transaction that should be accounted for as an asset acquisition should not assume that the valuation process is any less time-consuming or extensive than that for a business combination. In other words, concluding that an asset acquisition has occurred (instead of a business combination) does not negate the need to determine the fair value of the assets acquired and liabilities assumed. In addition, the concept of a measurement period does not exist with respect to the accounting for an asset acquisition, which means the valuation process must be complete by the time the acquirer issues (or makes available for issuance) its first financial statements that include the asset acquisition.

Section 4.3 discusses: (a) the steps the buyer should take to help ensure that the accounting for a business combination goes as smoothly as possible and (b) the repercussions for unnecessarily delaying the accounting for a business combination. These steps and repercussions are equally applicable to the accounting for an asset acquisition.

The authoritative guidance applicable to asset acquisitions is included in ASC 805-50. If an entity buys net assets that do not constitute a business as described in Section 4.1, or a VIE as described in Section 3.1.3, then the entity should account for that purchase as an asset acquisition. However, before accounting for the asset acquisition under ASC 805-50, the acquirer should determine whether there are other elements to the transaction that should be accounted for separately under other U.S. GAAP. For example, if the asset acquisition results in the settlement of a preexisting relationship between the acquirer and sellers, the settlement of that relationship should be accounted for separate from the asset acquisition. Absent other guidance in U.S. GAAP being applicable to the settlement of the relationship, we believe it is appropriate to analogize to the guidance provided in ASC 805-10 related to the settlement of a preexisting relationship in conjunction with a business combination (see Section 13.2).

The key activities involved in accounting for an asset acquisition as of the acquisition date include:

- Determine the cost of the acquisition (see Section 15.2)
- Identify the assets acquired and liabilities assumed and measure their fair values (or other appropriate amount) (see Section 15.3)
- Allocate the cost of the acquisition to the assets acquired and liabilities assumed on a relative fair value (or other appropriate amount) basis (see Section 15.4)

After the asset acquisition, other applicable U.S. GAAP or accounting policies are used to subsequently account for the net assets recognized in the acquisition.

**How does this compare to business combination accounting?**

The business combination accounting model and the asset acquisition accounting model are fundamentally different. The business combination accounting model results in the recognition of the assets acquired and liabilities assumed at primarily their fair values, while the asset acquisition model results in the allocation of the cost of the acquisition to the assets acquired and liabilities assumed based primarily on their relative fair values. This fundamental difference underscores the need for an acquirer to appropriately determine whether the net assets it acquired meet the definition of a business (see Section 4.1).

Other significant differences (but not all differences) between the accounting for a business combination and asset acquisition include the following:

| | Business combination | Asset acquisition |
|---|---|---|
| Goodwill or gain from a bargain purchase | Recognize one or the other as a result of applying the acquisition method (see Section 12.1). | Do not recognize, and any difference between the cost of the acquisition and the fair values (or other amounts) of the net assets acquired is reallocated to certain of the assets acquired (see Section 15.4). |
| Consideration transferred is nonfinancial assets or in substance nonfinancial assets | Measure using the fair value of the assets transferred (see Section 12.3). | Consider whether the transfer of such assets is within the scope of ASC 610-20 or 845 or other U.S. GAAP, in which case the nonfinancial assets or in substance nonfinancial assets may not be measured at fair value (see Section 15.2.2). |
| Nonderivative contingent consideration | Recognize and measure at its fair value (see Section 12.4). | Neither ASC 805-50 nor other U.S. GAAP directly addresses the accounting for contingent consideration in an asset acquisition. We believe the acquirer should recognize a contingent consideration liability when probable and reasonably estimable and usually recognize a contingent consideration asset when realized (see Section 15.2.3). |
| Transaction costs (other than debt or equity issuance costs) | Expense (see Section 13.5). | Capitalize as part of the cost of the acquisition (see Section 15.2.5). |

| | Business combination | Asset acquisition |
|---|---|---|
| Intangible assets | Recognize only when the definition of an asset in CON 8 is satisfied and the intangible asset is identifiable, which requires it to meet one or both of two criteria focused on whether the asset is separable or legal-contractual in nature (see Section 10.8). | Recognize only when the definition of an asset in CON 8 is satisfied (see Section 15.3.1). |
| Assembled workforce intangible asset | Do not recognize (see Section 10.11). | Recognize when the definition of an asset in CON 8 is satisfied (see Section 15.3.1). |
| IPR&D | Recognize as an indefinite-lived intangible asset (see Section 10.12). | Only recognize as an intangible asset if it has an alternative future use (see Section 15.3.3). If not, the cost of the acquisition allocated to the IPR&D is immediately expensed. |
| Preacquisition contingencies | Recognized at their acquisition-date fair values if those fair values can be determined, or if not, recognized when probable and reasonably estimable (see Section 11.2). | Neither ASC 805-50 nor other U.S. GAAP directly addresses the accounting for preacquisition contingencies assumed in an asset acquisition. We believe the acquirer should recognize a contingent liability when probable and reasonably estimable and usually recognize a contingent asset when realized (see Section 15.3.4). |
| Deferred taxes | A simultaneous equation is used to determine the amount of goodwill and related deferred tax asset to recognize when tax-deductible goodwill is greater than goodwill for book purposes (see Section 11.4.5). | A simultaneous equation is used to determine the amount of certain noncurrent assets and related deferred tax assets to recognize when the cost of the acquisition exceeds the fair value of the net assets acquired (see Section 15.3.6). |

*15Q.1.1 If the net assets acquired in an asset acquisition are in a legal entity that was purchased by the acquirer for which separate financial statements will be prepared, may the asset acquisition be pushed down to the separate financial statements of the acquired legal entity?*

No. Pushdown accounting only applies in the context of a business combination.

*15Q.1.2 What are the accounting implications for an asset acquisition between entities under common control?*

Transfers between entities under common control are discussed in detail in Section 3.2.

## 15.2 Determine the cost of the acquisition

The cost of the acquisition depends on the nature of the consideration given by the acquirer to obtain the net assets from the sellers. When the consideration given by the acquirer is cash, then the cost of the acquisition includes the amount of cash surrendered. Other consideration that may be given by the acquirer in an asset acquisition is discussed in Sections 15.2.1 to 15.2.4. In addition, transaction costs are included in the cost of the acquisition (see Section 15.2.5).

### 15.2.1 Acquirer incurs liabilities or issues equity

If an entity incurs liabilities or issues equity to acquire net assets, then the liabilities or equity are recognized at the date of acquisition and the cost of the acquisition includes the more clearly evident and more reliably measurable of: (a) the fair value of the liabilities incurred or equity issued or (b) the fair value of the net assets acquired.

### 15.2.2 Acquirer surrenders nonfinancial assets or in substance nonfinancial assets

If the consideration given is made up of nonfinancial assets or in substance nonfinancial assets, the acquirer must consider whether the transfer of those nonfinancial assets or in substance nonfinancial assets is within the scope of ASC 845, ASC 610-20 or other U.S. GAAP. If so, that other guidance should be applied. ASC 610-20 is discussed in detail in Appendix A of our revenue recognition guide. If the transfer of the nonfinancial assets or in substance nonfinancial assets is not within the scope of other U.S. GAAP, the cost of the acquisition includes the more clearly evident and more reliably measurable of: (a) the fair value of the nonfinancial assets surrendered or (b) the fair value of the net assets acquired. In addition, the acquirer should recognize a gain or loss when the fair value of the nonfinancial assets surrendered differs from the carrying amount of those assets.

### 15.2.3 Contingent consideration

Because ASC 805-50 does not specifically address the accounting for contingent consideration included in an asset acquisition, we believe the acquirer should first determine whether the contingent consideration meets the definition of a derivative. When it does, it should be accounted for in accordance with the guidance in ASC 815. When the contingent consideration does not meet the definition of a derivative, we believe it should generally be recognized and measured using the guidance in ASC 450. Applying ASC 450 to nonderivative contingent consideration in an asset acquisition results in the recognition of: (a) a contingent consideration liability when it is probable and reasonably estimable and (b) a contingent consideration asset usually when it is realized. If application of either ASC 815 or ASC 450 results in the recognition of an asset or liability related to the contingent consideration, the amount recognized for that asset or liability is included in the cost of the acquisition.

### 15.2.4 Acquirer with a PHEI

If an acquirer has a PHEI in the entity acquired, the acquirer must determine how to account for the PHEI in the cost of the acquisition. As measurement of a PHEI in an asset acquisition is not addressed in ASC 805-50, there is diversity in practice. We believe that either of the following accounting alternatives would be acceptable:

- The acquisition date carrying amount of the PHEI is included in the cost allocated to the assets acquired and liabilities assumed. This alternative is consistent with the guidance in ASC 805-50-30-1 to recognize assets based on their cost to the acquirer.
- The acquisition date fair value of the PHEI (after recognizing a gain or loss for the difference between the fair value of the PHEI and its carrying amount) is included in the cost allocated to the assets acquired and liabilities assumed. This alternative is based on an analogy to the accounting treatment of the PHEI in a business combination per ASC 805-30-30-1.

### 15.2.5 Transaction costs

If the acquisition is not within the scope of ASC 845, ASC 610-20 or other U.S. GAAP, transaction costs are included in the cost of the acquisition. For this purpose, only direct costs may be included in the transaction costs included in the cost of the acquisition. Examples of such costs include finder's fees and professional or consulting fees for advisory, legal, accounting, valuation or other services. Internal costs, such as those related to an internal acquisitions or corporate development group are not considered direct costs and should not be included in the cost of the acquisition. In addition, debt or equity issuance and registration costs incurred by the acquirer to finance the asset acquisition should be accounted for in accordance with other applicable U.S. GAAP, which typically results in the deferral and amortization of debt issuance costs and the inclusion of equity issuance costs in the appropriate paid-in capital account.

## 15.3 Identify and measure the assets acquired and liabilities assumed

Because ASC 805-50 does not provide specific recognition guidance for assets and liabilities acquired in an asset acquisition, the acquirer should identify the assets purchased and liabilities assumed by reference to the four recognition criteria in paragraph 63 of CON 5, the first of which requires meeting the definition of assets or liabilities (as appropriate). For that purpose, the following definitions in CON 8 are used:

> E16. An asset is a present right of an entity to an economic benefit.
>
> E37. A liability is a present obligation of an entity to transfer an economic benefit.

The other three criteria in paragraph 63 of CON 5 relate to measurability, relevance and reliability.

Once the assets and liabilities acquired in the asset acquisition have been identified, the acquirer must next estimate the fair value (or other appropriate amount) for each of those assets and liabilities, which facilitates allocating the cost of the acquisition to those assets and liabilities. The following sections provide additional information about identifying and estimating the fair value (or other appropriate amount) of certain assets and liabilities that may be acquired in an asset acquisition.

### 15.3.1 Intangible assets (including an assembled workforce)

Based on the guidance in ASC 350-30-25-4, intangible assets should be recognized when they meet the criteria in CON 5, which includes satisfying the definition of an asset. This basis for recognizing intangible assets in an asset acquisition is less restrictive than the basis for recognizing intangible assets in a business combination because the latter requires an intangible asset to be separable and contractual-legal in nature (see Section 10.8). As a result, the intangible assets recognized in a business combination may also be recognized in an asset acquisition (see Chapter 10). In addition, there may be other assets recognized in an asset acquisition that should not be recognized in a business combination. ASC 350-30-25-4 specifically provides as examples "specially-trained employees or a unique manufacturing process related to an acquired manufacturing plant." The asset recognized for specially-trained employees is commonly referred to as an assembled workforce.

It is not uncommon for an assembled workforce to also include a substantive process based on the knowledge of that workforce. As such, to the extent the acquirer in an asset acquisition concludes an assembled workforce was included in the net assets it purchased, the acquirer should consider whether the presence of the assembled workforce gives rise to it also having acquired a substantive process. To the extent the acquirer has purchased both an assembled workforce and a substantive process, it should reconsider whether what it acquired is a business (see Section 4.1).

### 15.3.2 Defensive intangible assets

As discussed in Section 10.10, the Master Glossary of the Codification defines a defensive intangible asset as "An acquired intangible asset in a situation in which an entity does not intend to actively use the asset but intends to hold (lock up) the asset to prevent others from obtaining access to the asset." An example is an acquired trade name that the acquirer does not intend to use or allow any other entity to use. Based on the guidance in ASC 805-50-30-3, defensive intangible assets should be recognized at their relative fair values in an asset acquisition, which should reflect their highest and best use, regardless of the acquirer's intended use (or nonuse) of the asset.

### 15.3.3 In-process research & development (IPR&D)

Tangible or intangible assets for IPR&D are only recognized as an asset in an asset acquisition if they have an alternative future use. If there is no alternative future use for IPR&D tangible or intangible assets acquired in an asset acquisition, which is most often the case, the cost of the acquisition allocated to the IPR&D assets (see Section 15.4) is immediately expensed.

### 15.3.4 Contingencies

An acquirer may assume contingencies in an asset acquisition. For example, the acquirer may purchase a manufacturing facility, as well as some existing litigation related to the construction or operation of the manufacturing facility. While ASC 805-50 does not specifically address how acquired contingencies should be accounted for in an asset acquisition, there is guidance in ASC 450 related to accounting for loss and gain contingencies. When contingencies within the scope of ASC 450 are acquired in an asset acquisition, we believe ASC 450 should be applied in determining whether a contingent liability or asset should be recognized in the accounting for the asset acquisition. ASC 450 requires recognition of a contingent liability when it is probable and reasonably estimable. When a contingent liability should be recognized, ASC 450-20-30-1 provides guidance on how it should be measured. With respect to contingent assets acquired in an asset acquisition, ASC 450 indicates that a contingent gain usually should not be recognized until it is realized.

### 15.3.5 Indemnification assets

In some cases, the party selling the net assets to the acquirer in an asset acquisition may contractually indemnify the acquirer for the outcome of an acquired contingency. Because ASC 805-50 does not specifically address how indemnifications should be accounted for in an asset acquisition, we believe an acquirer should apply, by analogy, the guidance provided in ASC 805-20 with respect to accounting for indemnification assets in a business combination (see Section 11.3).

### 15.3.6 Deferred taxes

Deferred taxes should be recognized in the accounting for an asset acquisition to the extent there are temporary differences between the book bases and tax bases of the acquired assets and assumed liabilities, and deferred taxes would otherwise be recognized for that basis difference under ASC 740. An additional consideration arises with respect to deferred taxes recognized for certain assets given that neither goodwill nor a bargain purchase gain is recognized in the accounting for an asset acquisition. As discussed in Section 15.4, when there is an excess of the cost of the acquisition over the fair value of the net assets acquired or an excess of the fair value of the net assets acquired over the cost of the acquisition, the excess is allocated to certain assets. Allocating that excess to certain assets results in a circular calculation because allocation of the excess will change the book bases of those assets, which will change the deferred taxes recognized for those assets, which will change the excess to be allocated to those assets, and so on and so forth. As such, a simultaneous equation such as the following one in

ASC 805-740-55-10 may be used to calculate the amount of the deferred tax asset, and ultimately, the amount of the asset that should be recognized for book purposes:

$$\left(Tax\ Rate \div (1 - Tax\ Rate)\right) \times Preliminary\ Temporary\ Difference = Deferred\ Tax\ Asset$$

For example, assume the initial allocation of the cost of the acquisition results in the allocation of $500,000 to equipment, which has a tax basis of $400,000. Also, assume that after the initial allocation of the cost of the acquisition there is a $50,000 excess of cost over the fair value of the net assets acquired. The only asset acquired to which this excess may be allocated based on the guidance discussed in Section 15.4 is the equipment. Assuming a 30% tax rate, the deferred tax asset and adjustment to the carrying amount of the equipment that should be recognized is $64,286 ([30% ÷ (1 – 30%)] × [($500,000 + $50,000) − $400,000]). As such, the amount that should be recognized for the equipment is $614,286 ($500,000 + $50,000 + 64,286). To prove out the accuracy of these amounts, the deferred tax asset should be recalculated using the difference between the book basis and tax basis of the equipment multiplied by the tax rate ([$614,286 − $400,000] × 30% = $64,286). Refer to Section 15.4 for additional discussion related to recognizing certain assets above their fair value in an asset acquisition.

### 15.4 Allocate the cost of the acquisition to the acquired assets and assumed liabilities

The cost of the acquisition is allocated to the assets acquired and liabilities assumed based on their relative fair values (or other appropriate amounts). The allocation of the cost of the acquisition may result in there either being an excess of the cost of the acquisition over the fair value of the net assets acquired or an excess of the fair value of the net assets acquired over the cost of the acquisition. When such an excess exists, the acquirer should first revisit all of the following aspects of its accounting for the asset acquisition:

- Whether the net assets acquired meet the definition of a business
- Whether there are other elements to the transaction (in addition to the asset acquisition) that should be accounted for separately
- Whether the identification, recognition and measurement of the assets and liabilities acquired is complete and accurate

If an excess continues to exist after the acquirer revisits the preceding aspects of its accounting for the asset acquisition, the excess must be reallocated to certain of the acquired assets on a relative fair value (or other appropriate amount) basis. For this purpose, IPR&D is considered an acquired asset that is immediately written off when the IPR&D has no alternative future use (see Section 15.3.3). None of the excess is allocated to any liabilities acquired. The reallocation of the excess to certain assets is necessary because neither goodwill nor a gain from a bargain purchase should be recognized in an asset acquisition.

While ASC 805-50 does not provide any specific guidance with respect to the assets the excess should or should not be allocated to, the predecessor business combination guidance in Statement 141 (which was superseded by Statement 141R [see Section 1.2]) was based on a purchase price allocation model and provided such guidance for when there was an excess of the amounts assigned to the acquired assets and liabilities over the cost of the acquired entity. Given that both ASC 805-50 and Statement 141 include cost allocation models, we believe it would be appropriate to analogize to the guidance in paragraph 44 of Statement 141 for purposes of identifying those assets to which an excess of fair value over cost in an asset acquisition should not be allocated, which includes the following:

- Financial assets, except for equity method investments
- Assets held for sale
- Deferred tax assets

- Prepaid assets related to pension and other postretirement employee benefit plans
- Other current assets

We also believe that an excess of cost over fair value in an asset acquisition should not be allocated to the preceding list of assets because to do so could result in the recognition of an immediate loss when subsequently accounting for those assets under the applicable U.S. GAAP. For that same reason, we believe another asset to which an excess of cost over fair value in an asset acquisition should not be allocated is an indefinite-lived intangible asset.

Allocating the excess of the cost of the acquisition over the fair value of the net assets acquired to certain purchased assets will result in those assets being recognized at amounts above their fair values. We believe the ASC 360 impairment model for assets to be held and used applies to most of those assets. After the occurrence of a triggering event, the held-and-used impairment model first requires a recoverability test to be performed on an asset group based on undiscounted cash flows. The asset group will likely include assets other than those just acquired in the asset acquisition. In addition, only after failing the recoverability test are the fair values of the assets in the asset group considered for purposes of measuring an impairment loss. Based on these mechanics, we think it would be unlikely that allocating the excess of the cost of the acquisition over the fair value of the net assets acquired to certain purchased assets would result in an immediate impairment loss.

**Example 15-1: Accounting for an asset acquisition**

Acquirer purchases the following net assets from Seller:

- Manufacturing equipment
- IPR&D related to the next generation of the manufacturing equipment (which does not have an alternative future use)
- Manufacturing supplies
- Accounts payable

Acquirer pays Seller $5 million in cash for the net assets and also agrees to pay an additional $500,000 if products manufactured using the purchased equipment surpass 120,000 units in the first year after the acquisition. The fair values of the manufacturing equipment, IPR&D, manufacturing supplies and accounts payable are $4 million, $800,000, $1.2 million and $700,000, respectively. The manufacturing supplies turnover multiple times per year, as such they are considered a current asset. Acquirer incurs $100,000 of transaction costs with third-party service providers (e.g., legal, valuation) related to the asset acquisition. For ease of illustration, accounting for the tax effects of the acquisition have not been incorporated into this example.

Acquirer reviews the net assets acquired and concludes that it did not acquire a business because it did not acquire a substantive process.

With respect to the contingent consideration, Acquirer applies ASC 450 and determines that it is probable it will surpass 120,000 units produced by the acquired equipment in the first year after the acquisition. Given that there are two possible outcomes related to the contingency, $0 and $500,000, and Acquirer believes payment of the $500,000 is probable, the amount that should be recognized for the contingent consideration liability and included in the cost of the acquisition based on the measurement guidance in ASC 450-20-30-1 is $500,000.

The cost of the acquisition is $5.6 million, which includes the $5 million of cash, $500,000 of contingent consideration and $100,000 of transaction costs. The following table illustrates how the $5.6 million should be allocated to the net assets purchased in the asset acquisition:

| Net assets acquired | Fair value or other measured amount | Allocation of excess (Note 1) | Amount recognized |
|---|---|---|---|
| Manufacturing equipment | $4,000,000 | $250,000 | $4,250,000 |
| IPR&D | 800,000 | 50,000 | 850,000 |
| Manufacturing supplies | 1,200,000 | | 1,200,000 |
| Accounts payable | (700,000) | | (700,000) |
| | $5,300,000 | | $5,600,000 |
| Cost of the acquisition | 5,600,000 | | |
| Excess of the cost of the acquisition over the fair value (or other measured amounts) of the net assets acquired | $300,000 | $300,000 | |

**Note 1:** The excess of the cost of the acquisition over the fair value (or other measured amounts) of the net assets acquired is only allocated to the manufacturing equipment and IPR&D because the excess should not be allocated to current assets (i.e., manufacturing supplies) or liabilities (i.e., accounts payable).

Prior to recording the asset acquisition, Acquirer reviews and confirms its conclusions that: (a) it did not acquire a substantive process (which means it did not acquire a business), (b) there are no other elements to the transaction with Seller that should be accounted for separately and (c) its identification, recognition and measurement of the assets and liabilities acquired is complete and accurate.

The following is a summary journal entry representing the overall effects of the business combination on Acquirer's financial statements at the acquisition date:

| | Debit | Credit |
|---|---|---|
| Manufacturing equipment | $4,250,000 | |
| IPR&D expense | 850,000 | |
| Manufacturing supplies | 1,200,000 | |
| Cash (to Seller) | | $5,000,000 |
| Cash (to third-party service providers for transaction costs) | | 100,000 |
| Contingent consideration liability | | 500,000 |
| Accounts payable | | 700,000 |

### 15.5 Presentation and disclosure

There is no specific guidance in ASC 805-50 related to how an acquirer should present the cash flows related to an asset acquisition in its cash flow statement. As such, the acquirer should follow the general guidance in ASC 230 for this purpose.

While ASC 805-50 does not include any specific disclosures related to an asset acquisition, there are existing disclosure requirements elsewhere in U.S. GAAP that may apply to the assets and liabilities acquired in an asset acquisition. Examples include the disclosure requirements in ASC 350-30-50 and 360-10-50, which include disclosure requirements related to intangible assets and property, plant and equipment, respectively.

## 16. Changes in buyer's ownership interest in target after a business combination

After the buyer in a business combination obtains control over the target, its ownership interest in the target may change for a number of reasons. The accounting for changes in the buyer's ownership interest depends on any number of factors, including whether the buyer's ownership interest increases (see Section 16.1) or decreases (see Section 16.2). For purposes of this section, the terms parent and subsidiary are used instead of buyer and target because the buyer became the parent of the target (and the target became the subsidiary of the parent) when the buyer obtained control over the target in the business combination.

From an overall perspective, the accounting repercussions in U.S. GAAP are generally more substantial when an entity gains control or loses control of another entity. As discussed in Section 2.1, the acquisition method is only required to be used when the buyer gains control of the target. ASC 805 does not prescribe the use of the acquisition method in any other circumstances. As discussed in Section 16.2, upon loss of control, the parent must recognize a gain or loss when the deconsolidation guidance in ASC 810-10-40 is applicable. The substantial accounting repercussions of gaining or losing control can be tied to the significant change that has occurred in the relationship between the buyer (or parent) and target (or subsidiary):

- When the buyer gains control, the relationship becomes that of parent and subsidiary.
- When the parent loses control, the relationship becomes that of investor and investee.

In contrast, when a parent decreases its ownership interest while still maintaining control (see Section 16.2) or increases its controlling ownership interest (see Section 16.1), a significant change in the relationship between the parent and subsidiary has not occurred. That is, the relationship is still that of a parent and subsidiary. As a result, when the increase or decrease is within the scope of ASC 810-10-45, the accounting repercussions are less substantial in that such changes are accounted for in equity.

### 16.1 Increases in parent's ownership interest in subsidiary

A parent's ownership interest in its subsidiary may increase for any number of reasons, including the purchase of additional ownership interests by the parent or the reacquisition of its own shares by the subsidiary. Under ASC 810-10-45, a parent should account for an increase in its ownership interest in a subsidiary as an equity transaction as follows: (a) adjust the NCI to reflect the decrease in the corresponding ownership interest and (b) adjust the parent's equity (e.g., additional paid-in capital) to reflect the difference between (a) and the consideration paid (if any) by the parent or subsidiary (i.e., the consolidated entity). In addition, the parent should adjust any amounts in accumulated other comprehensive income (AOCI) attributed to the parent and NCI to reflect the increase in the parent's ownership interest and the decrease in the NCI's ownership interest.

**Example 16-1: Increase in parent's ownership interest in existing subsidiary**

Parent owns 60% of Subsidiary and includes Subsidiary in its consolidated financial statements. On June 1, 20X1, Parent purchases an additional 15% interest in Subsidiary from third parties for $3.2 million, bringing its total ownership interest in Subsidiary to 75%. This purchase decreases the NCI's ownership interest from 40% to 25%. Prior to Parent's purchase, the carrying amount of Subsidiary's net assets was $20 million and the carrying amount of the 40% NCI in Subsidiary was $8 million. There are no amounts in AOCI related to Subsidiary.

Because Parent already had a controlling financial interest in Subsidiary, Parent should not apply business combination accounting related to the increase in its controlling financial interest. Instead, the carrying amount of the NCI should be adjusted to reflect the decrease in the NCI's ownership interest from 40% to 25%, and the difference between that adjustment and the cash paid by Parent for its additional 15% interest should be recognized in equity. As such, the carrying amount of the NCI should be reduced by $3 million, from $8 million to $5 million (25% of $20 million), and $200,000 should be recognized in equity ($3.2 million paid for Parent's additional 15% interest – $3 million reduction in the NCI's carrying amount).

The following is a summary journal entry representing the overall effects of Parent's purchase of the additional 15% interest in Subsidiary on its consolidated financial statements:

| | Debit | Credit |
|---|---|---|
| NCI in Subsidiary | $3,000,000 | |
| Additional paid-in capital | 200,000 | |
| Cash | | $3,200,000 |

### 16.2 Decreases in parent's ownership interest in subsidiary

A parent's ownership interest in its subsidiary may decrease for any number of reasons, including a sale of ownership interests by the parent or the sale of new ownership interests by the subsidiary to parties other than the parent. Other events may also cause a parent to lose control of its subsidiary, such as the expiration of a contractual agreement that gave control of the subsidiary to the parent or the subsidiary becoming subject to the control of the government, a court, an administrator or a regulator. The parent's accounting for a decrease in its ownership interest in a subsidiary depends on a number of factors, including whether the subsidiary is a business (see Section 4.1), whether the parent loses control of the subsidiary and the guidance that is applicable to the transfer or transaction that resulted in the decrease in control. The following table summarizes these factors and the related outcomes.

| Did a nonreciprocal transfer to owners (e.g., a spinoff) result in the parent losing control of the subsidiary? | |
|---|---|
| No | Yes |
| ↓ | Account for the nonreciprocal transfer to owners using the guidance applicable to such transfers in ASC 845-10. |

| **Is the transaction that resulted in the decrease in the parent's ownership interest within the scope of U.S. GAAP other than ASC 810-10-45 (when control is maintained) or ASC 810-10-40 (when control is lost)? (See Note 1)** | |
|---|---|
| No | Yes |
| ↓ | Account for the transaction that resulted in the decrease in the parent's ownership interest under that other applicable U.S. GAAP. |

| **Did the transaction that resulted in the decrease in the parent's ownership interest cause the parent to lose control of the subsidiary?** | |
|---|---|
| No | Yes |
| • Account for the transaction that resulted in the decrease in the parent's ownership interest based on the guidance in ASC 810-10-45 as an equity transaction as follows: (a) adjust the NCI to reflect the increase in the corresponding ownership interest and (b) adjust the parent's equity (e.g., additional paid-in capital) to reflect the difference between (a) and any consideration received by the parent or subsidiary (i.e., the consolidated entity).<br>• Adjust any amounts in AOCI attributed to the parent and NCI to reflect the decrease in the parent's ownership interest and the increase in the NCI's ownership interest. | • Stop applying consolidation accounting.<br>• Consider whether the loss in control represents a discontinued operation under ASC 205-20, and if so, perform any necessary impairment testing before accounting for the loss in control.<br>• Account for the loss in control by following the guidance in ASC 810-10-40 to recognize a gain or loss in consolidated net income, calculated as the difference between: (a) the sum of (i) the proceeds from the transaction (if any) (see Section 12.4.10 related to a seller's accounting for contingent consideration), (ii) the fair value of the former parent's retained noncontrolling equity interest in the former subsidiary (if any) and (iii) the carrying amount of the NCI in the former subsidiary (including any amounts in AOCI [see Note 2]), all measured as of the date control was lost and (b) the net carrying amount of the former subsidiary's assets and liabilities prior to deconsolidation (see Note 3).<br>• Account for any remaining investment in the former subsidiary using other applicable U.S. GAAP (e.g., equity method of accounting). |

**Note 1:** When the subsidiary is a business, the other U.S. GAAP that should be considered is: (a) a conveyance of oil and gas mineral rights within the scope of ASC 932-360 or (b) a transfer of a good or service to a customer within the scope of ASC 606. When the subsidiary is a not a business, the other U.S. GAAP that should be considered includes (but is not limited to) the following: (a) a transfer of a good or service to a customer within the scope of ASC 606, (b) a nonmonetary exchange within the scope of ASC 845, (c) a transfer of financial assets within the scope of ASC 860, (d) a conveyance of mineral rights within the scope of ASC 932 or (e) a transfer of nonfinancial assets or in substance nonfinancial assets within the scope of ASC 610-20.
**Note 2:** See ASC 810-10-40-4 if the subsidiary being deconsolidated is a foreign entity or if the deconsolidation is the complete or substantially complete liquidation of a foreign entity that includes the subsidiary.
**Note 3:** If the subsidiary being deconsolidated is a reporting unit or business, any goodwill associated with that reporting unit or business should be included in the net carrying amount of the subsidiary's assets and liabilities prior to deconsolidation [see ASC 350-20-40-1 and 40-2]).

**Example 16-2: Decrease in parent's ownership interest in existing subsidiary while maintaining control**

As of May 31, 20X1, Parent owns 80% of Subsidiary (8,000 shares of common stock out of 10,000 shares of common stock issued and outstanding) and includes Subsidiary in its consolidated financial statements. The carrying amount of Subsidiary's net assets is $50 million and the carrying amount of the 20% NCI in Subsidiary is $10 million. Subsidiary is a business. There are no amounts in AOCI related to the subsidiary.

*Scenario A*

Parent sells 1,500 shares in Subsidiary to third parties for $7.8 million. Parent retains control of Subsidiary after this sale with an ownership interest of 65% ([8,000 shares – 1,500 shares] ÷ 10,000 shares). Parent concludes selling the 1,500 shares in Subsidiary is not within the scope of ASC 932-360 or ASC 606. As such, the guidance in ASC 810-10-45 related to decreases in controlling ownership interests (without losing control) should be applied.

Because Parent retained its controlling ownership interest in Subsidiary, it continues to consolidate subsidiary and does not recognize a gain or loss on its sale of the 1,500 shares in Subsidiary. Instead, the carrying amount of the NCI should be adjusted to reflect the increase in the NCI's ownership interest from 20% to 35% (100% – 65% [Parent's ownership interest in Subsidiary after selling 1,500 shares]), and the difference between that adjustment and the cash received by Parent for selling the 1,500 shares should be recognized in equity. As such, the carrying amount of the NCI should be increased by $7.5 million, from $10 million to $17.5 million (35% of $50 million), and $300,000 should be recognized in equity ($7.8 million received by Parent upon selling the 1,500 shares – $7.5 million increase in the NCI's carrying amount).

The following is a summary journal entry representing the overall effects of Parent selling 15% of its interest in Subsidiary on its consolidated financial statements:

| | Debit | Credit |
|---|---|---|
| Cash | $7,800,000 | |
| Additional paid-in capital | | $300,000 |
| NCI | | 7,500,000 |

*Scenario B*

Subsidiary sells 2,300 shares of its unissued common stock to third parties for $12 million. Parent retains control of Subsidiary after this sale with an ownership interest of 65% (8,000 shares ÷ [10,000 shares + 2,300 shares]). Parent concludes the decrease in its ownership interest in Subsidiary is not within the scope of ASC 932-360 or ASC 606. As such, the guidance in ASC 810-10-45 related to decreases in controlling ownership interests (without losing control) should be applied.

Because Parent retained its controlling ownership interest in Subsidiary, it continues to consolidate subsidiary. The carrying amount of the NCI should be adjusted to reflect the increase in the NCI's ownership interest from 20% to 35% (100% – 65% [Parent's ownership interest in Subsidiary after Subsidiary sells 2,300 shares]), and the difference between that adjustment and the cash received by Subsidiary for selling the 2,300 shares should be recognized in equity.

Subsidiary selling 2,300 shares of its unissued common stock to third parties for $12 million increases Subsidiary's net assets from $50 million to $62 million. As such, the adjusted carrying amount of the NCI should be $21.7 million (35% of $62 million). The $300,000 difference between the $11.7 million adjustment to increase the carrying amount of the NCI ($21.7 million – $10 million) and the $12 million proceeds from Subsidiary selling the 2,300 shares should be recognized in equity.

The following is a summary journal entry representing the overall effects on Parent's consolidated financial statements of Subsidiary selling 2,300 shares of its common stock to third parties:

| | Debit | Credit |
|---|---|---|
| Cash | $12,000,000 | |
| Additional paid-in capital | | $300,000 |
| NCI | | 11,700,000 |

**Example 16-3: Parent loses control of subsidiary**

As of May 31, 20X1, Parent owns 80% of Subsidiary (8,000 shares of common stock out of 10,000 shares of common stock issued and outstanding) and includes Subsidiary in its consolidated financial statements. The carrying amount of Subsidiary's net assets is $49 million and the carrying amount of the 20% NCI in Subsidiary is $9.8 million. Subsidiary is a business and is not a foreign entity. There are no amounts in AOCI related to Subsidiary.

On June 1, 20X1, Parent sells 5,500 shares in Subsidiary to third parties for $29.2 million. Parent retains a 25% interest ([8,000 shares – 5,500 shares] ÷ 10,000 shares) in Subsidiary, which it will account for as an equity method investment. The fair value of the 25% interest retained by Parent is $11 million.

Parent concludes selling the 5,500 shares in Subsidiary is not within the scope of ASC 932-360 or ASC 606. Parent also concludes that its loss of control over Subsidiary is not a discontinued operation under ASC 205-20. Parent applies the guidance in ASC 810-10-40 to deconsolidate Subsidiary as of June 1, 20X1, which requires recognition of a gain calculated as follows:

| | |
|---|---|
| Proceeds from the transaction | $29,200,000 |
| Fair value of Parent's retained noncontrolling equity interest in Subsidiary | 11,000,000 |
| Carrying amount of NCI in Subsidiary prior to Parent losing control | 9,800,000 |
| | $50,000,000 |
| Carrying amount of Subsidiary's net assets prior to Parent losing control | 49,000,000 |
| Gain on deconsolidation | $1,000,000 |

The following is a summary journal entry representing the overall effects of the deconsolidation on Parent's financial statements:

| | Debit | Credit |
|---|---|---|
| Cash | $29,200,000 | |
| Investment in Subsidiary | 11,000,000 | |
| NCI | 9,800,000 | |
| Gain on deconsolidation | | $1,000,000 |
| Net assets of Subsidiary | | 49,000,000 |

# 17. Private-company intangible asset alternative

## 17.1 General

This chapter addresses the guidance that is applicable if an entity elects the intangible asset alternative available for private companies and not-for-profit entities, which provides alternative guidance with respect to the recognition of intangible assets related to customers and NCAs acquired in a business combination. If an entity does not elect the intangible asset alternative, it would follow the guidance generally applicable to the recognition of intangible assets in a business combination when determining whether to recognize intangible assets related to customers and NCAs, which is discussed in detail in Section 10.6, Section 10.8 and Section 10.9. Even if an entity elects the intangible asset alternative, it must still apply the guidance generally applicable to the recognition of intangible assets in a business combination when determining whether to recognize intangible assets *other than those* related to customers and NCAs. In addition, the guidance on valuing and amortizing CRI assets in Section 10.6.4 and Section 10.6.5.2, respectively, is relevant to the extent application of the intangible asset alternative still results in the recognition of a CRI asset.

ASU 2014-18 introduced the intangible asset alternative to simplify the recognition of certain identifiable intangible assets by an entity in its accounting for a business combination. Under the intangible asset alternative, a private company or not-for-profit entity may choose to elect an accounting policy under which it does not separately recognize the following intangible assets in the accounting for a business combination: (a) intangible assets that would otherwise arise from NCAs or (b) CRI assets that cannot be separately sold or licensed. If the intangible asset alternative is elected, the value of these intangible assets is effectively subsumed into goodwill. An entity may elect the intangible asset alternative only if it also elects (or has already elected) the private-company goodwill amortization alternative (which is discussed in Section 18.3).

## 17.2 Scope

Private companies and not-for-profit entities that may elect the intangible asset alternative include entities other than the following: (a) those that meet the definition of a PBE as defined in the Master Glossary of the Codification or (b) employee benefit plans that fall within the scope of ASC 960, ASC 962 and ASC 965.

Transactions other than business combinations to which the intangible asset alternative also applies are: (a) the equity method of accounting for an investment when there is a difference between its carrying amount and the entity investor's share of the investee's underlying equity in net assets and (b) the application of fresh-start reporting in a reorganization.

If elected, the intangible asset alternative applies to *all* business combinations and other in-scope transactions entered into after the date of adoption. In other words, the intangible asset alternative cannot be elected on a business combination by business combination basis.

While an entity must elect the private-company goodwill amortization alternative if it elects the private-company intangible asset alternative, it does not have to elect the intangible asset alternative if it elects the goodwill amortization alternative.

## 17.3 CRI assets

When an entity elects the intangible asset alternative, it does not separately recognize in the accounting for a business combination any acquired CRI assets that cannot be separately sold or licensed from the business. It is expected that many CRI assets will not meet this recognition threshold. However, examples of CRI assets that *may* be capable of being sold or licensed separate from other assets of the business are: (a) core deposit intangibles (which arise from the relationships a financial institution has with its depositors), (b) mortgage servicing rights, (c) commodity supply contracts and (d) customer information (e.g., customer lists). CRI assets that will typically not meet this threshold are those that arise from expected future contracts with existing customers (e.g., customer relationships). While many CRI assets will not meet the intangible asset alternative's recognition threshold, an entity must still analyze each of its CRI assets (e.g., customer backlog, customer list) to determine whether they can be separately sold or licensed. In other words, an entity should not just assume its CRI assets are incapable of being separately sold or licensed. Among the factors that should be taken into consideration in analyzing whether the intangible asset alternative's recognition threshold is met is whether sale of the CRI asset requires input or approval from the customer. If so, it would not meet the recognition threshold. In addition, while a CRI asset that arises from an above-market (i.e., favorable) customer contract (e.g., the customer is obligated to pay an above-market price for a good) is not recognized under the intangible asset alternative unless that contract could be separately sold or licensed, a liability continues to be recognized for a below-market (i.e., unfavorable) customer contract regardless of whether the customer contract could be separately sold or licensed. As a result, an entity must still analyze each of its acquired customer contracts to determine whether it is below market.

For purposes of the intangible asset alternative, CRI assets do not include: (a) leases or (b) contract assets as that term is used in ASC 606 (see Section 10.6.2). As a result, intangible assets related to leases (see Section 10.13) and contract assets should be separately recognized (as otherwise required) and should not be subsumed into goodwill.

### *17Q.3.1 What is the difference between the recognition criterion for CRI assets under the intangible asset alternative and the general recognition criteria for CRI assets in ASC 805?*

When an entity elects the alternative, it only recognizes CRI assets that are capable of being sold or licensed separate from the other assets of the business. When an entity does not elect the alternative, it must apply the general recognition criteria for identifiable intangible assets in ASC 805 (see Section 10.6, Section 10.8 and Section 10.9). Those criteria, only one of which must be met, are focused on the following: (a) the separability of the asset and (b) the contractual-legal nature of the asset.

One significant difference between the alternative's and ASC 805's recognition criteria is that the alternative's recognition criterion does not consider whether the CRI asset is contractual or legal in nature. Whether a CRI asset is contractual or legal in nature is not a determining factor in considering whether it should be recognized when an entity elects the alternative. As a result, it is possible that some (perhaps even many) CRI assets that meet the contractual-legal criterion will be subsumed into goodwill under the alternative because they cannot be sold or licensed separate from other assets of the business. Additional discussion about contractual-legal CRI assets is provided in the next two questions.

Another significant difference between the alternative's and ASC 805's recognition criteria is that the separability criterion under ASC 805 requires an intangible asset to be capable of being sold or licensed *either* on its own or combined with a related contract, identifiable asset or liability. In contrast, the recognition criterion under the alternative requires an intangible asset to be capable of being sold or licensed on its own *without any other assets of the business*. There is no allowance under the alternative (as there is under ASC 805's separability criterion) to consider whether the intangible asset can be sold with a related contract, identifiable asset or liability. As a result, a CRI asset may meet ASC 805's separability criterion, but not meet the alternative's recognition criterion.

### *17Q.3.2 Why did the FASB exclude contract assets from the scope of the intangible asset alternative (indicating that such assets should continue to be recognized as otherwise appropriate)?*

The contract assets excluded from the scope of the alternative are those that meet the following definition included in the Master Glossary of the Codification: "An entity's right to consideration in exchange for goods or services that the entity has transferred to a customer when that right is conditioned on something other than the passage of time (for example, the entity's future performance)." Contract asset, as used in the capacity of ASC 606, has a meaning that is very different from the meaning of a contractual-legal CRI asset (see the previous question). One key attribute of a contract asset is that it relates to goods or services already transferred to the customer. Another key attribute of a contract asset is that it is expected to eventually convert into accounts receivable once the entity has an unconditional right to consideration for its performance. Both of these attributes do not exist in most contractual-legal CRI assets. While use of similar terminology (contract asset vs. contractual-legal CRI asset) has justifiably caused some confusion, it is clear that contractual-legal CRI assets are subject to the scope of the alternative and should be evaluated to determine whether they can be sold or licensed separate from other assets of the business. Only if that is the case should those assets be recognized. Otherwise, they should be subsumed into goodwill.

### *17Q.3.3 Should contractual-legal CRI assets (e.g., backlog, above-market customer contracts) continue to be recognized if an entity elects the intangible asset alternative?*

Whether contractual-legal CRI assets should be recognized when an entity elects the alternative depends on whether they can be sold or licensed separate from other assets of the business. The fact that there is an underlying contract does not automatically mean that an intangible asset should be recognized under the alternative. In other words, whether there is a contract underlying the CRI asset is not a determining factor in considering whether an intangible asset should be recognized under the alternative.

### *17Q.3.4 What does it mean to say that a CRI asset can be sold or licensed separate from other assets of the business?*

When assessing whether a CRI asset can be sold or licensed separate from other assets of the business, an entity should first evaluate whether the CRI asset can be *sold or licensed*, and if it can, then evaluate whether it can be sold or licensed *separate from other assets of the business*.

When considering whether a CRI asset can be *sold or licensed*, the entity should evaluate whether there are any restrictions on selling the CRI asset. For example, the entity should consider whether it is precluded from selling a customer contract or customer information. Consider a situation in which a customer contract explicitly indicates that the entity cannot sell the contract or that it cannot sell the contract without obtaining the customer's approval. In either of those situations, the CRI asset is not capable of being sold or licensed. As a result, a CRI asset should not be recognized for the customer contract under the intangible asset alternative. Consider another situation in which an entity informs its customers when they sign up on the entity's website that their information may be sold to third parties, but gives them the ability to opt out of their information being sold. In this situation, only the customer information for those customers who did not opt out should be considered capable of being sold or licensed by the entity.

When considering whether a CRI asset can be sold or licensed *separate from other assets of the business*, the entity should evaluate whether the CRI asset is dependent on other assets of the business. In other words, the entity needs to determine whether another party would be able to use or benefit from the CRI asset without other assets of the business. Consider two situations in which an entity acquires order backlog in a business combination. In the first situation, the entity acquires order backlog for the custom manufacture of industrial equipment. If the entity concludes that another party would not be able to fulfill that order backlog without the use of patented intellectual property or specialized processes or knowledge not available in the marketplace, then the entity would conclude that the CRI asset for the order backlog cannot be sold or licensed *separate from other assets of the business*. As a result, the order backlog would not be recognized separately (i.e., it would be subsumed into goodwill). In the second situation, the entity acquires order backlog for generic dry-cleaning services. If the entity concludes that another party would be able to fulfill that order backlog because it has the capabilities to do so with its own dry cleaning equipment or because others in the marketplace have the capabilities to do so, then the entity would conclude that the CRI asset for the order backlog can be sold or licensed *separate from other assets of the business*. As a result, the order backlog would be recognized as a separate intangible asset (assuming there are no restrictions on selling or licensing the backlog).

One type of evidence that may exist to corroborate that a CRI asset can be sold or licensed separate from other assets of the business is an exchange transaction in which the same or similar CRI asset was sold on its own.

*17Q.3.5 What are examples of CRI assets that can be sold or licensed separate from other assets of the business?*

ASC 805-20-25-31 lists CRI assets that *may* be capable of being sold or licensed separate from other assets of the business. Included on this list are mortgage servicing rights, commodity supply contracts, core deposit intangibles (which arise from the relationships a financial institution has with its depositors) and customer information. Whether these CRI assets are capable of being sold or licensed separate from other assets of the business depends on the facts and circumstances. An entity should not assume that these assets meet the criterion for separate recognition. Each CRI asset needs to be analyzed to determine whether it can be sold or licensed separate from other assets of the business (see the previous question).

*17Q.3.6 How are the recognition of intangible assets for customer relationships and customer information (e.g., customer lists) interrelated?*

In practice, the application of the general recognition criteria for CRI assets in ASC 805 has not typically resulted in the recognition of a separate customer list intangible asset when related customer relationship intangible assets are recognized. Given that many customer relationship intangible assets will be subsumed into goodwill under the alternative, if an entity elects the alternative, it will be necessary to determine whether a separate customer list intangible asset should be recognized. If a customer list can be sold or licensed separate from other assets of the business, and it is determined to be material, it must be recognized under the alternative. In this situation, the fair value of the customer list should not be subsumed into goodwill with the related customer relationship intangible assets.

*17Q.3.7 Should a customer relationship intangible asset be recognized under the intangible asset alternative when the target has a history of entering into contracts with a customer (even though no contracts with the customer exist at the acquisition date)?*

Under the general recognition criteria for CRI assets in ASC 805 (see Section 10.6), if the target has a history of entering into contracts with a customer, but has no contracts with the customer at the acquisition date, a customer relationship intangible asset exists because the target has a history of entering into contracts with the customer (which satisfies the contractual-legal criterion) (see Section 10.6.2). Whether a customer relationship intangible asset should be recognized under the alternative in this situation depends on whether the customer relationship can be sold or licensed separate from other assets of the business. Given that there is no underlying contract for this customer relationship at the acquisition date, it is unlikely that there is a customer relationship that could be sold or licensed. However, an analysis still needs to be performed to reach that conclusion in a specific set of facts and circumstances. While a customer relationship intangible asset likely does not exist in this situation, a customer information intangible asset may exist. Additional discussion on customer information intangible assets is provided in the three preceding questions.

*17Q.3.8 Does an entity still have to recognize a liability for a below-market (i.e., unfavorable) customer contract if it elects the intangible asset alternative?*

Yes. The alternative only applies to CRI assets, not customer-related liabilities. As such, an entity that elects the alternative must analyze all its customer contracts to determine whether they are in an above-market or below-market position. Those that are in a below-market position must be recognized as liabilities. Those that are in an above-market position must be analyzed to determine whether they can be sold or licensed separate from other assets of the business. An entity cannot net customer-related liabilities against CRI assets subsumed into goodwill.

*17Q.3.9 Given that paragraph BC17 of ASU 2014-18 indicates that "customer-related intangible assets often will not meet the criterion for recognition," is it appropriate to forgo the analysis of customer contracts and the identification of CRI assets when accounting for a business combination? In other words, is it acceptable to assume that an entity has not acquired any CRI assets that should be recognized when it has elected the intangible asset alternative?*

No. If an entity elects the alternative, it must still analyze its customer contracts to determine which are in an above-market position (and subject to the alternative) and which are in a below-market position resulting in recognition of a liability (see the previous question). Once the entity has identified its above-market customer contracts and all other CRI assets it acquired, it must evaluate whether each of those assets can be sold or licensed separate from other assets of the business. While the statement made in paragraph BC17 of ASU 2014-18 about the frequency with which intangible assets will meet the alternative's recognition criterion may be true in a general sense, it is not appropriate for an entity to assume that generality applies in its situation and ignore the specific facts and circumstances surrounding the particular CRI assets it acquired in a business combination.

*17Q.3.10 Given that paragraph BC21 of ASU 2014-18 indicates that "it is inappropriate to classify a contract asset as a customer-related intangible asset at the acquisition date when the contract asset will eventually be reclassified as a receivable," should a backlog intangible asset not be classified as a CRI asset (which would make it ineligible to be subsumed into goodwill under the intangible asset alternative) because it will eventually lead to a receivable?*

No. A contract asset arises as a result of the entity transferring goods or services to the customer for which it does not have the unconditional right to receive payment. With respect to a backlog intangible asset, the entity has not yet transferred the related goods or services to the customer. As a result, an order backlog intangible asset is a CRI asset and not a contract asset. As a CRI asset, an entity that has elected the alternative must evaluate a backlog intangible asset to determine whether it can be sold or licensed separate from other assets of the business.

*17Q.3.11 How should an entity evaluate noncontractual customer relationships for recognition under the intangible asset alternative?*

As with any CRI asset, the entity should determine whether the noncontractual customer relationships can be sold or licensed separate from other assets of the business. In general, noncontractual customer relationships typically cannot be sold or licensed separate from other assets of the business because they represent expected future sales from customers (e.g., future sales from a walk-up customer base).

*17Q.3.12 Can a lessor apply the intangible asset alternative to its leases?*

No. The alternative specifically excludes leases from its scope. As a result, CRI assets related to leases should be recognized as otherwise required by ASC 805 and should not be subsumed into goodwill.

*17Q.3.13 How does the intangible asset alternative affect the recognition of a bargain purchase gain?*

Consider a situation in which an entity acquires 100% of a target for $100 million. Assume that the net assets acquired consist of the following:

- Tangible assets whose fair values total $120 million
- CRI assets whose fair values total $20 million
- Liabilities whose fair values total $30 million

Further assume that the CRI assets cannot be sold or licensed separate from other assets of the business. If the entity has *not* elected the alternative, the identifiable net assets acquired would be measured at $110 million. If the entity has elected the alternative, the identifiable net assets acquired would be measured at $90 million (as the CRI assets of $20 million would not be separately recognized).

Based on this discussion and the discussion in Section 12.1 and Section 12.2, the effects of electing and not electing the alternative in this situation are summarized in the following table:

| | Alternative is elected | Alternative is *not* elected |
|---|---|---|
| Consideration transferred | $100,000,000 | $100,000,000 |
| Identifiable net assets acquired | 90,000,000 | 110,000,000 |
| Goodwill (bargain purchase gain) | $10,000,000 | ($10,000,000) |

In this situation, election of the alternative results in goodwill when a bargain purchase gain would have otherwise resulted. This outcome is an appropriate reflection of how the alternative should be applied and its effects on the recognition of a bargain purchase gain.

*17Q.3.14 Does an entity's election of the intangible asset alternative mean it no longer has to perform valuations (or have valuations performed) for purposes of accounting for a business combination?*

No. Clearly, an entity that elects the alternative and does not have any CRI assets that meet the recognition criterion should not value and separately recognize those CRI assets in the accounting for the business combination. However, the entity must consider what other assets and liabilities it acquired that should be recognized at fair value in the accounting for the business combination (e.g., other intangible assets, inventory, property, plant and equipment). Section 10.9 lists and discusses several types of intangible assets that may need to be recognized (and, as a result, valued) in connection with a business combination. To the extent the entity acquires any other assets or liabilities that must be recognized at fair value, it will have to perform valuations for those assets or liabilities or hire a valuation specialist to perform those valuations. For example, if the entity acquires a trademark and a patent, it will need to estimate their fair values for purposes of recognizing them in the accounting for the business combination regardless of whether it has elected the alternative.

*17Q.3.15 When valuing other assets acquired in the business combination, will it be necessary to estimate the fair value of CRI assets that are being subsumed into goodwill under the intangible asset alternative?*

Depending on the nature of the CRI assets being subsumed into goodwill and the nature of the other assets being valued, as well as the valuation methods being used to measure these assets, it may be necessary to perform a valuation of the CRI assets that are being subsumed into goodwill.

For example, contributory asset charges (CACs) are often used in the multi-period excess earnings method (MPEEM), which is an income approach valuation method that may be used to estimate the fair value of certain assets. A common CAC used in the MPEEM relates to an entity's assembled workforce. Under ASC 805, an entity does not recognize an intangible asset for an assembled workforce (see Section 10.11). However, if the MPEEM is used to value an acquired asset such as intellectual property or a license, the value of the assembled workforce acquired is typically estimated for purposes of applying a CAC in the MPEEM because the assembled workforce is a contributory asset to the cash flows of the intellectual property or license. In a similar sense, a CRI asset being subsumed into goodwill under the alternative may need to be valued and treated as a CAC in the MPEEM. This may be necessary when dealing with the valuation of technology or a brand acquired in a business combination, but may not be necessary in a business combination in which minimal intangible assets were acquired. If a CAC for CRI assets subsumed into goodwill under the alternative were inappropriately excluded from the MPEEM, this may result in overvaluing the intangible asset whose fair value is being estimated.

For another example, when an entity acquires technology assets and uses the relief from royalty method to value those assets, it may be necessary to value the CRI assets subsumed into goodwill to help determine if the royalty rates and values for the technology assets can be supported by the profit margin of the target and the returns generated by the other tangible and intangible assets.

### 17.4 Assets arising from NCAs

With respect to NCAs, the intangible asset alternative does not provide guidance on when an NCA should be accounted for as part of the business combination or separate from the business combination. While this question has arisen historically and there is some diversity on how it has been treated in practice, the accounting implications were often not significant because the preexisting guidance typically resulted in the recognition of an intangible asset both when an NCA was accounted for as part of the business combination, as well as when an NCA was accounted for separate from the business combination. However, under the intangible asset alternative, treating an NCA as part of the business combination does not result in the recognition of a separate intangible asset (i.e., its value is subsumed into goodwill). We believe an intangible asset alternative under which an entity can elect to not separately recognize the intangible assets that would otherwise arise from NCAs with selling shareholders is an indication that those NCAs should be considered part of the business combination for accounting purposes when an entity elects the intangible asset alternative. In other words, if an entity elects the intangible asset alternative, it *should not* conclude that NCAs with selling shareholders should be accounted for separate from the business combination.

Additional information related to determining what is and is not part of the business combination for accounting purposes is provided in Chapter 13.

### 17.5 Disclosures

An entity's policy related to its accounting for CRI assets and NCAs acquired in a business combination should be disclosed in accordance with ASC 235-10-50. In addition, if an entity elects the intangible asset alternative, it should provide the disclosures related to a change in accounting principle as appropriate under ASC 250-10-50.

There are no incremental disclosure requirements associated with the intangible asset alternative. However, an entity that elects the intangible asset alternative should be mindful of the preexisting requirement discussed in Section 14.2.3 to *qualitatively* describe the factors that make up goodwill, which includes intangible assets that are not separately recognized. An entity does not need to estimate the fair value of NCA intangible assets and CRI assets subsumed into goodwill for this purpose.

Additional information about the required disclosures for intangible assets acquired in a business combination is provided in Section 14.2.5.

### 17.6 Effective date and transition

An entity is permitted to make a first-time election to apply the intangible asset alternative at any time without having to perform a preferability assessment (as otherwise required by ASC 250).

The intangible asset alternative should be applied prospectively, starting with the first business combination or other transaction within its scope (see Section 17.2) that occurs after it is first elected. Any previously recognized NCA intangible assets or CRI assets should continue to be recognized and measured in accordance with preexisting guidance. In other words, these preexisting intangible assets should not be subsumed into goodwill upon election of the intangible asset alternative.

### 17.7 Considerations related to the election of the intangible asset alternative

An entity may elect the intangible asset alternative only if it also elects (or has already elected) the private-company goodwill amortization alternative (which is discussed in Section 18.3). If an entity has not already elected the goodwill amortization alternative when it elects the intangible asset alternative, the goodwill amortization alternative would be applied on a prospective basis in the period the intangible asset alternative is elected.

Before electing the private-company intangible asset and goodwill amortization alternatives, an entity should carefully consider whether doing so makes sense in its facts and circumstances. For example, many of the anticipated benefits resulting from election of these alternatives could be negated or offset if there is a reasonable possibility that the entity will go public or be acquired by a PBE in the future. If an entity goes public or is acquired by a PBE after it has elected the intangible asset and goodwill amortization alternatives, the entity would have to discontinue those elections and retrospectively apply U.S. GAAP applicable to PBEs. In other words, the entity would have to retrospectively undo the accounting under *both* alternatives. The ramifications of doing so involve the performance of prior-year impairment tests using the goodwill impairment model applicable to PBEs, reversing goodwill amortization and valuing, recognizing and amortizing intangible assets for NCAs and CRI assets previously subsumed into goodwill. Given that many of the anticipated benefits of electing the intangible asset and goodwill amortization alternatives could be negated or offset by the ramifications of later discontinuing the use of those alternatives, an entity should carefully consider whether electing the alternatives makes sense in its facts and circumstances.

An entity should discuss the effects of electing the intangible asset and goodwill amortization alternatives with the users of its financial statements to understand whether the entity's election of the alternatives is acceptable to those users. The users who should be considered in this regard include investors, lenders and regulators, among others. Thoughtful consideration also should be given to upcoming or potential changes in the users of its financial statements and the willingness of any potential new users of the financial statements to accept financial statements in which the intangible asset and goodwill amortization alternatives have been applied.

# 18. Private-company goodwill alternatives

## 18.1 General

This chapter addresses the guidance that is applicable if an entity elects one or both of the following accounting alternatives available for private companies and not-for-profit entities, which simplify the subsequent accounting for goodwill:

- Goodwill amortization alternative, which was initially introduced to private companies by ASU 2014-02
- Goodwill impairment triggering event alternative, which was introduced to both private companies and not-for-profit entities by ASU 2021-03

The primary differences in an entity's accounting for goodwill if it elects one or both of the goodwill alternatives as its accounting policy are summarized in the following table:

| | Alternative is elected | Alternative is not elected |
|---|---|---|
| **Goodwill amortization alternative** | | |
| Amortization of goodwill | Yes, over a period not to exceed 10 years (see Section 18.3.1) | No |
| Level at which impairment testing is performed | Choice of entity level or reporting unit level (see Section 18.3.2) | Reporting unit level |
| Frequency of impairment testing | When there is a triggering event (see Section 18.3.3 and 18.4) | Annually on the same date, or sooner if there is a triggering event |
| Testing and measuring goodwill for impairment | When the carrying amount of the entity (or reporting unit) is greater than its fair value, recognize an impairment loss for the excess, not to exceed the carrying amount of goodwill (see Section 18.3.4) | *Prior to the adoption of ASU 2017-04 (see Section 18.1.1)*: When the carrying amount of the reporting unit (unless zero or negative) is greater than its fair value (Step 1) and the carrying amount of goodwill is greater than its implied fair value (Step 2), recognize an impairment loss for the excess<br><br>*After the adoption of ASU 2017-04*: When the carrying amount of the reporting unit is greater than its fair value, recognize an impairment loss for the excess, not to exceed the carrying amount of goodwill |
| **Goodwill impairment triggering event alternative** | | |
| Triggering event impairment analysis (and any resulting impairment test) | Performed as of the end of each reporting period, whether an interim or annual reporting period (with any resulting impairment test performed as of the end of the reporting period) (see Section 18.4) | Performed throughout the reporting period (with any resulting impairment test performed as of the date the triggering event occurred) |

If the goodwill amortization alternative is elected, all aspects of it must be elected. In other words, an entity cannot elect to apply the impairment guidance and not elect to apply the amortization guidance.

There is another accounting alternative for private companies and not-for-profit entities related to the identifiable intangible assets recognized in the accounting for a business combination (see Chapter 17). While an entity may elect the goodwill amortization alternative without electing the intangible asset alternative, it cannot elect the intangible asset alternative without electing the goodwill amortization alternative.

### 18.1.1 Goodwill amortization alternative (ASU 2017-04)

ASU 2017-04 simplified the testing of goodwill for impairment for PBEs and other entities that have not elected the goodwill amortization alternative. The two primary simplifications provided were:

- Eliminating Step 2 from the goodwill impairment model and calculating any impairment charge based on the excess of the carrying amount of the reporting unit over its fair value (net of any related tax effect), not to exceed the carrying amount of the reporting unit's goodwill
- Recognizing no goodwill impairment charge when the reporting unit has a zero or negative carrying amount

These simplifications are effective for PBEs that are SEC filers, except for entities eligible to be SRCs (as defined by the SEC) in annual and any interim impairment tests performed for periods beginning after December 15, 2019. For all other entities that have not elected the goodwill amortization alternative, these simplifications are effective in annual and any interim impairment tests performed for periods beginning after December 15, 2022. Early adoption is permitted for all entities. For additional information about the changes made by ASU 2017-04, see our white paper, Simplifying the test for goodwill impairment.

An entity that has elected the goodwill amortization alternative is permitted (but not required) to change to the goodwill guidance in U.S. GAAP applicable to PBEs and other entities that have not elected the goodwill amortization alternative (as amended by ASU 2017-04). However, the manner in which it does so depends on whether it has previously elected only the goodwill amortization alternative or both the goodwill and intangible asset alternatives. When the entity only previously elected the goodwill amortization alternative, it does not have to justify the preferability of changing to the goodwill guidance in U.S. GAAP applicable to PBEs and other entities that have not elected the goodwill amortization alternative, provided it makes the change on or before the effective date of ASU 2017-04. When the entity previously elected the goodwill and intangible asset alternatives, it must follow the guidance in ASC 250 when changing to the goodwill guidance in U.S. GAAP applicable to PBEs and other entities that have not elected the goodwill amortization alternative, which includes justifying why the change is preferable and retrospective application of the change.

## 18.2 Scope of goodwill alternatives

Private companies and not-for-profit entities that may elect the goodwill alternatives include entities other than (a) those that meet the definition of a PBE as defined in the Master Glossary of the Codification or (b) employee benefit plans that fall within the scope of ASC 960, 962 and 965.

If elected, both goodwill alternatives apply to all new and existing goodwill. In other words, the goodwill alternatives cannot be elected for the goodwill related to some acquisitions, but not the goodwill related to other acquisitions. Both goodwill alternatives also apply to the excess reorganization value that may arise in applying fresh-start reporting as described in ASC 852. In addition, the amortization component of the goodwill amortization alternative applies to equity method goodwill, which is a component of an investor's equity method investment (i.e., it is not recorded separately from the equity method investment). As a result, when the goodwill amortization alternative is elected, an investor includes amortization of equity method goodwill in the equity method income or loss it recognizes. However, equity method goodwill is not tested for impairment separately from the overall equity method investment. In other words, the goodwill amortization alternative, the goodwill impairment triggering event alternative and the goodwill guidance in U.S. GAAP applicable to PBEs and other entities that have not elected the goodwill alternatives are not used to test equity method goodwill for impairment.

## 18.3 Goodwill amortization alternative

### 18.3.1 Amortization

The unit of account for goodwill amortization (or the amortization of excess reorganization value) is the goodwill related to each acquisition (or the excess reorganization value related to each reorganization event).

If the goodwill amortization alternative is elected, goodwill related to each acquisition is amortized on a straight-line basis over a period not to exceed 10 years. An entity may default to a 10-year amortization period (without justification) or choose to identify and use a shorter useful life if it can demonstrate that the shorter life is more appropriate for the particular acquisition. For example, if an entity acquires a target primarily to gain control of the target's proprietary intellectual property, and the underlying patent for that intellectual property expires in seven years, it may be appropriate to use a useful life of seven years to amortize any related goodwill. It would rarely, if ever, be possible to demonstrate that a useful life of zero is appropriate.

If the facts and circumstances related to the useful life of an entity's goodwill warrant a revision to that life, the entity may choose to (but does not have to) change the goodwill's useful life. When an entity chooses to change the useful life of goodwill, it should ensure that the change will not result in a cumulative useful life for that goodwill in excess of 10 years. The effects of a change to the useful life of goodwill are accounted for prospectively.

### 18.3.2. Unit of account for impairment testing

If the goodwill amortization alternative is elected, an entity must make an accounting policy election to test goodwill for impairment at the entity level or the reporting unit level. The definition of a reporting unit and the related guidance in the Codification has resulted in numerous practice issues for entities over time. Some of these practice issues arise because the definition of a reporting unit has its origins in ASC 280, which is only directly applicable to public entities. Electing to perform goodwill impairment testing at the entity level under the goodwill amortization alternative will save an entity from having to deal with these practice issues and the related costs. Additional information about assigning goodwill to reporting units is provided in Section 12.8.

### 18.3.3. Frequency of impairment testing

If the goodwill amortization alternative is elected, goodwill should only be tested for impairment when a *triggering event* occurs (unless the goodwill impairment triggering event alternative has been elected [see Section 18.4]). A triggering event is when events occur or circumstances change indicating that the fair value of the entity (or reporting unit) may be below its carrying amount (which includes goodwill). The occurrence of a triggering event draws into question whether the fair value of the entity (or reporting unit) may be below its carrying amount. ASC 350-20-35-3C provides many (but not all of the potential) examples of triggering events, including a deterioration in general economic conditions, an increased competitive environment, increases in the costs of raw materials or labor, negative or declining cash flows and changes in key personnel. This list is not all-inclusive, and an entity should consider other relevant events and circumstances that might affect the fair value or carrying amount of the entity (or reporting unit). Positive and mitigating events and circumstances also should be considered.

Identifying and evaluating a triggering event is a subjective practice requiring professional judgment and diligent documentation, and each entity should ensure it has the necessary processes and controls in place. A determination should be made at the end of each reporting period as to whether any triggering events occurred during the reporting period. If one or more triggering events occurred, then the entity should test its goodwill for impairment.

### 18.3.4 Impairment testing and recognition

If the goodwill amortization alternative is elected and one or more triggering events occur, an entity must test its goodwill for impairment. As part of that testing, an entity must first decide whether it will perform a qualitative assessment of whether its goodwill is impaired. If elected, the qualitative assessment requires the entity to answer the following question after considering all the relevant information available: Is it more likely than not that the fair value of the entity (or reporting unit) is less than the carrying amount of the entity (or reporting unit)? Each time a triggering event occurs, the entity can choose to perform or not perform the qualitative assessment. In other words, the entity's decision to perform or not perform the qualitative assessment when a triggering event occurs does not predetermine what it will have to do the next time a triggering event occurs.

Spending the time and effort to perform a qualitative assessment is likely not justified from a cost-benefit perspective under the goodwill amortization alternative, given that the performance of the goodwill impairment assessment was prompted by the entity concluding that the fair value of the entity (or reporting unit) may be below its carrying amount because a triggering event occurred. In other words, we believe it would be very unlikely that an entity would be able to conclude that it is not more likely than not that the fair value of the entity (or reporting unit) is less than its carrying amount (i.e., passing the qualitative assessment) after having just concluded that the fair value of the entity (or reporting unit) may be below its carrying amount (which was the outcome of the triggering event analysis that led to the goodwill impairment testing in the first place).

In the unlikely event that an entity opts to perform the qualitative assessment under the goodwill amortization alternative and passes, the entity is finished with its impairment testing and no impairment is recognized. Otherwise, the entity must proceed to a quantitative assessment, which is also performed if the entity chooses not to perform the qualitative assessment. The quantitative assessment compares the fair value of the entity (or reporting unit) to its carrying amount (which includes goodwill). If the fair value of the entity (or reporting unit) is more than its carrying amount, no impairment is recognized. If the fair value of the entity (or reporting unit) is less than its carrying amount, then an impairment loss is recognized for the excess of the carrying amount over fair value. However, the amount of the impairment loss cannot be more than the carrying amount of the goodwill. Section 18.3.4.1 discusses the consideration of deferred taxes under the goodwill amortization alternative.

Under the goodwill amortization alternative, if a goodwill impairment loss is recognized and the entity has goodwill from more than one acquisition recorded, the impairment loss should be allocated among the goodwill related to each acquisition using a reasonable and rational method. One such method allocates the impairment loss based on the carrying amount of each acquisition's goodwill relative to the entity's (or reporting unit's) total goodwill. Another method might take into consideration whether the impairment loss could be attributed to a particular acquisition.

Recognition of a goodwill impairment loss establishes a new basis for the goodwill. It is not appropriate to reverse the impairment loss under any circumstances. The new basis in goodwill is amortized over its remaining useful life (see Section 18.3.1). Consider a situation in which an entity amortizing goodwill over 10 years recognizes a goodwill impairment loss four years after the related acquisition. Once the impairment loss is recognized, the entity may choose to amortize the new basis in goodwill prospectively by: (a) using the remaining life of six years or (b) revising the useful life to something less than six years if more appropriate. Limiting a revised useful life to something less than six years ensures that the cumulative useful life for the goodwill does not exceed 10 years.

#### 18.3.4.1 Deferred taxes

Under the goodwill amortization alternative, deferred income taxes should be included in the carrying amount of the entity (or reporting unit) for those entities subject to the provisions of ASC 740. The inclusion of deferred income taxes in the carrying amount is *not* dependent on whether the fair value of the entity (or reporting unit) is measured assuming a taxable or nontaxable transaction.

ASU 2017-04 clarified that when an entity measures a goodwill impairment loss, it should consider how the deferred tax effects of that impairment affect the amount of impairment loss that should be recognized (as applicable) (see Section 18.1.1 for discussion of the effective date for ASU 2017-04). As discussed in Section 11.4.5, a deferred tax liability is not recognized when tax-deductible goodwill is less than goodwill for book purposes, but a deferred tax asset is recognized when tax-deductible goodwill is more than goodwill for book purposes. Determining the amount of the deferred tax asset to be recognized in this situation is not as simple as taking the difference in the tax and book bases of goodwill and multiplying it by the appropriate tax rate because goodwill is a residual.

Consider a situation in which an entity that has elected the goodwill amortization alternative (and to test goodwill at the entity level) experiences a triggering event that requires it to test its goodwill for impairment. The carrying amount of the entity prior to measuring any goodwill impairment loss is $2,000 and its fair value is $1,800. Included in the entity's carrying amount is $800 of goodwill (all of which is tax deductible) and a $400 deferred tax asset related to the excess of the tax-deductible goodwill over the goodwill for book purposes. Under the goodwill amortization alternative, the entity preliminarily determines that an impairment loss of $200 should be recognized. The tax effects of that impairment loss (assuming a 30% tax rate) would increase the deferred tax asset by $60 ($200 additional basis difference × 30%) because recognition of the impairment for book purposes, but not for tax purposes, increases the amount by which tax-deductible goodwill exceeds goodwill for book purposes. Reducing goodwill by $200 and increasing deferred tax assets by $60 would result in an adjusted carrying amount for the entity of $1,860 ($2,000 – $200 + $60), which is still above the entity's fair value of $1,800, indicating a larger impairment loss should be recognized. A simultaneous equation, such as the following one in ASC 805-740-55-10, may be used to calculate the additional deferred tax asset that should be recognized due to the impairment loss, and ultimately, the amount of loss that should be recognized for book purposes:

$$\left(Tax\ Rate \div (1 - Tax\ Rate)\right) \times Preliminary\ Temporary\ Difference = Deferred\ Tax\ Asset$$

Using this equation, the additional deferred tax asset that should be recognized related to the impairment loss is $86 ([30% ÷ (1 – 30%)] × $200), which results in a final impairment loss to be recognized of $286 ($200 + $86). To prove out the accuracy of these amounts, the tax effects of the increase in the amount by which the tax-deductible goodwill exceeds the adjusted amount of goodwill ($286 × 30% = $86) should be the same as the additional deferred tax asset recognized as a result of the impairment calculated using the simultaneous equation ($86).

### 18.3.5 Sequencing of impairment testing

Before evaluating goodwill at the entity level (or reporting unit level) for impairment under ASC 350, an entity should first consider the other assets included in the entity (or that reporting unit) and whether there are impairments that may need to be recognized. In general, the following steps should be followed:

- Step 1 – Evaluate assets outside the scope of ASC 360-10 to determine whether the carrying amounts need to be adjusted. Such assets include, but are not limited to, inventory (ASC 330), loans and receivables (ASC 310), investments in debt and equity securities (ASC 320 and ASC 321, respectively), and indefinite-lived intangible assets (other than goodwill) (ASC 350).
- Step 2 – Evaluate long-lived assets, such as property, plant and equipment, leasing ROU assets (ASC 842), and finite-lived-intangible assets for impairment under ASC 360-10.

- Step 3 – Evaluate goodwill for impairment by comparing the adjusted book value of the entity (or reporting unit) (to the extent impairments of other assets were recognized from the first two steps) to the fair value of the entity (or reporting unit) to determine whether an impairment should be recognized.

If other assets have to be tested for impairment at the same time goodwill is being tested for impairment (because other applicable guidance in the Codification requires those assets to be tested for impairment), those other assets should be tested for impairment before goodwill is tested. For example, a triggering event that gives rise to testing goodwill for impairment under the goodwill amortization alternative may also result in the entity having to test property, plant and equipment for impairment in accordance with ASC 360-10. In that situation, the property, plant and equipment should be tested for impairment before the goodwill. Given the implications of this guidance, entities should carefully consider whether the triggering event giving rise to the goodwill impairment test causes other assets of the entity (or reporting unit) (e.g., accounts receivable, inventory, equity method investments, intangible assets, property, plant and equipment) to be tested for impairment.

### 18.3.6 Derecognition

Under the goodwill amortization alternative, when part of an entity is going to be disposed of, consideration should be given to whether any goodwill should be allocated to that part. If the part being disposed of meets the definition of a business, goodwill should be allocated to it using a reasonable and rational approach. The definition of a business used for this purpose is the same one used to determine whether a business was acquired (see Section 4.1). When goodwill is allocated to a business to be disposed of, the allocated goodwill factors into the amount of gain or loss recognized upon disposal. If the part of the entity being disposed of does not meet the definition of a business, goodwill should not be allocated to it.

When the entity tests goodwill for impairment at the reporting unit level and the business being disposed of is only part of a reporting unit, ASC 350-20-40-1 to 40-6 should be referred to for guidance about what constitutes a reasonable and rational approach to allocating goodwill to the business. Given that this guidance discusses allocation of an impairment loss to part of a whole reporting unit, it should also be referred to for purposes of understanding what would be appropriate for purposes of allocating an impairment loss to part of a whole entity when impairment testing is performed at that level.

### 18.3.7 Presentation

An entity that elects the goodwill amortization alternative must present goodwill net of accumulated amortization as a separate line item on its balance sheet. Income statement charges related to goodwill (i.e., amortization and impairment) should be included in income from continuing operations, unless the goodwill relates to a discontinued operation, in which case, the charges (net of tax) should be included in the results from discontinued operations. For those amounts included in income from continuing operations, there is no specific requirement to present them as a separate line item or within a specific line item.

For additional information about discontinued operations, refer to our white paper, Discontinued operations: Identification, presentation and disclosure.

### 18.3.8 Disclosure

An entity's policy related to its accounting for goodwill should be disclosed in accordance with ASC 235-10-50. In addition, if an entity elects the goodwill amortization alternative, it would also be required to disclose the nature and reason for the change in accounting principle in accordance with ASC 250.

When an entity elects the goodwill amortization alternative, it is required to provide many of the same disclosures required under U.S. GAAP applicable to PBEs and other entities that have not elected the goodwill amortization alternative (see Section 14.2.3 and Section 14.4.4). However, some incremental disclosure requirements would also apply. For example, the entity should disclose information related to the amortization of goodwill, including accumulated amortization, total amortization expense and the weighted-average amortization period for goodwill in total, as well as for each major business combination. Other disclosures related to goodwill and goodwill impairment losses also apply. Refer to ASC 350-20-50-4 to 50-7 for all of the disclosures required when an entity elects the goodwill amortization alternative. While entities that elect the goodwill amortization alternative no longer have to disclose changes to goodwill in a tabular format, much of the information that was required to be included in the table is still otherwise required.

### 18.3.9 Effective date and transition

An entity is permitted to make a first-time election to apply the goodwill amortization alternative at any time without having to perform a preferability assessment (as otherwise required by ASC 250). Entities that elect the goodwill amortization alternative should apply it prospectively to existing goodwill as of the beginning of the fiscal year of adoption and new goodwill recognized thereafter. For example, if an entity decides to first elect the goodwill amortization alternative in its 20X1 calendar-year-end financial statements, it would adopt the alternative as of January 1, 20X1. As such, amortization of any goodwill in existence on January 1, 20X1, starts on that date (and absent any derecognition events, a full year of amortization expense should be recognized on that goodwill in 20X1), and amortization of any new goodwill related to acquisitions in 20X1 should begin on the acquisition date of the related business combination. In addition, for goodwill that exists as of the beginning of the fiscal year of adoption, an entity can default to amortizing it over a useful life of 10 years (without justification) on a straight-line basis, or it can choose to identify and use a shorter useful life if it can demonstrate that the shorter life is more appropriate.

## 18.4 Goodwill impairment triggering event alternative

### 18.4.1. Nature and implications of the alternative

Under the goodwill impairment triggering event alternative, an entity performs the goodwill impairment triggering event analysis required by ASC 350-20-35-30 or ASC 350-20-35-66 as of the end of each reporting period, whether an interim or annual reporting period, instead of throughout the reporting period (see Section 18.3.3 for information about triggering events). In addition, any goodwill impairment test resulting from the related triggering event analysis is performed as of the end of the reporting period, instead of the date the triggering event occurred.

The FASB did not include any guidance in the ASC on what constitutes a reporting period or how the nature of the information reported by the entity affects the way the alternative is applied (i.e., does a reporting period exist only when what the entity reports under U.S. GAAP is a full set of financial statements [including footnotes] or does a reporting period exist any time what the entity reports under U.S. GAAP includes financial information that would be affected by a goodwill impairment [e.g., goodwill, total assets, net income]). However, the FASB did include the following in the basis for conclusions of ASU 2021-03:

- In paragraph BC28, an acknowledgment that many entities report some level of financial information with an indication that it complies with the recognition and measurement principles under U.S. GAAP on an interim basis for various reasons (e.g., debt covenant compliance, regulatory requirements).
- In paragraphs BC29 and BC30, observations that any time an entity reports in compliance with U.S. GAAP, it should be following the guidance in ASC 350-20, which requires the evaluation of interim goodwill triggering events when interim financial information is reported.
- In paragraph BC30, an indication "…that it would be misleading to allow entities that provide interim financial information to delay evaluating goodwill for impairment until the end of the annual reporting period."

During the PCC meeting in April 2021, the FASB staff clarified the following related to ASU 2021-03:

- The ASU does not define *reporting date*, nor is it a term already defined in U.S. GAAP.
- Management should continue to determine the entity's reporting date based on when it reports under U.S. GAAP. In other words, this is not a new determination, and the preexisting determination made by management is not affected by the ASU.
- Reporting under U.S. GAAP encompasses more than just issuing a complete set of financial statements (including the notes to the financial statements). For example, issuing only a balance sheet prepared in accordance with U.S. GAAP should be considered reporting under U.S. GAAP for purposes of the ASU.

Based on the totality of guidance included in the ASC and ASU 2021-03, as well as the FASB staff's clarifications in April 2021, we believe the implications of an entity electing the goodwill triggering event alternative are as follows:

- If the entity reports financial information that would be affected by goodwill impairment (e.g., goodwill, total assets, net income) on an interim basis, and that financial information is in compliance with the recognition and measurement principles under U.S. GAAP, the entity would perform its goodwill impairment triggering event analysis (and any resulting impairment test) as of the interim reporting date. In other words, the entity would not be allowed to wait and perform its goodwill impairment triggering event analysis (and any resulting impairment test) as of its annual reporting date. The benefit of the goodwill triggering event alternative in this situation is that the entity is able to perform the goodwill triggering event analysis (and any resulting impairment test) as of the interim reporting date instead of performing that analysis throughout the interim reporting period (and any resulting impairment test as of the date during the interim reporting period on which a triggering event occurred).
- If the entity *only* reports financial information that would be affected by goodwill impairment on an annual basis and that information is in compliance with the recognition and measurement principles under U.S. GAAP, the entity would perform its goodwill impairment triggering event analysis (and any resulting impairment test) as of its annual reporting date. The benefit of the goodwill triggering event alternative in this situation is that the entity is able to perform the goodwill impairment triggering event analysis (and any resulting impairment test) as of the annual reporting date instead of performing the analysis throughout the annual reporting period (and any resulting impairment test as of the date or dates during the annual reporting period on which a triggering event occurred).

Given the implications to the benefits provided from electing the goodwill triggering event alternative, an entity should carefully consider whether the financial information it reports on an interim basis is prepared in compliance with the recognition and measurement principles under U.S. GAAP.

A question may arise with respect to the effects of an entity increasing the frequency with which it reports financial information affected by goodwill impairment under U.S. GAAP from reporting such information on an annual basis to reporting such information on an interim and annual basis. For example, assume an entity with a calendar year end elects the goodwill triggering event alternative for 20X2, and that the only financial information reported under U.S. GAAP by the entity related to 20X2 was its annual financial statements, which were issued before March 31, 20X3. Also assume that starting with the first quarter of 20X3, the entity is required to report total assets and net income under U.S. GAAP on a quarterly basis to its lender in connection with changes made to a preexisting debt agreement in the first quarter of 20X3. In connection with its interim reporting for the first quarter of 20X3, the entity performs its goodwill impairment triggering event analysis (and any resulting impairment test) as of March 31, 20X3. Based on the guidance in ASC 350-20-35-86, the entity does not retroactively perform a triggering event impairment analysis as of March 31, 20X2 for comparative purposes because the entity has already issued its financial statements for 20X2.

### 18.4.2 Disclosures

If an entity elects the goodwill triggering event alternative, that election should be disclosed in accordance with ASC 235-10-50-1, in addition to the information otherwise required to be disclosed by ASC 350-20-50-1 to ASC 350-20-50-7.

### 18.4.3 Effective date and transition

The goodwill triggering event alternative is effective for fiscal years beginning after December 15, 2019, with early adoption permitted in both interim and annual financial statements provided those financial statements have not been issued or made available for issuance as of March 30, 2021 (the date ASU 2021-03 was issued). If an entity does not elect the alternative on or before its effective date, it may use an unconditional one-time election to adopt the alternative after the effective date without assessing preferability under ASC 250.

While the goodwill triggering event alternative should be applied prospectively, it should be applied as of the beginning of the interim or annual period for financial statements that have not yet been issued or made available for issuance in the year of adoption. However, the alternative should not be applied as of the beginning of the year of adoption if financial statements for interim periods within that year have already been issued or made available for issuance.

The following are examples of how the effective date and transition guidance should be applied by an entity that has elected the goodwill amortization alternative (and, therefore, only tests goodwill for impairment upon the occurrence of a triggering event) and decides to elect the goodwill triggering event alternative in September 20X1 for its December 31, 20X1 annual financial statements:

- *The entity has a calendar year end and reports a complete set of interim financial statements under U.S. GAAP to its lender on a quarterly basis 45 days after the quarter end.* Since the entity issued a complete set of interim financial statements each time it reported to the lender for the first and second quarters of 20X1, it does not reperform its goodwill impairment triggering event analyses (and any resulting impairment tests) for the first or second quarters as of the end of those quarters, but does perform its goodwill impairment triggering event analyses (and any resulting impairment tests) for the third and fourth quarters as of September 30, 20X1 and December 31, 20X1, respectively.
- *The entity has a calendar year end and does not report under U.S. GAAP except on an annual basis.* Because the entity has not reported under U.S. GAAP on an interim basis during 20X1, it performs the goodwill impairment triggering event analysis (and any resulting impairment test) for the 20X1 annual reporting period as of December 31, 20X1.

## 18.5 Considerations related to an entity's election of the goodwill alternatives

Before electing one or both of the goodwill alternatives, an entity should carefully consider whether doing so makes sense in its facts and circumstances. For example, many of the anticipated benefits resulting from election of the goodwill alternatives could be negated or offset if there is a reasonable possibility that the entity will go public or be acquired by a PBE in the future. If an entity goes public or is acquired by a PBE after it has elected one or both of the goodwill alternatives, it would have to discontinue that election and retrospectively apply U.S. GAAP applicable to PBEs. In other words, the entity would have to retrospectively undo the accounting under the goodwill alternatives. While ASC 250 provides relief to retrospective application of an accounting change when it is impracticable to do so, electing to apply the goodwill guidance in U.S. GAAP applicable to PBEs, although potentially challenging and costly, would rarely, if ever, be deemed impracticable.

To illustrate the consequences of discontinuing the election to apply the goodwill amortization alternative, consider a situation in which an entity goes public three years after electing the goodwill amortization alternative. To prepare historical financial statements to be included in its filings with the SEC, the entity will have to reverse goodwill amortization during the three years it applied the goodwill amortization alternative and retroactively test its goodwill for impairment in each of those three years. While the reversal of goodwill amortization may not be time consuming, retroactive performance of goodwill impairment tests at a reporting unit level for those three years would likely be quite time consuming. In addition, the benefit of reduced financial reporting costs as a result of electing the goodwill amortization alternative would be negated by the costs incurred to retroactively test goodwill for impairment. If there is a reasonable possibility that an entity may become a PBE in the future, and it still wants to adopt the private-company goodwill amortization alternative, it may want to elect to test goodwill at a reporting unit level under the goodwill amortization alternative to help simplify the potential transition.

To illustrate the consequences of discontinuing the election to apply the goodwill triggering event alternative, consider a situation in which an entity with a calendar year end goes public three years after electing both the goodwill amortization alternative and the goodwill triggering event alternative. Prior to going public, the entity only ever issued financial information prepared in accordance with U.S. GAAP on an annual basis. As a result, prior to going public, it performed its goodwill impairment triggering event analyses (and any resulting impairment tests) as of its annual reporting dates. In the first year after the entity elected the goodwill triggering event alternative, a triggering event occurred in its first quarter, but by the entity's annual reporting date, the triggering event had corrected itself, and no other triggering events existed. As a result, the entity did not identify any triggering events as of its annual reporting date in that first year and did not perform a goodwill impairment test in that first year (given that it had adopted both of the goodwill alternatives). In undoing its election of the goodwill triggering event alternative upon going public (see the previous paragraph related to undoing the decision to elect the goodwill amortization alternative), the entity would have to go back and perform the goodwill impairment triggering event analysis by considering events that occurred throughout its first quarter, which would result in the identification of a triggering event for which the resulting impairment test would be performed on the date the triggering event occurred. Any benefit obtained by the entity in electing the goodwill triggering event alternative would be negated by the costs incurred to retroactively test goodwill for impairment in that situation. This example illustrates the difficulty that may be encountered in unwinding the application of the goodwill triggering event alternative, which is particularly pronounced given that the entity previously only reported under U.S. GAAP on an annual basis. While difficulties would exist in unwinding the application of the goodwill triggering event alternative if the entity previously reported under U.S. GAAP on an interim basis, those difficulties likely would be less pronounced.

An entity should discuss the effects of electing the goodwill alternatives with the users of its financial statements to understand whether the entity's election of the alternative is acceptable to those users. The users who should be considered in this regard include investors, lenders and regulators, among others. Thoughtful consideration also should be given to upcoming or potential changes in the users of its financial statements and the willingness of any potential new users of the financial statements to accept financial statements in which one or both of the goodwill alternatives has been applied.

# Appendix A: Application checklist for ASC 805

## Introduction

This appendix includes a checklist that will assist in the application of ASC 805, which addresses the buyer's accounting for a business combination. The checklist includes a series of questions that, when answered, will help the buyer apply the provisions of ASC 805. These questions are divided into the following categories:

- Preparation for the application of ASC 805, much of which should ideally take place in advance of finalizing the business combination
- Determination of whether the business combination is within the scope of ASC 805
- Conclusions that should be reached prior to performing a comprehensive accounting for the business combination (i.e., pervasive conclusions)
- Calculation of goodwill or a gain from a bargain purchase, including considerations relevant to:
    - Identifying and measuring the consideration transferred in the business combination
    - Accounting for any NCI that exists after the business combination
    - Accounting for the buyer's PHEI in the target
    - Identifying and measuring the net assets acquired in the business combination
    - Recognizing and measuring goodwill or a gain from a bargain purchase
- Finalization of the initial accounting for the business combination and the disclosures included in the financial statements issued for the reporting period that includes the acquisition date
- Considerations for when the acquisition date of the business combination falls after the end of the current reporting period, but before the date the financial statements for that reporting period are issued or available to be issued
- Considerations related to the accounting for amounts recognized in a business combination after the acquisition date

To determine the answers to the questions posed in the checklist and to understand the accounting implications of those answers, it will be necessary to consult the relevant sections in the guide that provide additional information on the topic of that question. Those sections have been identified in the checklist.

## 1. Questions to consider in advance of finalizing a business combination:

| | | Comments |
|---|---|---|
| 1.1 | Are there appropriate procedures in place to identify situations in which the buyer gains control of a business through the occurrence of an event that may not have involved any direct action on the part of the buyer (e.g., the buyer did not transfer any consideration, but obtained control through the lapsing of minority veto rights or the target's purchase of its own outstanding interests) (see Section 3.1.2 and Section 12.5)? | |
| 1.2 | Are adequate procedures and internal controls in place to accumulate the information needed to account for and disclose information about the business combination in accordance with ASC 805? | |
| 1.3 | Will valuation or other specialists, either external or internal, be needed to assist in the identification, recognition and measurement activities involved in accounting for a business combination in accordance with ASC 805? If so: (a) have the specialists been identified on a timely basis, (b) are appropriate procedures and internal controls in place to review the qualifications and reports of the specialists and (c) have communications with the specialists taken place regarding (i) the timing and extent of the work to be performed and (ii) the nature and content of the report to be provided by the specialist? | |
| 1.4 | Has a trial run of the accounting for the business combination in accordance with ASC 805 been performed to gain an understanding of the effects the business combination will have on the buyer's financial statements? | |
| 1.5 | Has a draft plan been developed for integrating and coordinating the accounting for the target's activities with the accounting processes, internal controls and systems that already exist within the buyer's operations? | |
| 1.6 | Have the tax effects of the business combination been determined (see Section 11.4)? | |
| 1.7 | Has a communication plan regarding the effects of the business combination on the buyer's financial statements been developed? | |
| 1.8 | Will the financial statements that include the accounting for the business combination be audited? If so, have the auditors been made aware of the business combination and will the auditors be involved in reviewing management's accounting decisions on a timely basis (see Section 4.3)? | |

## 2. Questions to consider when determining whether the business combination is within the scope of ASC 805:

| | | Relevant guide chapters/sections | Comments |
|---|---|---|---|
| 2.1 | Did the buyer gain control over a business as a result of a transaction or other event that falls within the scope of ASC 805? | 2.1, 3.1, 4.1 | |
| 2.1.1 | Is the target a *business* as that term is defined in the Codification and used in ASC 805? | 2.1, 4.1 | |
| 2.1.2 | Did the buyer obtain *control* of the target as that term is defined in the Codification and used in ASC 805? | 2.1 | |
| 2.1.3 | Does the transaction involve one joint venturer acquiring the other joint venturer's interest in the joint venture? | 3.4 | |
| 2.1.4 | If the target is a VIE, is the VIE a business and are the PB and the VIE *not* under common control? | 2.1, 3.1.3, 3.2.1, 4.1 | |
| 2.1.5 | Is the combination between mutual entities? | 3.1.1 | |
| 2.1.6 | Is the transaction a leveraged buyout? | 3.1.1 | |
| 2.1.7 | Is the transaction an exchange of a business for a business? | 3.1.1 | |
| 2.2 | Did the buyer enter into a transaction that is not a business combination or that does not fall within the scope of ASC 805? | 2.1, 3.1, 4.1 | |
| 2.2.1 | Is the transaction an asset acquisition instead of a business combination? | 3.1.1, 4.1, 15 | |
| 2.2.2 | Does the transaction represent a combination or transfer between entities under common control? | 3.1.1, 3.2 | |
| 2.2.3 | Does the transaction involve not-for-profit entities? | 3.1.1, 3.3 | |
| 2.2.4 | Is the transaction the formation of a joint venture? | 3.1.1, 3.4 | |
| 2.2.5 | If the target is a VIE, are the PB and the VIE under common control? | 2.1, 3.1.3, 3.2.1 | |
| 2.2.6 | Does the transaction involve financial assets and liabilities of a consolidated VIE that is a collateralized financing entity (as defined) for which specific guidance in ASC 810-10 applies? | 3.1.1 | |

| | | Relevant guide chapters/sections | Comments |
|---|---|---|---|
| 2.3 | If the target is a VIE, are the target and the PB *not* under common control and is the target *not* a business? | 2.1, 3.1.3, 3.2.1, 4.1 | |

**If a business combination within the scope of ASC 805 has, in fact, occurred, the remainder of this checklist is applicable to the buyer in the business combination as it applies the acquisition method (see Section 2.2).**

**3. Questions to consider prior to performing a comprehensive accounting for the business combination (i.e., questions for which the answers have a pervasive effect on the accounting for the business combination):**

| | | Relevant guide chapters/sections | Comments |
|---|---|---|---|
| *General* | | | |
| 3.1 | Which of the entities involved in the business combination is the buyer (i.e., which of the entities gained control over the other)? | 5.1 | |
| | 3.1.1 Has a reverse acquisition occurred? | 5.2 | |
| | 3.1.2 Has the PB been identified as the buyer when the target is a VIE, the VIE is a business and the PB and VIE are not under common control? | 3.1.3, 5.1 | |
| 3.2 | What is the acquisition date (i.e., what date did the buyer obtain control over the target)? | 6 | |
| | 3.2.1 Has a convenience acquisition date been designated (i.e., a date close to, but different from, the actual acquisition date)? | 6 | |
| *What is or is not part of the business combination?* | | | |
| 3.3 | Have all other transactions and relationships between the buyer and any of the following parties been identified: (a) the target, (b) employees of the target or (c) the sellers? | 7.3, 13.1 | |
| 3.4 | Should any of the other transactions or relationships identified in Question 3.3 be accounted for separate from (or outside of) the business combination? | 7.3, 13.1 | |
| | 3.4.1 Has the effective settlement of a preexisting relationship between the buyer and the target or sellers (e.g., litigation, an executory contract) been accounted for separate from the business combination, including recognition of a gain or loss on that effective settlement? | 13.1, 13.2 | |
| | 3.4.2 Have employee and nonemployee replacement share-based payment awards been apportioned, as appropriate, between | 13.1, 13.4 | |

| | | | Relevant guide chapters/sections | Comments |
|---|---|---|---|---|
| | | consideration transferred and future compensation or other costs for goods or services, with that portion representing compensation or other costs for goods or services being accounted for separate from the business combination? | | |
| | 3.4.3 | Have arrangements with the employees or sellers of the target been analyzed to determine whether they should be included within the accounting for the business combination (e.g., as an assumed liability or contingent consideration) or treated separate from the accounting for the business combination (e.g., as compensation)? | 13.1, 13.3 | |
| | 3.4.4 | Have arrangements with employees of the target under which payments to each employee are contingent upon that employee's continuing employment (i.e., payments to employees are forfeited upon termination of employment) been accounted for separate from the business combination as compensation? | 13.3.1.1 | |
| | 3.4.5 | Do any of the ongoing arrangements between the buyer and the sellers of the target (e.g., supply contracts, lease agreements) include above-market or below-market terms? | 13.3 | |
| 3.5 | Have debt or equity issuance and registration costs incurred in connection with raising funds to enter into a business combination been accounted for separate from the business combination in accordance with other applicable U.S. GAAP? | | 13.5.1 | |
| 3.6 | Have transaction costs not covered by other applicable U.S. GAAP been accounted for separate from the business combination as an expense when incurred and when the related services have been received by the buyer and has this expense been reflected in operating income? | | 13.5.1 | |
| | 3.6.1 | Have the buyer's transaction costs been paid by the target or the seller? | 13.5.2 | |
| | 3.6.2 | Have the buyer's transaction costs been paid by a related party (e.g., the buyer's shareholder)? | 13.5.3 | |
| | 3.6.3 | Has a service provider (e.g., a law firm, an investment banking firm) provided multiple services to the buyer in connection with the acquisition of the target (e.g., a law firm | 13.5.4 | |

| | | | Relevant guide chapters/sections | Comments |
|---|---|---|---|---|
| | | provides legal advice and assistance in drafting documents related to the buyer's purchase of the target and the buyer's issuance of debt to finance its purchase of the target)? | | |
| | 3.6.4 | Have any of the acquisition-related services been provided by a related party (e.g., a PEG provides acquisition-related services in connection with the purchase of a business by one of its portfolio companies)? | 13.5.5 | |
| | 3.6.5 | If any transaction costs or services have been paid or provided by a related party, has the buyer recognized those costs in the appropriate period and at the appropriate amount, regardless of whether the related party has billed the buyer for those costs or services? | 13.5.3, 13.5.5 | |
| | 3.6.6 | Has the buyer paid any of the sellers' transaction costs? | 13.5.6 | |
| | 3.6.7 | Have cash payments for transaction costs been classified within operating activities on the cash flow statement? | 13.5.1 | |
| | 3.6.8 | Have the income tax effects related to transaction costs been appropriately considered? | 11.4.6 | |
| 3.7 | | Have any anticipated restructuring activities expected to be undertaken by the buyer with respect to the target's operations been accounted for separate from the business combination (e.g., recognized as a liability and expensed by the buyer after the business combination when the appropriate conditions are met)? | 10.15, 13.6 | |
| 3.8 | | Have restructuring activities undertaken by the target prior to the acquisition date been analyzed to determine whether those restructuring activities were undertaken for the primary benefit of the buyer (and [or] the combined entity), and if so, accounted for separate from the business combination? | 13.6 | |

**The next five sets of questions (sets 4 to 8) are organized based on the main elements involved in calculating the amount of goodwill or the amount of a gain from a bargain purchase recognized in the accounting for a business combination. The main elements consist of:**

| | |
|---|---|
| Element 1 | Consideration transferred (measured predominantly at fair value) |
| Element 2 | **Acquisition-date fair value of any NCI in the target** |

| | |
|---|---|
| Element 3 | **Acquisition-date fair value of the buyer's PHEI in the target** |
| Element 4 | **Net assets acquired by the buyer (which is 100% of the target's net assets measured predominantly at fair value)** |
| Goodwill or | **Excess of Elements 1 to 3 over Element 4** |
| Gain from a bargain purchase | Excess of Element 4 over Elements 1 to 3 |

**4. Questions to consider in identifying and measuring the consideration transferred (i.e., Element 1) in the business combination:**

| | Relevant guide chapters/sections | Comments |
|---|---|---|
| 4.1 Has all consideration transferred or to be transferred been identified? [Note: Consideration transferred may include, among other things, cash, other assets, contingent consideration, equity securities of the buyer and payables to the sellers (e.g., notes payable to the sellers).] | 12.1, 12.3 | |
| 4.1.1 If consideration transferred has a carrying amount at the acquisition date that is different from its fair value and the consideration will no longer be under the control of the buyer after it is transferred, has a gain or loss been recognized? | 12.3.2 | |
| 4.1.2 Have employee and nonemployee replacement share-based payment awards been apportioned between consideration transferred and future compensation costs or other costs for goods or services? | 11.7, 13.4 | |
| 4.1.3 Has all contingent consideration been identified? | 12.3, 12.4, 13.3 | |
| 4.1.3.1 Has any consideration contingent on resolution of a tax issue been identified? | 11.4.4.4 | |
| 4.1.4 Has consideration transferred subject to a working capital adjustment been identified? | 12.10 | |
| 4.1.5 Did the buyer pay off the seller's debt in conjunction with the business combination? | 12.3.1.1 | |

| | | Relevant guide chapters/sections | Comments |
|---|---|---|---|
| | 4.1.6 Is any of the consideration transferred being held in escrow? | 12.3.1.2 | |
| | 4.1.7 Does the consideration transferred include rollover equity? | 12.3.3.1 | |
| | 4.1.8 Is any of the consideration transferred preferred shares of the buyer? | 12.3.3.2 | |
| | 4.1.9 Was any of the consideration paid before control was obtained? | 12.3.4 | |
| 4.2 | Has all consideration transferred, except for employee and nonemployee replacement share-based payment awards, been measured at its acquisition-date fair value? | 12.3.2, 12.4 | |
| | 4.2.1 If there is an active market price for the buyer's shares, was the fair value of any equity securities of the buyer issued as consideration transferred measured by taking that active market price and multiplying it by the number of shares issued (as required by ASC 820)? | 12.3.3 | |
| | 4.2.2 If there is not an active market price for the buyer's shares, was the fair value of any equity securities of the buyer issued as consideration transferred measured using the guidance in ASC 820 (e.g., use of an appropriate valuation technique and inputs)? | 12.3.3 | |
| | 4.2.3 Has seller-financed debt been measured at its fair value using the guidance in ASC 820? | 12.3.2 | |
| 4.3 | Have employee and nonemployee replacement share-based payment awards (or the portion thereof) that represent consideration transferred been measured using the guidance in ASC 718? | 11.7, 13.4 | |
| | 4.3.1 Have expected forfeitures been appropriately reflected in the share-based payment awards (or portion thereof) that represent consideration transferred? | 13.4.3 | |
| 4.4 | Were contingent consideration and preferred shares and other equity-linked instruments of the buyer issued as consideration properly classified as an asset, liability or equity using the applicable guidance in the Codification? | 12.3.3.2, 12.4.2 | |

| | | Relevant guide chapters/sections | Comments |
|---|---|---|---|
| 4.5 | Have the income tax effects of contingent consideration been appropriately considered? | 11.4.4 | |

**5. Questions to consider in accounting for any NCI that exists after the business combination (i.e., Element 2):**

| | | | Relevant guide chapters/sections | Comments |
|---|---|---|---|---|
| 5.1 | Does an NCI in the target exist after the acquisition?<br>[Note: This would be the case in what is often referred to as a partial acquisition, which results when the buyer owns less than 100% of the target after the acquisition.] | | 10.19, 12.1 | |
| 5.2 | Have the financial instruments (or embedded features) that make up the NCI been properly identified using the applicable guidance in the Codification? | | 10.19.2 | |
| 5.3 | Has the NCI been measured at its acquisition-date fair value? | | 10.19.3, 12.1 | |
| | 5.3.1 | If there is an active market price for the shares held by the NCI shareholders, was the fair value of the NCI measured by taking that active market price and multiplying it by the number of shares held by the NCI shareholders (as required by ASC 820)? | 10.19.3 | |
| | 5.3.2 | If there is not an active market price for the shares held by the NCI shareholders, has the fair value of the NCI been measured using the guidance in ASC 820 (e.g., use of an appropriate valuation technique and inputs), which may require incorporation of a DLOC or DLOM? | 10.19.3 | |
| 5.4 | Within the consolidated balance sheet, has the NCI been clearly identified and labeled and presented separately within equity (unless it should otherwise be presented as temporary equity)?<br>[Note: The public company redeemable securities guidance, which was issued by the SEC and SEC staff, may result in the presentation of certain instruments that make up the NCI as temporary equity, depending on the facts and circumstances. While this guidance is | | 10.19.4 | |

| | Relevant guide chapters/sections | Comments |
|---|---|---|
| only technically applicable to public companies, we believe it is preferable for private companies to also follow this guidance.] | | |

6. **Questions to consider in accounting for the buyer's PHEI in the target (i.e., Element 3):**

| | Relevant guide chapters/sections | Comments |
|---|---|---|
| 6.1 Did the buyer previously hold an equity interest in the target?<br>[Note: This would be the case in what is often referred to as a step acquisition or a business combination achieved in stages.] | 12.1, 12.6 | |
| 6.2 Has the buyer's PHEI in the target been remeasured to its acquisition-date fair value? | 12.1, 12.6.2 | |
| 6.2.1 If there is an active market price for the shares held by the buyer prior to obtaining control of the target and consideration was transferred in the business combination, was the fair value of the buyer's PHEI in the target measured by taking that active market price and multiplying it by the number of shares held by the buyer prior to obtaining control (as required by ASC 820)? | 12.6.2 | |
| 6.2.2 If there is not an active market price for the shares held by the buyer prior to obtaining control of the target and consideration was transferred in the business combination, was the fair value of the buyer's PHEI in the target measured on a noncontrolling basis using the guidance in ASC 820 (e.g., use of an appropriate valuation technique and inputs), which may require incorporation of a DLOC or DLOM? | 12.6.2 | |
| 6.2.3 If consideration was not transferred in the business combination and the buyer had a PHEI in the target, was the fair value of that PHEI measured on a controlling basis? | 12.5 | |
| 6.3 Has a gain or loss been recognized by the buyer for the difference between the carrying amount and fair value of its PHEI in the target? | 12.1, 12.5, 12.6.1 | |

## 7. Questions to consider in identifying and measuring the net assets acquired (i.e., Element 4) in the business combination:

| | Relevant guide chapters/sections | Comments |
|---|---|---|
| *Recognition* | | |
| 7.1 Have all the identifiable assets acquired and liabilities assumed that meet the definitions of assets and liabilities in CON 8 been recognized? (Note 1) | 7.1, 10.1, 17 | |
| 7.1.1 Do all intangible assets recognized satisfy the separability or contractual-legal criterion? Have all identifiable intangible assets that satisfy the separability or contractual-legal criterion been identified? | 10.8, 10.9, 17 | |
| 7.1.2 Has the buyer's intended use (or nonuse) of an acquired asset been ignored for purposes of determining whether an asset should be recognized? | 10.2, 10.8, 10.10 | |
| 7.1.3 Were any of the following acquired and if so, should an asset (an intangible asset in many cases) or liability be recognized based on the definitions of assets and liabilities in CON 8 and the separability or contractual-legal criterion [Note: The items that follow are not a complete list of all of the assets that could be acquired or liabilities that could be assumed in a business combination. For a more comprehensive list of items that give rise to *intangible* assets (or, in some cases, liabilities) that could be acquired in a business combination, refer to Section 10.8 and Section 10.9.] | 7.1, 10.1, 10.8, 10.9, 17 | |
| (a) Customer lists? (Note 1) | 10.8, 17 | |
| (b) Off-market customer contracts? (Note 1) | 10.6.2, 17 | |
| (c) Customer relationships? (Note 1) | 10.6.2, 17 | |
| (d) Order or production backlog (e.g., backlog of purchase and sale orders)? (Note 1) | 10.6.2, 17 | |
| (e) Contract assets or contract liabilities (i.e., deferred revenue) related to customer contracts? | 10.6.2, 11.9 | |

| | | Relevant guide chapters/sections | Comments |
|---|---|---|---|
| | (f) R&D activities? | 10.9, 10.12 | |
| | (g) Servicing rights that are contractually separate from the financial assets to which they relate? | 10.8 | |
| | (h) Defensive intangible assets? | 10.10 | |
| | (i) Asset retirement obligations? | 10.16 | |
| | (j) Reacquired rights (i.e., rights previously licensed by the buyer to the target)? | 11.6 | |
| | (k) Contingent consideration liabilities of the target, which relate to business combinations in which the target was the acquirer? | 12.4.9 | |
| | (l) Restructuring activities undertaken by the target prior to the acquisition date that should be included within the accounting for the business combination? | 13.6 | |
| 7.1.4 | Have intangible R&D assets for which there is not topic-specific guidance in U.S. GAAP been classified as indefinite-lived intangible assets? | 10.12 | |
| 7.1.5 | None of the following should be recognized in the accounting for the business combination: | | |
| | (a) An intangible asset for an assembled workforce | 10.11 | |
| | (b) A liability for any anticipated restructuring activities expected to be undertaken by the buyer with respect to the target's operations | 10.15, 13.6 | |
| | (c) A liability for any restructuring activities undertaken by the target prior to the acquisition date that should be accounted for separate from the business combination (e.g., those restructuring activities undertaken by the target for the primary benefit of the buyer and [or] the combined entity) | 13.6 | |
| | (d) A customer relationship intangible asset for the relationship that existed | 10.6.6 | |

| | Relevant guide chapters/sections | Comments |
|---|---|---|
| between the buyer (as the target's customer) and the target prior to the business combination | | |
| (e) Servicing rights that are *not* contractually separate from the financial assets to which they relate | 10.4 | |
| (f) An asset for any incremental costs to obtain a customer capitalized by the target in accordance with ASC 340-40 | 10.6.7 | |
| (g) A deferred tax liability for the excess of goodwill for book purposes over tax-deductible goodwill | 11.4.5 | |
| (h) If the buyer has elected the private-company intangible asset alternative (see Chapter 17), intangible assets for NCAs and CRI assets that cannot be separately sold or licensed | 17 | |
| 7.2 Have the following been recognized even if they do not meet the definitions of assets and liabilities in CON 8?<br>[Note: ASC 805 provides other recognition thresholds for these acquired assets and assumed liabilities.] | 7.1, 11.1 | |
| 7.2.1 Assets or liabilities for contingencies not specifically addressed in ASC 805 (e.g., litigation contingencies, assurance-type warranty obligations [see Question 11Q.2.1.1]) whose fair value can be determined or for which: (a) it is probable at the acquisition date that an asset or liability exists and (b) the amount is reasonably estimable? | 11.2 | |
| 7.2.2 Indemnification assets for which the indemnified item has been recognized? | 11.3 | |
| 7.2.3 All income tax-related assets and liabilities (including valuation allowances on any recognized deferred tax assets) using the guidance in ASC 805-740 and 740? | 11.4 | |
| 7.2.4 Employee benefit-related assets and liabilities using the applicable guidance in | 11.5 | |

| | | Relevant guide chapters/sections | Comments |
|---|---|---|---|
| | the Codification (e.g., ASC 715-30, ASC 715-60)? | | |
| | 7.2.5 Employee and nonemployee share-based payment awards using the guidance in ASC 718? | 11.7, 13.4 | |
| | 7.2.6 Insurance and reinsurance contracts using the guidance in ASC 944? | 10.18 | |
| 7.3 | Have assets and liabilities related to acquired leases been appropriately recognized based on the classification of the lease (see Question 7.7)? | 10.13 | |
| 7.4 | Have all assets and liabilities been identified and recognized based on the facts and circumstances that existed as of the acquisition date? | 6 | |
| 7.5 | If the buyer reduces its preexisting valuation allowance on its deferred tax assets as a result of acquiring the target, have the effects of that reduction been recognized as an income tax benefit or, in certain limited situations, as a credit to contributed capital as required by ASC 740-10-45-20, and have the related disclosures been provided? | 11.4.3, 14.2.7 | |
| *Classification and designation* | | | |
| 7.6 | Do any of the assets acquired by the buyer (including any assets classified as held for sale by the target prior to the business combination) meet the criteria to be classified as held for sale in ASC 360-10-45? | 9, 11.8 | |
| 7.7 | Have acquired leases been appropriately classified? | 10.13.3 | |
| 7.8 | If the target is an entity that falls within the scope of ASC 944, was the classification of the contracts written by it as insurance contracts, reinsurance contracts or deposit contracts based on the terms, conditions and other relevant facts in existence at the inception of the contract, or if a subsequent modification occurred after inception (but before the acquisition date), based on the terms, conditions and other relevant facts in existence when the contract was modified? | 10.18 | |
| 7.9 | Have acquired transactions, instruments or agreements other than those covered by | 9 | |

| | Relevant guide chapters/sections | Comments |
|---|---|---|
| Questions 7.6 to 7.8 been redesignated, reclassified or re-evaluated by the buyer on the acquisition date, as appropriate?<br>[Note: The items that follow are not a complete list of all of the transactions, instruments or agreements that may need to be redesignated or reclassified on the acquisition date.] | | |
| 7.9.1 Do any of the acquired contracts include embedded derivatives within the scope of ASC 815, and if so, should those derivatives be separated from the host contracts? | 9 | |
| 7.9.2 Do any of the acquired contracts include derivatives within the scope of ASC 815 that qualified for the normal purchases and normal sales exception before the acquisition continue to qualify for that exception after the acquisition, and if so, has the exception been elected? | 9 | |
| 7.9.3 Do any of the acquired contracts involving derivatives within the scope of ASC 815 for which hedge accounting was applied before the acquisition continue to qualify for hedge accounting after the acquisition, and if so, has hedge accounting been elected? (Note 2) | 9 | |
| 7.9.4 Should acquired investments in debt securities that fall within the scope of ASC 320-10-25 be reclassified between trading, AFS or HTM, as appropriate? | 9 | |
| 7.9.5 Should the election be made to account for any of the instruments acquired that fall within the scope of ASC 825-10 using the fair value option provided for in that subtopic? | 9 | |
| 7.9.6 Should the multiple promises to provide goods or services in customer contracts within the scope of ASC 606 be bundled together (i.e., as a single performance obligation) or separated (i.e., as separate performance obligations) for accounting purposes based on the guidance in ASC 606-10 (see Chapter 6 of our revenue recognition guide)? | 9 | |

| | | Relevant guide chapters/sections | Comments |
|---|---|---|---|
| *Measurement* | | | |
| 7.10 | Have all of the assets acquired and liabilities assumed, except those in the list that follows, been measured at 100% of their fair value?<br>[Note: ASC 805 provides different measurement attributes for the acquired assets and assumed liabilities listed next.] | 8.1, 11.1 | |
| 7.10.1 | Have contingent assets and liabilities not specifically addressed in ASC 805 (e.g., litigation contingencies, assurance-type warranty obligations) for which the fair value can be determined been recognized and measured at that fair value? | 11.2.2 | |
| 7.10.2 | Have contingent assets and liabilities not specifically addressed in ASC 805 (e.g., litigation contingencies, assurance-type warranty obligations) for which the fair value cannot be determined been recognized (and measured at their reasonably estimable amounts) if: (a) it is probable at the acquisition date that such assets and liabilities exist and (b) their amounts are reasonably estimable? | 11.2.2 | |
| 7.10.3 | Have indemnification assets been measured consistent with the basis used to measure the indemnified item and have collectibility and contractual limitations been taken into consideration as appropriate? | 11.3 | |
| 7.10.4 | Have all income tax-related assets and liabilities (including valuation allowances on any recognized deferred tax assets) been measured using the guidance in ASC 805-740 and 740? | 11.4 | |
| 7.10.5 | Have employee benefit-related assets and liabilities been measured using the applicable guidance in the Codification (e.g., ASC 715-30 and 715-60)? | 11.5 | |
| 7.10.6 | Did the approach taken to measure the fair value of reacquired rights *not* take renewals into consideration? | 11.6.2 | |
| 7.10.7 | Have employee and nonemployee share-based payment awards been | 11.7, 13.4 | |

| | | Relevant guide chapters/sections | Comments |
|---|---|---|---|
| | measured using the guidance in ASC 718? | | |
| | 7.10.8 Have assets that meet the held-for-sale criteria in ASC 360-10-45 been measured using fair value less costs to sell? | 11.8 | |
| | 7.10.9 Have insurance and reinsurance contracts been measured using the guidance in ASC 944? | 10.18 | |
| | 7.10.10 Have acquired accounts and loans receivables and investments in debt securities been appropriately measured based on whether the buyer has or has not adopted ASC 326 (see Section 10.3.2)? | 10.3, 10.5 | |
| | 7.10.11 Have assets and liabilities related to acquired leases been appropriately measured? | 10.13 | |
| | 7.10.12 Have contract assets and liabilities related to customer contracts been measured in accordance with ASC 606 (after adoption of ASU 2021-08)? | 11.9 | |
| 7.11 | Have all amounts been measured based on the facts and circumstances that existed as of the acquisition date? | 6 | |
| 7.12 | Have the fair value measurements for all nonfinancial assets been based on their highest and best use from a market participant's perspective? | 10.2, 10.10 | |
| 7.13 | If the buyer believes that the target's carryover bases in accounts payable and accrued liabilities approximates their fair values, has the buyer documented how it determined that there are not material differences between the carryover basis and fair value for each of those accounts? | 10.14 | |
| 7.14 | Was the fair value of a tangible long-lived asset with a related ARO measured exclusive of the effects of the ARO? | 10.16 | |
| 7.15 | Has inventory been measured at the price that would be received to sell it in an orderly transaction between market participants on the acquisition date (i.e., its fair value), which often is | 10.7 | |

| | | Relevant guide chapters/sections | Comments |
|---|---|---|---|
| | not the same as its carrying amount prior to the business combination? | | |
| 7.16 | Has property, plant and equipment been measured at the price that would be received to sell it in an orderly transaction between market participants on the acquisition date (i.e., fair value), which often is not the same as its carrying amount prior to the business combination? | 8.1 | |
| 7.17 | Has any assumed debt been measured at the price that would be paid to transfer it in an orderly transaction between market participants on the acquisition date (i.e., its fair value), which often is not the same as its carrying amount prior to the business combination? | 10.17 | |

**Note 1:** If the buyer has elected the private-company intangible asset alternative (see Chapter 17), the following intangible assets are not recognized in the accounting for a business combination: (a) intangible assets that would otherwise arise from NCAs or (b) CRI assets that cannot be separately sold or licensed. With respect to intangible assets other than CRI assets and those related to NCAs (e.g., trademarks, patents), the guidance generally applicable to the recognition of intangible assets in a business combination should be applied.
**Note 2:** In general, there are complexities associated with qualifying for hedge accounting with a preexisting derivative that no longer has a zero fair value.

## 8. Questions to consider with respect to recognizing and measuring goodwill or a gain from a bargain purchase:

| | | Relevant guide chapters/sections | Comments |
|---|---|---|---|
| 8.1 | Have valuation or other specialists been engaged to assist in identifying assets acquired and liabilities assumed, as well as measuring the fair value of: (a) an acquired asset or assumed liability, (b) any part of the consideration transferred, (c) any NCI in the target and (d) any PHEI in the target held by the buyer? | 7.1, 8.1, 12.1 | |
| 8.2 | Has the amount of goodwill or gain from a bargain purchase been calculated in accordance with ASC 805? | 12.1 to 12.7, 12.10 | |
| 8.3 | If a bargain purchase results: | 12.1 | |
| | 8.3.1 Has the accuracy and completeness of the identifiable assets acquired and liabilities assumed and the appropriateness and application of the procedures to value each item that | 12.2 | |

| | | Relevant guide chapters/sections | Comments |
|---|---|---|---|
| | affects the accounting for the business combination been double checked? | | |
| | 8.3.2 Has the buyer documented and disclosed the factors specific to its business combination that gave rise to the bargain purchase? | 12.2, 14.2.3 | |
| | 8.3.3 Was the gain from the bargain purchase attributed entirely to the buyer (and none attributed to any NCI)? | 12.2 | |
| 8.4 | If applicable, have the acquired assets, assumed liabilities and goodwill been assigned to reporting units using a reasonable and supportable methodology? (Note 3) | 12.8 | |
| | 8.4.1 Has adequate documentation supporting the basis for the methodology and the methodology itself been prepared? (Note 4) | 12.8 | |
| 8.5 | When a business combination affects one or more foreign subsidiaries, have the related goodwill and intangible assets been assigned to those subsidiaries using a reasonable and supportable methodology? (Note 4) | 12.9 | |
| | 8.5.1 Has adequate documentation supporting the assignment process been prepared? (Note 4) | 12.9 | |
| 8.6 | If applicable, has goodwill been allocated to the controlling interest and NCI? | 12.1 | |

**Note 3:** If the buyer has elected the private-company goodwill amortization alternative (see Section 18.3), it may adopt an accounting policy to test and measure goodwill for impairment at either the reporting unit or entity level. If the buyer elects to test for and measure goodwill impairment at the entity level, assignment of amounts to reporting units for purposes of testing goodwill for impairment is not necessary.

**Note 4:** When a business combination affects one or more subsidiaries, the allocation of goodwill and intangible assets to foreign subsidiaries is required regardless of whether the entity has elected the private-company goodwill amortization alternative (see Section 18.3).

## 9. Questions to consider in finalizing the initial accounting for the business combination and the disclosures included in the financial statements issued for the reporting period that includes the acquisition date:

| | | Relevant guide chapters/sections | Comments |
|---|---|---|---|
| 9.1 | Which aspects, if any, of the initial accounting for the business combination are incomplete? | 12.7 | |

| | | Relevant guide chapters/sections | Comments |
|---|---|---|---|
| | 9.1.1 Is the process of identifying all assets acquired and liabilities assumed complete for purposes of the initial accounting? | 12.7 | |
| | 9.1.2 Have any provisional amounts been reflected in the initial accounting? | 12.7 | |
| 9.2 | Have the required disclosures been made for those items for which the initial accounting is not complete (e.g., provisional amounts) in the financial statements issued for the reporting period that includes the acquisition date? | 12.7, 14.2.6 | |
| 9.3 | Have all other disclosures required by ASC 805 been included in the financial statements? | 14.1, 14.2 | |
| 9.4 | Have the additional disclosures for intangible assets required by ASC 350-30-50-1 to 50-5 been included in the financial statements? | 14.2.5 | |
| 9.5 | If a contingent consideration asset or liability meets the definition of a derivative, have the presentation and disclosure requirements applicable to derivatives been satisfied? | 12.4.2, 12.4.4.2 | |
| 9.6 | For share-based contingent consideration, have the following disclosure requirements been satisfied (as necessary): (a) those in ASC 480-10-50 and 815-40-50 when the consideration is classified as an asset or liability and (b) those in ASC 505-10-50 and 815-40-50 when the consideration is classified as equity? | 14.2.4 | |
| 9.7 | Have the additional disclosures required upon the initial consolidation of a VIE been included in the financial statements? | 3.1.3, 14.6 | |
| 9.8 | Have the additional disclosures for goodwill required by ASC 350-20-50-1 and 50-1A been included in the financial statements? | 14.4.4 | |

**10. Questions to consider if the acquisition date for the business combination falls after the end of the current reporting period, but before the date the financial statements for that reporting period are issued or available to be issued:**

| | | Relevant guide chapters/sections | Comments |
|---|---|---|---|
| 10.1 | Have the appropriate disclosures been made?<br>[Note: If the buyer's initial accounting for the business combination is complete when the financial statements are issued or available to be issued, ASC 805 requires the same comprehensive disclosures in this situation as are required when the business combination occurs during the current reporting period. If the buyer's initial accounting is *not* complete when the financial statements are issued or available to be issued, the buyer provides the disclosures it can, describes the disclosures it cannot provide and explains why those disclosures could not be provided.] | 14.1, 14.3 | |

**11. Questions to consider related to the accounting for amounts recognized in the accounting for a business combination after the acquisition date:**

| | | Relevant guide chapters/sections | Comments |
|---|---|---|---|
| *Adjustments to amounts recorded in the accounting for the business combination* | | | |
| 11.1 | Should an amount recorded in the accounting for the business combination be adjusted?<br>[Note: The remainder of this set of questions discusses measurement period adjustments (which affect the accounting for the business combination) and subsequent accounting adjustments (which typically affect net income).] | 12.7 | |
| *Measurement period adjustments* | | | |
| 11.2 | Should the adjustment be recorded as a measurement period adjustment? | 12.7.1 | |
| | 11.2.1 Did the adjustment occur during the measurement period? | 12.7.1.1 | |
| | 11.2.2 Does the adjustment result from the buyer obtaining additional information about the facts and circumstances that existed *as of* the acquisition date | 12.7.1.1 | |

| | Relevant guide chapters/sections | Comments |
|---|---|---|
| that would have affected the accounting for the business combination *as of* the acquisition date if it had been known? | | |
| 11.3 Has any working capital adjustment been analyzed to determine whether it should be accounted for as a measurement period adjustment? | 12.10 | |
| 11.4 If the adjustment should be accounted for as a measurement period adjustment: | 12.7 | |
| 11.4.1 Has the measurement period adjustment been measured as of the acquisition date and recorded in the period in which it occurred? | 12.7.1 | |
| 11.4.2 Does the measurement period adjustment take into consideration the income statement effects (if any) that would have resulted in the intervening period (i.e., the period from the acquisition date through the period that ended before the adjustment occurred) if the measurement period adjustment (hypothetically) had been recorded as of the acquisition date (e.g., if the measurement period adjustment affects the fair value estimate for a piece of equipment, does the measurement period adjustment reflect the income statement effects of what the depreciation expense on the equipment would have been since its acquisition if it were based on the adjusted fair value estimate of the equipment)? | 12.7.1.3 | |
| 11.4.2.1 Has the amount of any measurement period adjustment recognized in the current-period income statement that would have been recognized in previous periods if the adjustment were recognized as of the acquisition date been either separately presented on the face of the income statement | 14.4.2 | |

| | Relevant guide chapters/sections | Comments |
|---|---|---|
| or disclosed in the notes to the financial statements? | | |
| 11.4.3 Have the appropriate disclosures been made about the measurement period adjustment and the effects it has on goodwill? | 12.7.1.2, 14.4.2, 14.4.4 | |
| *Subsequent accounting adjustments* | | |
| 11.5 Should the adjustment be accounted for using the subsequent accounting guidance in ASC 805 or other guidance in the Codification applicable to assets and liabilities recognized in the accounting for the business combination?<br>[Note: The remaining items in this set of questions are not a complete list of all of the items for which the Codification provides subsequent accounting guidance that is applicable to assets and liabilities recognized in the accounting for a business combination (see Section 8.2). For example, the lack of questions related to the depreciation and impairment of property, plant and equipment does not mean there is no applicable guidance in the Codification. The buyer should apply the same subsequent accounting guidance to the property, plant and equipment it acquired in the business combination as it applies to its other property, plant and equipment (see ASC 360).] | 8.2, 12.7.1.1 | |
| *Contingent consideration* | | |
| 11.6 Has contingent consideration classified as an asset or liability been remeasured to its fair value at the end of each reporting period it remains outstanding with the change in fair value reflected in the income statement (except in the unlikely situation that the contingent consideration qualifies for and is designated as a hedging instrument in a hedge relationship for which ASC 815-20-35 requires the change in fair value to be recognized in OCI)? | 12.4.4.2 | |
| 11.6.1 If the contingent consideration asset or liability is *not* a derivative, has the change in fair value been reflected in operating income? | 12.4.4.2 | |

| | Relevant guide chapters/sections | Comments |
|---|---|---|
| 11.7 Has a contingent consideration liability of the target (i.e., a liability from a business combination in which the target was the acquirer) been remeasured to its fair value at the end of each reporting period it remains outstanding with the change in fair value reflected in a manner consistent with a change in the fair value of a contingent consideration liability of the buyer (see Question 11.6)? | 12.4.9 | |
| 11.8 Should the classification of contingent consideration as a liability or equity be reassessed at the balance-sheet date (e.g., because the contingent consideration falls within the scope of ASC 815-40)? | 12.4.3 | |
| 11.9 Has a contingent consideration liability only been derecognized upon settlement or expiration of the contingency? | 12.4.4.3 | |
| 11.10 Have cash payments to settle contingent consideration obligations been properly classified in the cash flow statement? | 12.4.6 | |
| 11.11 If contingent consideration classified as equity is settled by issuing equity shares, has the par value of the shares been reclassified from additional paid-in capital to common stock? | 12.4.4.2 | |
| 11.12 Have other accounting implications of not meeting the threshold that makes contingent consideration payable (e.g., impairment of goodwill or customer relationship intangible assets) been considered? | 12.4.8 | |
| *Acquired accounts and loans receivable with deteriorated credit quality (prior to the adoption of ASC 326 [see Section 10.3.2])* | | |
| 11.13 Has the appropriate subsequent accounting guidance been applied to acquired accounts or loan receivables with deteriorated credit quality? | 10.3.3.1 | |
| *Acquired accounts and loans receivable that are not PCD assets and acquired HTM investments in debt securities that are not PCD assets or beneficial interests that meet the conditions in ASC 325-40-30-1A (after the adoption of ASC 326 [see Section 10.3.2])* | | |

| | Relevant guide chapters/sections | Comments |
|---|---|---|
| 11.14 Has an allowance for credit losses on the fair value of any non-PCD assets been recognized through credit loss expense immediately after completing the accounting for the business combination (resulting in a day-one loss)? | 10.3.4, 10.5.2.2 | |
| *Customer relationship intangible assets* | | |
| 11.15 Are the amortization method and period used to amortize the customer relationship intangible asset consistent with the assumptions used to estimate the fair value of the customer relationship intangible asset? (Note 5) | 10.6.5.2, 17 | |
| *Defensive intangible assets* | | |
| 11.16 Has the appropriate useful life for a defensive intangible asset been determined? | 10.10 | |
| *Contingent assets and liabilities* | | |
| 11.17 Is the buyer's subsequent accounting policy for contingent assets and contingent liabilities not specifically addressed by ASC 805 (e.g., litigation contingencies, assurance-type warranty obligations) systematic and rational? | 11.2.4 | |
| *Indemnification assets* | | |
| 11.18 Does the subsequent measurement of an indemnification asset follow the subsequent measurement of the indemnified item and have collectibility and contractual limitations been taken into consideration as appropriate? | 11.3.3, 11.3.4 | |
| 11.19 Has an indemnification asset only been derecognized if: (a) the asset has been collected, (b) the asset has been sold or (c) the right to the asset has been lost? | 11.3.5 | |
| *Reacquired rights* | | |
| 11.20 Is a reacquired right being amortized over the remaining term of the agreement that existed between the buyer and the target? | 11.6.3 | |
| *Indefinite-lived R&D intangible assets* | | |
| 11.21 Have any R&D activities acquired in a business combination (other than those | 10.12.2.1 | |

| | Relevant guide chapters/sections | Comments |
|---|---|---|
| related to computer software to be sold, leased or otherwise marketed) been completed or abandoned, and if so, have the effects of the completion or abandonment been taken into consideration in the subsequent accounting for the related indefinite-lived R&D intangible asset? | | |
| 11.22 Have any R&D activities related to computer software to be sold, leased or otherwise marketed that were acquired in the business combination reached technological feasibility or been abandoned, and if so, have the effects of that been taken into consideration in the subsequent accounting for the related indefinite-lived R&D intangible asset? | 10.12.2.2 | |
| *Insurance and reinsurance contracts* | | |
| 11.23 For insurance and reinsurance contracts within the scope of ASC 944-10 that were acquired in a business combination, has the subsequent accounting guidance in ASC 944-805-35 been considered? | 10.18 | |
| *Income-tax related* | | |
| 11.24 Has an adjustment to a deferred tax asset valuation allowance that is not a measurement period adjustment been recognized within income tax expense (or, in certain limited situations, as a direct adjustment to contributed capital as required by ASC 740-10-45-20)? | 11.4.7.1 | |
| 11.25 Have changes in uncertain tax positions that affect income tax-related amounts recognized in the accounting for the business combination (e.g., deferred tax assets or liabilities, payables to or receivables from taxing authorities, a liability for unrecognized tax benefits) that are not measurement period adjustments been recognized as they would have been recognized if the changes related to uncertain tax positions that were not acquired in, or did not result from, a business combination? | 11.4.7.2 | |
| 11.26 Have the tax effects of subsequent adjustments made to the contingent consideration recognized related to a | 11.4.4.2, 11.4.4.3 | |

| | Relevant guide chapters/sections | Comments |
|---|---|---|
| business combination been appropriately accounted for by the buyer? | | |
| *Goodwill* | | |
| 11.27 If the private-company goodwill amortization alternative has been elected, is goodwill being amortized over a period of 10 years or a shorter period that can be shown to be more appropriate? (Note 6) | 18.3.1 | |
| *Buyer's ownership interest* | | |
| 11.28 Have changes in the buyer's ownership interest after the acquisition date been accounted for appropriately? | 16 | |
| *Disclosures* | | |
| 11.29 Have the disclosures in ASC 805 about the subsequent accounting for certain amounts recorded in the accounting for the business combination been provided in the financial statements? | 14.4, 14.7 | |

**Note 5:** If the buyer has elected the private-company intangible asset alternative (see Chapter 17), CRI assets that cannot be separately sold or licensed are not recognized in the accounting for the business combination.
**Note 6:** If the buyer has elected the private-company goodwill amortization alternative (see Section 18.3), goodwill must be amortized. Otherwise, goodwill is not amortized.

# Appendix B: ASC 805 disclosure checklists and illustration

## Introduction

This appendix consists of the following three sections:

- *Section 1: Disclosures required by ASC 805* includes a checklist that will assist in determining whether the disclosures required by ASC 805-10-50, 805-20-50, 805-30-50 and 805-740-50 have been provided in the financial statements when required for a business combination that occurs during or shortly after the period presented. Chapter 14 provides discussion related to these disclosure requirements.
- *Section 2: Disclosures for combinations or transfers between entities under common control* lists the disclosures required by ASC 805-50-50 for combinations between entities under common control. Section 3.2 includes discussion on the accounting for combinations or transfers between entities under common control.
- *Section 3: Illustration of ASC 805 disclosure requirements* includes the disclosure illustration presented in ASC 805-10-55-37 to 55-50. As appropriate, each disclosure requirement listed in Section 1 is cross-referenced to where that disclosure is illustrated in Section 3. Likewise, each paragraph of the disclosure illustration in Section 3 is cross-referenced to the corresponding disclosure requirement in Section 1.

Topics in the Codification other than ASC 805 also require that certain information be disclosed related to a business combination or amounts recognized in connection with a business combination. For example, the buyer needs to consider the disclosure requirements in:

- ASC 350-20-50 and 350-30-50 (disclosures related to goodwill and intangible assets)
- ASC 740-10-50 (disclosures related to income taxes)
- ASC 810-10-50-2A to 50-19 (disclosures related to VIEs [see Section 14.6])
- ASC 820-10-50 (disclosures related to fair value measurements [see Section 14.7])

In addition, public companies are required to comply with additional disclosure requirements, such as those included in Rule 3-05 of Regulation S-X, which requires disclosure of the financial statements of businesses acquired or to be acquired.

## Section 1: Disclosures required by ASC 805

The following table lists the disclosures required by ASC 805-10-50, 805-20-50, 805-30-50 and 805-740-50. Other topics also require that certain information be disclosed related to a business combination or amounts recognized in connection with a business combination. Examples of these topics are listed in the introduction to this appendix. Chapter 14 in the guide provides discussion of the disclosures that must be provided in conjunction with a business combination. Additionally, refer to Section C.7 for disclosure requirements when pushdown accounting is applied.

The disclosures in the table that follows are required to be provided in the financial statements for business combinations that occur during the current *interim or annual* reporting period or that occurred after the end of the current *interim or annual* reporting period, but before the financial statements for that period were issued or available to be issued.

The first column in the table is meant to facilitate the simultaneous use of the disclosure checklist and the footnote illustration in Section 3 of this appendix. Refer to Section 3 for additional information.

| Section 3 paragraph identifier | ASC 805- | Disclosure requirement | Yes or No | Remarks |
|---|---|---|---|---|
| | 10-50-2<br>20-50-1<br>30-50-1 | 1. The buyer has disclosed the following information for each business combination that occurred during the reporting period: | | |
| 1 | 10-50-2(a) | a. The name and a description of the target. | | |
| 1 | 10-50-2(b) | b. The acquisition date. | | |
| 1 | 10-50-2(c) | c. The percentage of voting equity interests acquired. | | |
| 1 | 10-50-2(d) | d. The primary reasons for the business combination and a description of how the buyer obtained control of the target. | | |
| 2 | 30-50-1(a) | e. A qualitative description of the factors that make up the goodwill recognized, such as expected synergies from combining operations of the target and the buyer, intangible assets that do not qualify for separate recognition or other factors.<br>(**Note:** If the private-company intangible asset alternative [see Chapter 17] has been elected, the intangible assets that do not qualify for separate recognition, and therefore, contribute to the goodwill recognized, may include those related to customers and NCAs.) | | |
| 4, 8 | 30-50-1(b) | f. The acquisition-date fair value of the total consideration transferred and the acquisition-date fair value of each major class of consideration, such as: | | |
| 5 | 30-50-1(b)(1) | (1) Cash. | | |
| Note 1 | 30-50-1(b)(2) | (2) Other tangible or intangible assets, including a business or subsidiary of the buyer. | | |
| 7, 14 | 30-50-1(b)(3) | (3) Liabilities incurred (e.g., a liability for contingent consideration). | | |
| 6, 13 | 30-50-1(b)(4) | (4) Equity interests of the buyer, including the number of instruments or interests issued or issuable and the method of | | |

| Section 3 paragraph identifier | ASC 805- | Disclosure requirement | Yes or No | Remarks |
|---|---|---|---|---|
| | | determining the fair value of those instruments or interests. | | |
| 7, 14 | 20-50-1(a)<br>30-50-1(c) | g. For contingent consideration arrangements and indemnification assets: | | |
| 7, 14 | 20-50-1(a)(1)<br>30-50-1(c)(1) | (1) Amount recognized as of the acquisition date. | | |
| 14 | 20-50-1(a)(2)<br>30-50-1(c)(2) | (2) A description of the arrangement and the basis for determining the amount of the payment. | | |
| 14 | 20-50-1(a)(3)<br>30-50-1(c)(3) | (3) An estimate of the range of outcomes (undiscounted) or if a range cannot be estimated, that fact and the reasons why a range cannot be estimated. | | |
| Note 1 | 20-50-1(a)(3)<br>30-50-1(c)(3) | (4) If the maximum amount of the payment is unlimited, that fact. | | |
| 15 | 20-50-1(b) | h. For acquired receivables not subject to the requirements of ASC 310-30 before the adoption of ASC 326; or acquired receivables that are not PCD assets (see Section 10.3.4) after the adoption of ASC 326 (see Section 10.3.2 for information about ASC 326): | | |
| Note 1 | 20-50-1(b)(1) | i. For receivables other than those of a lessor arising from sales-type leases or direct financing leases, the fair value of the receivables. | | |
| 15 | 20-50-1(b)(1) | ii. For receivables of a lessor arising from sales-type leases or direct financing leases, the amounts recognized as of the acquisition date. | | |
| 15 | 20-50-1(b)(2) | iii. The gross contractual amounts receivable. | | |
| 15 | 20-50-1(b)(3) | iv. The best estimate at the acquisition date of the contractual cash flows not expected to be collected. | | |
| 15 | 20-50-1(b) | (**Note:** This information should be | | |

| Section 3 paragraph identifier | ASC 805- | Disclosure requirement | Yes or No | Remarks |
|---|---|---|---|---|
| | | provided for each major class of receivables. Examples include: (a) loans, (b) net investment in sales-type or direct financing leases in accordance with ASC 840-30 or 842-30 [as applicable] and (c) any other class of receivables.) | | |
| 11 | 20-50-1(c) | i. The amounts recognized as of the acquisition date for each major class of assets acquired and liabilities assumed. | | |
| 17 | 20-50-1(d) | j. For contingencies: | | |
| 17 | 20-50-1(d)(1) | (1) For assets and liabilities arising from contingencies recognized at the acquisition date, the nature of the contingencies, the amounts recognized at the acquisition date and whether the amounts were measured at fair value or measured in accordance with ASC 450. | | |
| Note 1 | 20-50-1(d)(2) | (2) For contingencies that are not recognized at the acquisition date, the disclosures required by ASC 450 if the criteria for disclosures in that topic are met. | | |
| 17 | 20-50-1(d) | (**Note:** This information should be included in the footnote that describes the business combination. In addition, the buyer may aggregate disclosures for: (a) assets and liabilities arising from contingencies that are similar in nature and (b) contingencies that are not recognized at the acquisition date that are similar in nature.) | | |
| 3 | 30-50-1(d) | k. The total amount of goodwill that is expected to be deductible for tax purposes. | | |
| 2 | 30-50-1(e) | l. If the buyer is required to disclose segment information in accordance with ASC 280-10: | | |
| 2 | 30-50-1(e) | (1) The amount of goodwill by reportable segment unless the | | |

| Section 3 paragraph identifier | ASC 805- | Disclosure requirement | Yes or No | Remarks |
|---|---|---|---|---|
| | | assignment of goodwill to reporting units required by ASC 350-20-35-41 to 35-44 has not been completed as of the date the financial statements are issued or available to be issued. | | |
| Note 1 | 30-50-1(e) | (2) If the assignment of goodwill to reporting units required by ASC 350-20-35-41 to 35-44 has not been completed as of the date the financial statements are issued or available to be issued, that fact. | | |
| 10 | 10-50-2(e) | m. For transactions that are recognized separately from the acquisition of assets and assumptions of liabilities in the business combination: | | |
| 10 | 10-50-2(e)(1) | (1) A description of each transaction. | | |
| 10 | 10-50-2(e)(2) | (2) How the buyer accounted for each transaction. | | |
| 10 | 10-50-2(e)(3) | (3) The amounts recognized for each transaction and the line item in the financial statements in which each amount is recognized. | | |
| Note 1 | 10-50-2(e)(4) | (4) If the transaction is the effective settlement of a preexisting relationship, the method used to determine the settlement amount. | | |
| 10 | 10-50-2(f) | n. For the disclosure of separately recognized transactions required by item 1(m) in this section, the following information about transaction costs: | | |
| 10 | 10-50-2(f) | (1) The amount of such costs. | | |
| 10 | 10-50-2(f) | (2) The amount of such costs recognized as an expense. | | |
| 10 | 10-50-2(f) | (3) The line item or items in the income statement in which those expenses are recognized. | | |
| Note 1 | 10-50-2(f) | (4) The amount of any issuance costs not recognized as an expense and how they were recognized. | | |
| Note 1 | 30-50-1(f) | o. In a bargain purchase: | | |

| Section 3 paragraph identifier | ASC 805- | Disclosure requirement | Yes or No | Remarks |
|---|---|---|---|---|
| Note 1 | 30-50-1(f)(1) | (1) The amount of any gain recognized in accordance with ASC 805-30-25-2 and the line item in the income statement in which the gain is recognized. | | |
| Note 1 | 30-50-1(f)(2) | (2) A description of the reasons why the transaction resulted in a gain. | | |
| 12, 18 | 20-50-1(e) | p. For each business combination in which the buyer holds less than 100 percent of the equity interests in the target at the acquisition date: | | |
| 12 | 20-50-1(e)(1) | (1) The fair value of the NCI in the target at the acquisition date. | | |
| 18 | 20-50-1(e)(2) | (2) The valuation techniques and significant inputs used to measure the fair value of the NCI. | | |
| 9, 19 | 10-50-2(g) | q. In a business combination achieved in stages (i.e., a step acquisition): | | |
| 9 | 10-50-2(g)(1) | (1) The acquisition-date fair value of the equity interest in the target held by the buyer immediately before the acquisition date. | | |
| 19 | 10-50-2(g)(2) | (2) The amount of any gain or loss recognized as a result of remeasuring to fair value the equity interest in the target held by the buyer immediately before the business combination and the line item in the income statement in which that gain or loss is recognized. | | |
| Note 1 | 10-50-2(g)(3) | (3) The valuation techniques used to measure the acquisition-date fair value of the equity interest in the target held by the buyer immediately before the business combination. | | |
| Note 1 | 10-50-2(g)(4) | (4) Information that enables users of the buyer’s financial statements to assess the inputs used to develop the fair value measurement of the equity interest in the target held by | | |

| Section 3 paragraph identifier | ASC 805- | Disclosure requirement | Yes or No | Remarks |
|---|---|---|---|---|
| | | the buyer immediately before the business combination. | | |
| 20 | 10-50-2(h) | r. If the buyer is a public entity, as defined in the Master Glossary of the Codification: | | |
| 21 | 10-50-2(h)(1) | (1) The amounts of revenue and earnings of the target since the acquisition date that are included in the consolidated income statement for the reporting period. | | |
| 22 | 10-50-2(h)(2) | (2) If comparative financial statements are not presented, the revenue and earnings of the combined entity for the current reporting period as though the acquisition date for all business combinations that occurred during the year had been as of the beginning of the annual reporting period (supplemental pro forma information). | | |
| 23, 24 | 10-50-2(h)(3) | (3) If comparative financial statements are presented, the revenue and earnings of the combined entity as though the business combination that occurred during the current year had occurred as of the beginning of the comparable prior annual reporting period (supplemental pro forma information). | | |
| 25 | 10-50-2(h)(4) | (4) The nature and amount of any material, nonrecurring pro forma adjustments directly attributable to the business combination included in the reported pro forma revenue and earnings (supplemental pro forma information). | | |
| Note 1 | 10-50-2(h) | s. For any of the disclosures in item 1(r) of this section that are impracticable to provide: | | |
| Note 1 | 10-50-2(h) | (1) The fact that providing the information is impracticable. | | |
| Note 1 | 10-50-2(h) | (2) An explanation of why providing | | |

| Section 3 paragraph identifier | ASC 805- | Disclosure requirement | Yes or No | Remarks |
|---|---|---|---|---|
| | | these disclosures is impracticable. | | |
| Note 1 | 10-50-3<br>20-50-2<br>30-50-2 | 2. For individually immaterial business combinations occurring during the reporting period that are material collectively, the buyer has disclosed the information required in items 1(e) to 1(s) of this section in the aggregate. | | |
| Note 1 | 10-50-4<br>20-50-3<br>30-50-3 | 3. If the acquisition date for a business combination is after the reporting date but before the financial statements are issued or available to be issued, the buyer has disclosed the following: | | |
| Note 1 | 10-50-4<br>20-50-3<br>30-50-3 | a. If the initial accounting for the business combination is complete at the time the financial statements are issued or available to be issued, the information required by item 1 of this section. | | |
| Note 1 | 10-50-4<br>20-50-3<br>30-50-3 | b. If the initial accounting for the business combination is incomplete at the time the financial statements are issued or available to be issued, a description of the disclosures required by item 1 of this section that could not be provided and an explanation as to why those disclosures could not be provided. | | |
| 14, 16 | 20-50-4<br>30-50-4 | 4. For each material business combination, or in the aggregate for individually immaterial business combinations that are material collectively, the buyer has disclosed the following information: | | |
| 16 | 20-50-4A | a. If the initial accounting for a business combination is incomplete for particular assets, liabilities, any NCI or items of consideration and the amounts recognized in the financial statements for the business combination thus have been determined only provisionally: | | |
| 16 | 20-50-4A(a) | (1) The reasons why the initial accounting is incomplete. | | |
| 16 | 20-50-4A(b) | (2) The assets, liabilities, equity interests or items of consideration for which the initial accounting is incomplete. | | |

| Section 3 paragraph identifier | ASC 805- | Disclosure requirement | Yes or No | Remarks |
|---|---|---|---|---|
| Note 1 | 20-50-4A(c) | (3) The nature and amount of any measurement period adjustments recognized during the reporting period in accordance with ASC 805-10-25-17. | | |
| Note 1 | 20-50-4A(c) | (4) The amount of any measurement period adjustment recognized in the current-period income statement that would have been recognized in previous periods if the adjustment were recognized as of the acquisition date, unless the amount attributable to the previous periods is separately presented on the face of the income statement. | | |
| 14 | 30-50-4(a) | b. For each reporting period after the acquisition date until the entity collects, sells or otherwise loses the right to a contingent consideration asset, or until the entity settles a contingent consideration liability or the liability is canceled or expires: | | |
| 14 | 30-50-4(a)(1) | (1) Any changes in the recognized amounts, including any differences arising upon settlement. | | |
| 14 | 30-50-4(a)(2) | (2) Any changes in the range of outcomes (undiscounted) and the reasons for those changes. | | |
| 14 | 30-50-4(a)(3) | (3) The disclosures required by ASC 820-10-50. | | |
| Note 1 | 30-50-4(b) | c. A reconciliation of the carrying amount of goodwill at the beginning and end of the reporting period as required by ASC 350-20-50-1. | | |

| Section 3 paragraph identifier | ASC 805- | Disclosure requirement | Yes or No | Remarks |
|---|---|---|---|---|
| Note 1, Note 2 | 20-50-5 | 5. When measuring a contract asset or contract liability in accordance with ASC 606 in the accounting for a business combination, if either of the following practical expedients were used:<br>- For contracts that were modified before the acquisition date, an acquirer may reflect the aggregate effect of all modifications that occur before the acquisition date when:<br>1. Identifying the satisfied and unsatisfied performance obligations<br>2. Determining the transaction price<br>3. Allocating the transaction price to the satisfied and unsatisfied performance obligations.<br>- For all contracts, for purposes of allocating the transaction price, an acquirer may determine the standalone selling price at the acquisition date (instead of the contract inception date) of each performance obligation in the contract when the buyer has disclosed the following:<br>a. The expedients have been used<br>b. To the extent reasonably possible, a qualitative assessment of the estimated effect of applying each of these expedients. | | |
| Note 1 | 10-50-1<br>10-50-7 | 6. If the information provided in conjunction with items 1 to 3 of this section along with information required to be disclosed by other U.S. GAAP does not enable users of the financial statements to evaluate the nature and financial effect of a business combination that occurs either during the current reporting period or after the reporting date but before the financial statements are issued or available to be issued, the buyer has disclosed whatever additional information is necessary to enable users of the financial statements to perform that evaluation. | | |

| Section 3 paragraph identifier | ASC 805- | Disclosure requirement | Yes or No | Remarks |
|---|---|---|---|---|
| Note 1 | 10-50-5<br>10-50-7 | 7. If the information provided in conjunction with item 5 of this section along with information required to be disclosed by other U.S. GAAP does not enable users of the financial statements to evaluate the financial effects of adjustments recognized in the current reporting period that relate to business combinations that occurred in the current or previous reporting periods, the buyer has disclosed whatever additional information is necessary to enable users of the financial statements to perform that evaluation. | | |
| Note 1 | 740-50-1 | 8. The buyer has disclosed any acquisition-date income tax benefits or expenses recognized from changes in the buyer's valuation allowance for its previously existing deferred tax assets as a result of a business combination. | | |

**Note 1:** This information is not provided in the disclosure illustration included in ASC 805-10-55-37 to 55-50 and Section 3 of this appendix.
**Note 2:** This disclosure is not required prior to the adoption of ASU 2021-08. See Section 11.9.

## Section 2: Disclosures for combinations or transfers between entities under common control

The following table lists the disclosures required by ASC 805-50-50 for combinations between entities under common control (see Section 3.2).

| Disclosure requirement | Yes or No | Remarks |
|---|---|---|
| 1. For transfers of assets and liabilities or exchanges of equity interests between entities under common control, the receiving entity has made the following disclosures: | | |
| a. The nature of and effects on earnings per share of nonrecurring intra-entity transactions involving long-term assets and liabilities. | | |
| b. For the period in which the transfer of assets and liabilities or exchange of equity interests occurs: | | |
| (1) The name and brief description of the entity included in the reporting entity as a result of the net asset transfer or exchange of equity interests. | | |
| (2) The method of accounting for the transfer of net assets or exchange of equity interests. | | |

| Disclosure requirement | Yes or No | Remarks |
|---|---|---|
| c. Any additional disclosures required by ASC 850-10-50. | | |

## Section 3: Illustration of ASC 805 disclosure requirements

The footnote illustration in the table that follows was taken from ASC 805-10-55-37 to 55-50. The illustration is based on a hypothetical transaction in which Acquirer (a public entity) acquires Target (a private company). While the majority of the disclosures included in Section 1 are illustrated in this footnote, a limited number are not. As such, the disclosure requirements in Section 1 of this appendix should be referred to for a complete list of all of the disclosures required by ASC 805-10-50, 805-20-50, 805-30-50 and 805-740-50.

The footnote illustration itself is included in the third column of the table and is substantially as it appears in ASC 805-10-55-37 to 55-50. The two columns that precede the illustration are meant to facilitate the simultaneous use of the disclosure checklist in Section 1 and the footnote illustration included in this section. The first column lists the item from Section 1 of the disclosure checklist that is being illustrated and the second column provides a paragraph identifier that is used for cross-reference purposes in the disclosure checklist in Section 1.

In some cases, the information required to be disclosed has been presented in a tabular format in the illustration that follows. Keep in mind that this is one approach that could be used to satisfy these disclosure requirements. A narrative approach could also be used.

| Section 1 reference | Paragraph identifier (used as reference in Section 1) | Illustration from ASC 805-10-55-37 to 55-50 | |
|---|---|---|---|
| 1(a-d) | 1 | On June 30, 20X0, Acquirer acquired 15 percent of the outstanding common shares of Target. On June 30, 20X2, Acquirer acquired 60 percent of the outstanding common shares of Target. Target is a provider of data networking products and services in Canada and Mexico. As a result of the acquisition, Acquirer is expected to be the leading provider of data networking products and services in those markets. It also expects to reduce costs through economies of scale. | |
| 1(e), 1(l)(1) | 2 | The goodwill of $2,500 arising from the acquisition consists largely of the synergies and economies of scale expected from combining the operations of Acquirer and Target. All of the goodwill was assigned to Acquirer's network segment. | |
| 1(k) | 3 | None of the goodwill recognized is expected to be deductible for income tax purposes. | |
| | | The following table summarizes the consideration paid for Target and the amounts of the assets acquired and liabilities assumed recognized at the acquisition date, as well as the fair value at the acquisition date of the noncontrolling interest in Target. | |
| | | **At June 30, 20X2** | |
| 1(f) | 4 | **Consideration** | **$** |

| Section 1 reference | Paragraph identifier (used as reference in Section 1) | Illustration from ASC 805-10-55-37 to 55-50 | |
|---|---|---|---|
| 1(f)(1) | 5 | Cash | 5,000 |
| 1(f)(4) | 6 | Equity instruments (100,000 common shares of Acquirer) | 4,000 |
| 1(f)(3), 1(g)(1) | 7 | Contingent consideration arrangement | 1,000 |
| 1(f) | 8 | **Fair value of total consideration transferred** | 10,000 |
| 1(q)(1) | 9 | **Fair value of Acquirer's equity interest in Target held before the business combination** | 2,000 |
| | | | 12,000 |
| 1(m), 1(n) | 10 | **Acquisition-related costs** (included in selling, general, and administrative expenses in Acquirer's income statement for the year ending December 31, 20X2) | 1,250 |
| 1(i) | 11 | **Recognized amounts of identifiable assets acquired and liabilities assumed**<br>Financial assets<br>Inventory<br>Property, plant, and equipment<br>Identifiable intangible assets<br>Financial liabilities<br>Liability arising from a contingency<br>Total identifiable net assets | <br>3,500<br>1,000<br>10,000<br>3,300<br>(4,000)<br>(1,000)<br>12,800 |
| 1(p)(1) | 12 | **Noncontrolling interest in Target** | (3,300) |
| | | **Goodwill** | 2,500 |
| | | | 12,000 |
| 1(f)(4) | 13 | The fair value of the 100,000 common shares issued as part of the consideration paid for Target ($4,000) was determined on the basis of the closing market price of Acquirer's common shares on the acquisition date. | |
| 1(f)(3), 1(g), 4(b) | 14 | The contingent consideration arrangement requires Acquirer to pay the former owners of Target 5 percent of the revenues of an unconsolidated equity investment, referred to as Investee, owned by Target, in excess of $7,500 for 20X3, up to a maximum amount of $2,500 (undiscounted). The potential undiscounted amount of all future payments that Acquirer could be required to make under the contingent consideration arrangement is between $0 and $2,500. The fair value of the contingent consideration arrangement of $1,000 was estimated by applying the income approach. That measure is based on significant inputs that are not observable in the market, which Section 820-10-35 refers to as Level 3 inputs. Key | |

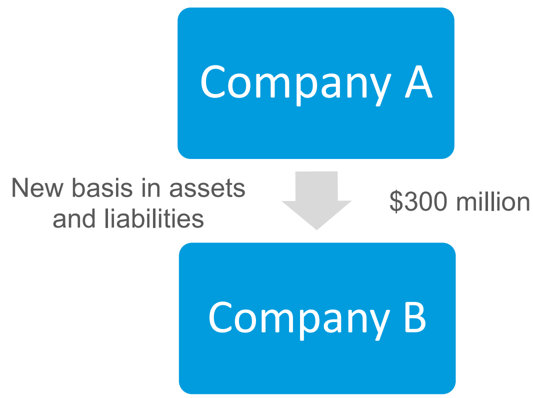
| Section 1 reference | Paragraph identifier (used as reference in Section 1) | Illustration from ASC 805-10-55-37 to 55-50 | | |
|---|---|---|---|---|
| | | assumptions include a discount rate range of 20 percent to 25 percent and a probability-adjusted level of revenues in Investee between $10,000 and $20,000. As of December 31, 20X2, the amount recognized for the contingent consideration arrangement, the range of outcomes, and the assumptions used to develop the estimates had not changed. | | |
| 1(h) | 15 | The fair value of the financial assets acquired includes receivables under sales-type leases or direct financing leases of data networking equipment with a fair value of $2,000. The gross amount due under the contracts is $3,100, of which $450 is expected to be uncollectible. | | |
| 4(a) | 16 | The fair value of the acquired identifiable intangible assets of $3,300 is provisional pending receipt of the final valuations for those assets. | | |
| 1(j) | 17 | A liability of $1,000 has been recognized at fair value for expected warranty claims on products sold by Target during the last 3 years. Acquirer expects that the majority of this expenditure will be incurred in 20X3 and that all will be incurred by the end of 20X4. | | |
| 1(p)(2) | 18 | The fair value of the noncontrolling interest in Target, a private entity, was estimated by applying the income approach and a market approach. This fair value measurement is based on significant inputs that are not observable in the market and thus represents a fair value measurement categorized within Level 3 of the fair value hierarchy described in Section 820-10-35. Key assumptions include a discount rate range of 20 percent to 25 percent, a terminal value based on a range of terminal earnings before interest, taxes, depreciation, and amortization multiples between 3 and 5 (or, if appropriate, based on long-term sustainable growth rates ranging between 3 percent and 6 percent), financial multiples of entities deemed to be similar to Target, and adjustments because of the lack of control or lack of marketability that market participants would consider when measuring the fair value of the noncontrolling interest in Target. | | |
| 1(q)(2) | 19 | Acquirer recognized a gain of $500 as a result of remeasuring to fair value its 15 percent equity interest in Target held before the business combination. The gain is included in other income in Acquirer's income statement for the year ending December 31, 20X2. | | |
| 1(r) | 20 | The amounts of Target's revenue and earnings included in Acquirer's consolidated income statement for the year ended December 31, 20X2, and the revenue and earnings of the combined entity had the acquisition date been January 1, 20X2 (if comparative financial statements are not presented), and January 1, 20X1 (if comparative financial statements are presented), are as follows. | | |
| | | | **Revenue** | **Earnings** |
| 1(r)(1) | 21 | Actual from 6/30/20X2–12/31/20X2 | $4,090 | $1,710 |

| Section 1 reference | Paragraph identifier (used as reference in Section 1) | Illustration from ASC 805-10-55-37 to 55-50 | | |
|---|---|---|---|---|
| 1(r)(2) | 22 | 20X2 supplemental pro forma from 1/1/20X2–12/31/20X2 | $27,670 | $12,870 |
| 1(r)(3) | 23 | 20X2 supplemental pro forma from 1/1/20X2–12/31/20X2 | $27,670 | $14,770 |
| 1(r)(3) | 24 | 20X1 supplemental pro forma from 1/1/20X1–12/31/20X1 | $26,985 | $12,325 |
| 1(r)(4) | 25 | 20X2 supplemental pro forma earnings were adjusted to exclude $1,250 of acquisition-related costs incurred in 20X2 and $650 of nonrecurring expense related to the fair value adjustment to acquisition-date inventory. 20X1 supplemental pro forma earnings were adjusted to include these charges. | | |

# Appendix C: Pushdown accounting

## C.1 Background

Pushdown accounting refers to pushing down the buyer's accounting and reporting basis (which is recognized in conjunction with its accounting for a business combination) to the target's standalone financial statements. For example, assume Company A buys 100% of Company B from an unrelated third party for consideration of $300 million. For purposes of its consolidated financial statements, Company A accounts for the acquisition using the guidance in ASC 805. Assume further that Company B's net book value was $40 million immediately prior to the acquisition and that it will continue to issue its own standalone financial statements after the acquisition. If Company B applies pushdown accounting, it establishes a new basis of $300 million for the net assets in its standalone financial statements (provided Company A's accounting for the business combination resulted in the recognition of goodwill and not a bargain purchase gain).




Pushdown accounting guidance applicable to both public and private entities is included in ASC 805-50. Key questions that arise with respect to pushdown accounting include the following:

- Who can apply pushdown accounting?
- When may pushdown accounting be applied?
- How is pushdown accounting applied?
- How should the assets and liabilities recognized in pushdown accounting be accounted for after the acquisition?
- When should acquisition debt or a contingent consideration liability be recognized by the target?
- What disclosures are required when pushdown accounting is applied?
- If pushdown accounting is not applied, would the target's standalone financial statements be affected in any other way by the acquisition?

This appendix addresses each of these questions and provides an example of pushdown accounting.

## C.2 Who can apply pushdown accounting?

Pushdown accounting may be applied by: (a) a business or businesses that are acquired in a business combination or (b) a nonprofit activity or business over which control is gained in an acquisition by a not-for-profit entity (see Section 3.3). Entities that may apply pushdown accounting are collectively referred to as targets in this appendix. Entities that acquire targets in a business combination or a not-for-profit acquisition are collectively referred to as buyers in this appendix. Given that pushdown accounting refers to the mechanics of pushing down the stepped-up bases recorded by the buyer in its accounting for the acquisition of a target in accordance with ASC 805 or ASC 958-805 to the target's standalone financial statements, only those targets acquired in a business combination or not-for-profit acquisition are permitted to apply pushdown accounting.

## C.3 When may pushdown accounting be applied?

Pushdown accounting is optional for a target when a buyer obtains control of the target and is required to apply business combination accounting (see Section 2.1). Examples of situations in which a buyer obtains control of a target that is not a VIE include the following:

- Buyer did not previously own an investment in Target and acquires a 60% interest in Target, which results in Buyer obtaining a controlling financial interest in Target.
- Buyer previously owned a 20% interest in Target and acquires an additional 35% interest in Target (for a total ownership interest in Target of 55%), which results in Buyer obtaining a controlling financial interest in Target.
- Buyer obtains control over Target through contract alone.

Whether an entity obtains control of a target that is a VIE depends on whether the entity is considered the PB of the target, which is determined using the guidance in ASC 810-10-25-38.

In each situation in which the buyer obtains control of the target (assuming the target is a business, and the buyer and target are not under common control), the buyer should account for its acquisition of the target as a business combination in accordance with ASC 805. It follows then, that the target has the option to push down to its standalone financial statements those amounts recognized by the buyer in its accounting for the business combination. This is the case regardless of whether the target is a voting interest entity or a VIE.

Pushdown accounting may not be applied when the parent of a subsidiary increases its controlling ownership interest in the subsidiary. For example, pushdown accounting may not be applied by the subsidiary when the parent acquires an additional 10% interest in its subsidiary such that the parent's ownership interest in the subsidiary increases from 70% to 80%. The parent controlled the subsidiary both before and after acquiring the additional 10% interest. Therefore, the parent's acquisition of the additional 10% interest did not result in the parent *obtaining* control over the subsidiary. The parent should account for the acquisition of the additional 10% interest in equity (see Section 16.1). While the subsidiary should not apply pushdown accounting as of the acquisition date for the additional 10% interest, as discussed in Question CQ.3.1, the subsidiary may elect to retrospectively apply pushdown accounting (in accordance with ASC 250) as of the acquisition date for the transaction or other event in which the parent initially obtained control of the subsidiary.

If the target is an SEC filer or conduit bond obligor for conduit debt securities traded in a public market (i.e., public conduit bond obligor), it should make its election to apply pushdown accounting before it issues its financial statements for the reporting period in which the buyer obtained control. If the target is not an SEC filer or a public conduit bond obligor, it should make its election to apply pushdown accounting before it makes available for issuance its financial statements for the reporting period in which the buyer obtained control.

*CQ.3.1 If the target does not make the election to apply pushdown accounting before it issues or makes available for issuance its financial statements for the reporting period in which the buyer obtained control, is it precluded from electing pushdown accounting at a later point in time?*

No. The target may elect to apply pushdown accounting at a later point in time. However, if it does so, the change in accounting principle guidance in ASC 250 must be applied. In general, ASC 250 requires a change in accounting principle to be preferable and requires retrospective application of that change in accounting principle. Regardless of when the election to apply pushdown accounting is made, pushdown accounting is always applied as of the acquisition date for the most-recent event in which the buyer obtained control of the target.

*CQ.3.2 May one of the target's subsidiaries apply pushdown accounting in its standalone financial statements?*

Yes. The subsidiary of a target may apply pushdown accounting in its standalone financial statements regardless of whether the target itself applied pushdown accounting. In other words, one of the target's subsidiaries may apply pushdown accounting even if the target does not itself apply pushdown accounting. The same guidance otherwise applicable to the target with respect to applying pushdown accounting is also applicable to the target's subsidiary.

*CQ.3.3 If the target or one of its subsidiaries elects to apply pushdown accounting, may it later decide to reverse its election?*

No. The election to apply pushdown accounting cannot be reversed.

*CQ.3.4 If control of the target has changed hands multiple times, is the target allowed to apply pushdown accounting in only some (i.e., not all) cases in which a buyer obtains control?*

Yes. The election to apply pushdown accounting is made each time a buyer obtains control of a target. The election to apply or not to apply pushdown accounting upon one buyer obtaining control of the target does not affect the target's subsequent opportunities to apply pushdown accounting when a different buyer obtains control of the target. In other words, the target not electing to apply pushdown accounting when previous buyers obtained control over it does not mean the target is precluded from electing pushdown accounting in the future if a different buyer obtains control over it.

*CQ.3.5 May the target apply pushdown accounting if the owner of target sells its controlling financial interest to multiple unrelated buyers such that no one buyer obtains control over the target?*

No. While there is a loss of control (i.e., control of target goes from the current owner to no one owner), none of the buyers obtains control of the target. For example, if the owner of a target sells five equal parts of its 100% ownership interest in the target to five different unrelated buyers (i.e., 20% to each buyer), none of the buyers applies business combination accounting to the acquisition of its 20% interest in the target. Because business combination accounting is not applied by any of the buyers, there is nothing to push down to the target's standalone financial statements.

## C.4 How is pushdown accounting applied?

In general, the target applies pushdown accounting by recording in its standalone financial statements the amounts recognized by the buyer in its accounting for the business combination. In applying ASC 805 to its acquisition of the target, the buyer records most of the assets and liabilities acquired at fair value. These are the amounts recognized by the target in its standalone financial statements.

There are limited situations in which the buyer is not required to apply ASC 805 to its acquisition of the target, but the target is still allowed to apply pushdown accounting. Examples include when the buyer is an individual who does not prepare financial statements in accordance with U.S. GAAP or when the buyer is an investment company following the guidance in ASC 946. In these situations, if the target applies pushdown accounting, the amounts that the buyer would have recognized if it had followed ASC 805 to account for its acquisition of the target would be pushed down to the target's standalone financial statements.

Special considerations arise in preparing the target's activity-based financial statements (e.g., income statement, cash flow statement) when it applies pushdown accounting. As the application of pushdown accounting effectively results in the creation of a new accounting entity, the target's operating results prior to pushdown accounting should not be combined with those subsequent to pushdown accounting. As such, if a full year of operations is shown in the activity-based financial statements, the periods prior to the application of pushdown accounting should be separated from the periods after the application of pushdown accounting by a heavy vertical black line and clearly labeled *Predecessor* (for operations prior to pushdown accounting) and *Successor* (for operations subsequent to pushdown accounting). The predecessor and successor amounts cannot be combined. In other words, a total amount of net income for the year should not be presented. Footnote disclosures with activity-based information also should be presented separately for the predecessor and successor accounting periods.

*CQ.4.1 Does the goodwill recognized by the buyer get pushed down to the target's standalone financial statements?*

Yes. The goodwill recognized by the buyer in its accounting for the business combination is pushed down to the target's standalone financial statements.

*CQ.4.2 Does a bargain purchase gain recognized by the buyer get pushed down to the target's standalone financial statements?*

No. Unlike goodwill, a bargain purchase gain recognized by the buyer does not get pushed down to the target's standalone financial statements because it is not part of the buyer's accounting basis. Given the mechanics of pushdown accounting, the amount of any bargain purchase gain recognized by the buyer is essentially recorded in the target's additional paid-in capital.

*CQ.4.3 Should the buyer's transaction costs be pushed down to the target?*

No. The buyer's transaction costs should not be pushed down to the target's standalone financial statements because they are not part of the buyer's accounting basis.

*CQ.4.4 What does the equity section of the target's standalone balance sheet consist of after pushdown accounting is applied?*

When applying pushdown accounting, none of the buyer's equity accounts should be pushed down to the target. Instead, the target's common stock account should reflect the par value of its issued shares. In addition, if the target has preferred stock outstanding, it should be reflected in the target's standalone financial statements. The target's additional paid-in capital account should represent the difference between the net assets recorded as a result of applying pushdown accounting and the sum of its common stock and preferred stock accounts. Retained earnings should be reset to zero given that pushdown accounting effectively results in the creation of a new accounting entity.

*CQ.4.5 How should the effects of pushdown accounting on the target's equity be reflected in its standalone statement of stockholders' equity?*

As discussed in Question CQ.4.4, the effects of pushdown accounting are included in the target's additional paid-in capital account. When reflecting these effects in the target's standalone statement of stockholders' equity, it should be clear that the effects of pushdown accounting on the target's additional paid-in capital are just that, and not a capital infusion from investors. A label such as *Application of pushdown accounting* (or something similar) should be used by the target as the post-pushdown accounting starting point for additional paid-in capital in its standalone statement of stockholders' equity.

*CQ.4.6 Should measurement period adjustments recognized by the buyer in its accounting for the business combination be pushed down to the target?*

Yes. As discussed in detail in Section 12.7, in situations in which the buyer is unable to complete its accounting for a business combination by the time it has to issue its financial statements, the buyer should recognize provisional amounts in its financial statements and has up to one year from the acquisition date (measurement period) to finalize those amounts. These provisional amounts are preliminary acquisition-date estimates that are expected to be adjusted to their final amounts during the measurement period when the buyer obtains additional information about the facts and circumstances that existed as of the acquisition date. While not specifically addressed in the Codification, we believe any measurement period adjustments recognized by the buyer should be pushed down to the target. We believe this is appropriate as the application of pushdown accounting refers to pushing down the acquirer's accounting and reporting basis to the target's standalone financial statements and these measurement period adjustments would form part of the acquirer's accounting basis.

### C.5 How should the assets and liabilities recognized in pushdown accounting be accounted for after the acquisition?

If ASC 805 provides subsequent accounting guidance for an asset or liability recognized by the target in pushdown accounting (e.g., indemnification asset), that guidance should be followed by the target. If ASC 805 does not provide subsequent accounting guidance for the asset or liability, other applicable guidance in the Codification should be used for subsequent accounting purposes. For example, the guidance in ASC 350 should be used by the target to subsequently account for the goodwill and other intangible assets it recognized as a result of applying pushdown accounting.

### C.6 When should acquisition debt or a contingent consideration liability be recognized by the target?

Acquisition debt or a contingent consideration liability of the buyer should only be recorded by the target if it represents an obligation of the target that should be recognized in accordance with other relevant guidance in the Codification. When this is the case, it is not that the buyer's acquisition debt or contingent consideration liability is being pushed down to the target per se, but that the target itself is obligated to repay the debt or pay the contingent consideration incurred by the buyer to purchase the target. For example, if the buyer and the target are jointly and severally liable for the acquisition debt, the target should apply the guidance in ASC 405-40 to determine whether a liability should be recognized, and if so, the amount of that liability. Specific disclosures related to joint and several liabilities are also required. For another example, if the terms of the purchase agreement obligate the target to pay contingent consideration to the sellers if it becomes due and payable, the target should recognize a contingent consideration liability.

Because acquisition debt and contingent consideration liabilities of the buyer are only recorded by the target if they represent obligations of the target in accordance with other relevant guidance in the Codification, if the buyer's acquisition debt or contingent consideration liability is not an obligation of the target, the debt or contingent consideration liability is not recognized by the target even if, for example, the target guarantees or pledges its assets as collateral for the debt or contingent consideration liability. However, if the target guarantees the acquisition debt or contingent consideration liability, it must consider the accounting guidance and disclosure requirements for guarantees in ASC 460.

### C.7 What disclosures are required when pushdown accounting is applied?

A target that applies pushdown accounting must disclose the information that users need to evaluate the effects of pushdown accounting on its financial statements. For this purpose, the disclosure requirements refer to the information otherwise required to be disclosed by the buyer in a business combination or the corollary information from the target's perspective, including:

- The name of the buyer
- A description of the buyer
- A description of how the buyer obtained control of the target
- The acquisition date
- The amounts for each of the following as of the acquisition date:
  - Total consideration transferred by the buyer
  - Major classes of assets and liabilities

- The provisional amounts recognized by the buyer (and pushed down to the target) because the buyer's accounting for the business combination was incomplete at the reporting date and the reasons why its accounting was incomplete
- When goodwill is recognized, a qualitative description of the factors that gave rise to the goodwill
- When a gain from a bargain purchase is recognized by the buyer:
  - The amount of the gain essentially recognized by the target in additional paid-in capital
  - A qualitative description of what gave rise to the gain
- Information to evaluate the financial effects of adjustments made in the current period to amounts pushed down in the current or previous period (e.g., measurement period adjustments)

## C.8 If pushdown accounting is not applied, would the target's standalone financial statements be affected in any other way by the acquisition?

Even when a target decides not to apply pushdown accounting in its standalone financial statements, the deferred taxes in its standalone financial statements may still be affected by the acquisition. If the acquisition of the target results in the tax basis of one of the target's assets or liabilities changing, the temporary difference related to the asset or liability changes as does the related deferred tax asset or liability. The tax effects of these changes in tax bases (along with any change in the valuation allowance for deferred tax assets as of the acquisition date) should be included in equity because the acquisition of target was among its shareholders (i.e., the transaction giving rise to the changes in tax bases involves the buyer and sellers, both shareholders of the target). Equity treatment is appropriate based on the guidance in ASC 740-20-45-11(g), which indicates that: "All changes in the tax bases of assets and liabilities caused by transactions among or with shareholders shall be included in equity including the effect of valuation allowances initially required upon recognition of any related deferred tax assets."

For example, consider a transaction in which the buyer purchases 100% of the target's shares in a transaction that is treated as a purchase of assets for tax purposes, but pushdown accounting is not applied. As a result of this transaction, the target's bases in its assets and liabilities for book purposes are not adjusted, but the tax bases of its assets and liabilities are adjusted. Consequently, the deferred tax liabilities and assets of the target must also be adjusted accordingly with a corresponding adjustment to additional paid-in capital. If a valuation allowance was required for any deferred tax assets in this scenario, the effect of this valuation allowance should also be included in equity. Changes in the valuation allowance in subsequent periods should be included in the income statement.

**Example C-1: Pushdown accounting**

On December 19, 20X2, a small group of investors pays $2.5 million in cash for the stock of Company A (which is a newly created holding company). On that same date, Company A obtains a bank term note in the amount of $8 million and acquires all the outstanding common stock of Company B (an operating company) for $10.5 million. The term note is collateralized by the stock of Company A. Company B will continue to prepare and issue its standalone financial statements.

For simplicity purposes, assume the amounts recorded by Company A as of the acquisition date for the assets and liabilities of Company B measured in accordance with ASC 805 were the same as their carrying amounts, except for property and equipment. The fair value of the property and equipment of Company B was determined, by appraisal, to be $15 million. Also for simplicity purposes, the income tax effects of the acquisition have been ignored.

The following table illustrates the application of pushdown accounting to Company B and the amounts that would be reflected in Company B's standalone financial statements after pushdown accounting is applied:

| | Company A (in 000s) | Company B (in 000s) | | |
|---|---|---|---|---|
| | | Before purchase at historical cost | Pushdown entries | Presentation on pushdown basis |
| Current assets | - | $6,800 | - | $6,800 |
| Property and equipment, net | - | 8,900 | $6,100 | 15,000 |
| Investment in Company B | $10,500 | - | - | - |
| Goodwill (Note 1) | - | - | 200 | 200 |
| Total assets | $10,500 | $15,700 | $6,300 | $22,000 |
| | | | | |
| Current liabilities | - | $6,700 | - | $6,700 |
| Long-term debt | $8,000 | 4,800 | - | 4,800 |
| Common stock | 2,500 | 1,000 | - | 1,000 |
| Additional paid-in capital | - | - | 9,500 | 9,500 |
| Retained earnings | - | 3,200 | (3,200) | - |
| Total liabilities and equity | $10,500 | $15,700 | $6,300 | $22,000 |

**Note 1:** Goodwill is the difference between the consideration transferred of $10.5 million and the net assets acquired (measured in accordance with ASC 805) of $10.3 million (which consists of current assets of $6.8 million, property and equipment of $15 million, current liabilities of $6.7 million and long-term debt of $4.8 million).

## Appendix D: U.S. GAAP vs. IFRS comparison

Currently, more than 120 countries require or permit the use of IFRS, with a significant number of countries requiring IFRS (or some form of IFRS) by public entities (as defined by those specific countries). Of those countries that do not require use of IFRS by public entities, perhaps the most significant is the U.S. The SEC requires domestic registrants to apply U.S. GAAP, while foreign private issuers are allowed to use IFRS as issued by IASB (which is the IFRS focused on in this comparison). While the SEC continues to discuss the possibility of allowing domestic registrants to provide supplemental financial information based on IFRS (with a reconciliation to U.S. GAAP), there does not appear to be a specified timeline for moving forward with that possibility.

Although the SEC currently has no plans to permit the use of IFRS by domestic registrants, IFRS remains relevant to these entities, as well as private companies in the U.S., given the continued expansion of IFRS use across the globe. For example, many U.S. companies are part of multinational entities for which financial statements are prepared in accordance with IFRS, or may wish to compare themselves to such entities. Alternatively, a U.S. company's business goals might include international expansion through organic growth or acquisitions. For these and other reasons, it is critical to gain an understanding of the effects of IFRS on a company's financial statements.

The guidance related to accounting for business combinations in U.S. GAAP is included in ASC 805. In IFRS, the guidance related to accounting for business combinations is included in IFRS 3.

### Comparison

The significant differences between U.S. GAAP and IFRS related to accounting for business combinations are summarized in the following table.

| | U.S. GAAP | IFRS |
|---|---|---|
| **Relevant guidance** | ASC 805 | IFRS 3 |
| **Definition of control for purposes of identifying a business combination** | For purposes of identifying a business combination, control is defined in ASC 810-10-15-8 as follows: "...the usual condition for a controlling financial interest is ownership of a majority voting interest, and, therefore, as a general rule ownership by one reporting entity, directly or indirectly, of more than 50 percent of the outstanding voting shares of another entity is a condition pointing toward consolidation."<br><br>Additional guidance applies for purposes of determining whether an entity obtains control over a limited partnership or a variable interest entity (as a result of becoming its primary beneficiary). | For purposes of identifying a business combination, control is defined in paragraph 6 of IFRS 10, *Consolidated Financial Statements*, as follows: "An investor controls an investee when the investor is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee." |

| | U.S. GAAP | IFRS |
|---|---|---|
| **Definition of a business** | Mandatory Screen Test<br>If substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets, the set is not a business. | Optional Screen test<br>An entity may elect on a transaction-by-transaction basis whether to apply the screen test when evaluating whether an acquired set is a business. |
| **Pushdown accounting** | An acquiree has the option to apply pushdown accounting in its separate financial statements when an acquirer obtains control of the acquiree. | IFRS does not contain the notion of pushdown accounting. |
| **Acquired operating leases when acquiree is a lessor** | The acquirer recognizes an intangible asset or liability for terms of an operating lease that are favorable or unfavorable to market. | The acquirer does not recognize an intangible asset or liability related to the operating lease separate from the leased asset. The terms of the lease factor into the estimate of the leased asset's fair value. |
| **Acquired contingencies** | The acquirer recognizes assets and liabilities arising from contingencies at fair value if fair value can be determined. If fair value cannot be determined, then assets and liabilities arising from contingencies are only recognized if it is probable at the acquisition date that an asset or liability exists and if its amount is reasonably estimable. | The acquirer recognizes contingent liabilities of the acquiree if a present obligation exists and its fair value can be measured reliably.<br>The acquirer does not recognize contingent assets. |
| **Contract assets and liabilities (after adoption of ASU 2021-08)** | The buyer should recognize and measure contract assets and liabilities based on the guidance in ASC 606 (except when one of the practical expedients provided in ASC 805-20-30-29 has been elected). | The buyer should recognize and measure contract assets and contract liabilities at their fair values. |
| **Noncontrolling interests** | Noncontrolling interests are measured at fair value, which results in the acquirer recognizing 100% of the acquiree's assets (including goodwill) and liabilities and | For noncontrolling interests that represent present ownership interests and entitle the holder to a proportionate share of net assets if the entity is liquidated, acquirers may elect to measure |

| | U.S. GAAP | IFRS |
|---|---|---|
| | measuring them predominantly at their respective fair values in accordance with ASC 805. | those interests at either (a) their full fair value or (b) their proportionate share of the net amount recognized for the acquiree's assets and liabilities. In general, all other noncontrolling interests must be measured at fair value. |
| **Measurement period adjustments** | The acquirer recognizes adjustments to provisional amounts identified for a business combination in the period the adjustments are determined (instead of retroactively). | The acquirer recognizes any adjustments occurring in the measurement period retroactively. |
| **Combinations of entities under common control** | Combinations of entities under common control are accounted for at historical cost for the group. | Combinations of entities under common control are outside the scope of IFRS 3. Entities commonly apply U.S. GAAP or can elect to apply acquisition accounting. |

These are the significant differences between U.S. GAAP and IFRS related to accounting for business combinations. Refer to ASC 805 and IFRS 3 for all of the specific requirements applicable to accounting for business combinations. In addition, refer to our U.S. GAAP vs. IFRS comparisons series for more comparisons highlighting other significant differences between these two financial reporting frameworks.

## Appendix E: Acronyms, literature and technical accounting guide references

Many acronyms are used throughout this guide, and numerous references are made to specific topics and subtopics in the ASC. Provided in this appendix are: (a) an acronym legend, which lists the acronyms used throughout this guide and their corresponding definition; (b) a literature listing, which lists the guidance referred to throughout this guide and the corresponding titles; and (c) a listing of our other technical accounting guides referred to throughout this guide.

### Acronym legend

| Acronym | Definition |
|---|---|
| AFS | Available for sale |
| AICPA | American Institute of Certified Public Accountants |
| AOCI | Accumulated other comprehensive income |
| ARO | Asset retirement obligation |
| ASC | FASB Accounting Standards Codification |
| ASR | SEC Accounting Series Release |
| ASU | FASB Accounting Standards Update |
| AVG | AICPA Accounting and Valuation Guide |
| CAC | Contributory asset charge |
| CON | FASB Statement of Financial Accounting Concepts |
| CRI | Customer-related intangible (assets) |
| DLOC | Discount for lack of control |
| DLOM | Discount for lack of marketability |
| EITF | Emerging Issues Task Force |
| FAS | Financial Accounting Standard |
| FASB | Financial Accounting Standards Board |
| FCC | Federal Communications Commission |
| FSP | FASB Staff Position |
| FTB | FASB Technical Bulletin |
| GAAP | Generally accepted accounting principles |
| HTM | Held to maturity |
| IASB | International Accounting Standards Board |
| IFRS | International Financial Reporting Standards |
| IP | Intellectual property |
| IPR&D | In-process research and development |
| MPEEM | Multi-period excess earnings method |

| Acronym | Definition |
|---|---|
| NCA | Noncompete agreement |
| NCI | Noncontrolling interest |
| NOL | Net operating loss |
| NYSE | New York Stock Exchange |
| OCI | Other comprehensive income |
| PB | Primary beneficiary |
| PBE | Public business entity |
| PCD | Purchased (financial assets with) credit deterioration |
| PCI | Purchased credit impaired (assets) |
| PEG | Private equity group |
| PHEI | Previously held equity interest |
| R&D | Research and development |
| ROU | Right-of-use (asset) |
| SAB | SEC Staff Accounting Bulletin |
| SEC | Securities and Exchange Commission |
| SRC | Smaller reporting company |
| TCJA | Tax Cuts and Jobs Act |
| U.S. | United States |
| VIE | Variable interest entity |

## Literature listing

| ASC topic or subtopic | Title |
|---|---|
| 205-20 | Presentation of Financial Statements – Discontinued Operations |
| 230 | Statement of Cash Flows |
| 235-10 | Notes to Financial Statements – Overall |
| 250 | Accounting Changes and Error Corrections |
| 250-10 | Accounting Changes and Error Corrections – Overall |
| 280 | Segment Reporting |
| 280-10 | Segment Reporting – Overall |
| 310 | Receivables |
| 310-10 | Receivables – Overall |
| 310-20 | Receivables – Nonrefundable Fees and Other Costs |

| ASC topic or subtopic | Title |
|---|---|
| 310-30 | Receivables – Loans and Debt Securities Acquired with Deteriorated Credit Quality |
| 320 | Investments—Debt Securities |
| 320-10 | Investments—Debt Securities – Overall |
| 321 | Investments—Equity Securities |
| 325-40 | Investments—Other – Beneficial Interests in Securitized Financial Assets |
| 326 | Financial Instruments—Credit Losses |
| 326-20 | Financial Instruments—Credit Losses – Measured at Amortized Cost |
| 326-30 | Financial Instruments—Credit Losses – Available-for-Sale Debt Securities |
| 330 | Inventory |
| 340-10 | Other Assets and Deferred Costs – Overall |
| 340-40 | Other Assets and Deferred Costs – Contracts with Customers |
| 350 | Intangibles—Goodwill and Other |
| 350-20 | Intangibles—Goodwill and Other – Goodwill |
| 350-30 | Intangibles—Goodwill and Other – General Intangibles Other than Goodwill |
| 360 | Property, Plant, and Equipment |
| 360-10 | Property, Plant, and Equipment – Overall |
| 405-40 | Liabilities – Obligations Resulting from Joint and Several Liability Arrangements |
| 410-20 | Asset Retirement and Environmental Obligations – Asset Retirement Obligations |
| 420 | Exit or Disposal Cost Obligations |
| 420-10 | Exit or Disposal Cost Obligations – Overall |
| 450 | Contingencies |
| 450-20 | Contingencies – Loss Contingencies |
| 450-30 | Contingencies – Gain Contingencies |
| 460 | Guarantees |
| 470-50 | Debt – Modifications and Extinguishments |
| 480 | Distinguishing Liabilities from Equity |
| 480-10 | Distinguishing Liabilities from Equity – Overall |
| 505-10 | Equity – Overall |
| 505-60 | Equity – Spinoffs and Reverse Spinoffs |
| 606 | Revenue from Contracts with Customers |
| 606-10 | Revenue from Contracts with Customers – Overall |

| ASC topic or subtopic | Title |
|---|---|
| 610-20 | Other Income – Gains and Losses from the Derecognition of Nonfinancial Assets |
| 710-10 | Compensation—General – Overall |
| 712 | Compensation—Nonretirement Postemployment Benefits |
| 712-10 | Compensation—Nonretirement Postemployment Benefits – Overall |
| 715 | Compensation—Retirement Benefits |
| 715-30 | Compensation—Retirement Benefits – Defined Benefit Plans—Pension |
| 715-60 | Compensation—Retirement Benefits – Defined Benefit Plans—Other Postretirement |
| 718 | Compensation—Stock Compensation |
| 718-10 | Compensation—Stock Compensation – Overall |
| 740 | Income Taxes |
| 740-10 | Income Taxes – Overall |
| 740-20 | Income Taxes – Intraperiod Tax Allocation |
| 805 | Business Combinations |
| 805-10 | Business Combinations – Overall |
| 805-20 | Business Combinations – Identifiable Assets, Liabilities, and Any Noncontrolling Interest |
| 805-30 | Business Combinations – Goodwill or Gain from Bargain Purchase, Including Consideration Transferred |
| 805-40 | Business Combinations – Reverse Acquisitions |
| 805-50 | Business Combinations – Related Issues |
| 805-740 | Business Combinations – Income Taxes |
| 808 | Collaborative Arrangements |
| 810 | Consolidation |
| 810-10 | Consolidation – Overall |
| 815 | Derivatives and Hedging |
| 815-10 | Derivatives and Hedging – Overall |
| 815-15 | Derivatives and Hedging – Embedded Derivatives |
| 815-20 | Derivatives and Hedging – Hedging—General |
| 815-40 | Derivatives and Hedging – Contracts in Entity's Own Equity |
| 820 | Fair Value Measurement |
| 820-10 | Fair Value Measurement – Overall |
| 825-10 | Financial Instruments – Overall |

| ASC topic or subtopic | Title |
|---|---|
| 840 | Leases |
| 840-30 | Leases – Capital Leases |
| 842 | Leases |
| 842-10 | Leases – Overall |
| 842-20 | Leases – Lessee |
| 842-30 | Leases – Lessor |
| 842-50 | Leases – Leveraged Lease Arrangements |
| 845 | Nonmonetary Transactions |
| 845-10 | Nonmonetary Transactions – Overall |
| 850 | Related Party Disclosures |
| 850-10 | Related Party Disclosures – Overall |
| 852 | Reorganizations |
| 860 | Transfers and Servicing |
| 860-50 | Transfers and Servicing – Servicing Assets and Liabilities |
| 932 | Extractive Industries—Oil & Gas |
| 932-360 | Extractive Industries—Oil & Gas – Property, Plant, and Equipment |
| 944 | Financial Services—Insurance |
| 944-10 | Financial Services—Insurance – Overall |
| 944-805 | Financial Services—Insurance – Business Combinations |
| 946 | Financial Services—Investment Companies |
| 954-805 | Health Care Entities – Business Combinations |
| 954-810 | Health Care Entities – Consolidation |
| 958-805 | Not-for-Profit Entities – Business Combinations |
| 958-810 | Not-for-Profit Entities – Consolidation |
| 960 | Plan Accounting—Defined Benefit Pension Plans |
| 962 | Plan Accounting—Defined Contribution Pension Plans |
| 965 | Plan Accounting—Health and Welfare Benefit Plans |
| 985-20 | Software – Costs of Software to Be Sold, Leased, or Marketed |

| Abbreviation used herein | Responsible party | Title |
|---|---|---|
| ASU 2014-02 | FASB | Intangibles—Goodwill and Other (Topic 350): Accounting for Goodwill |
| ASU 2014-09 | FASB | Revenue from Contracts with Customers (Topic 606) |
| ASU 2014-18 | FASB | Business Combinations (Topic 805): Accounting for Identifiable Intangible Assets in a Business Combination |
| ASU 2016-02 | FASB | Leases (Topic 842) |
| ASU 2016-09 | FASB | Compensation—Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting |
| ASU 2016-13 | FASB | Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments |
| ASU 2016-15 | FASB | Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments |
| ASU 2017-01 | FASB | Business Combinations (Topic 805): Clarifying the Definition of a Business |
| ASU 2017-04 | FASB | Intangibles—Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment |
| ASU 2017-05 | FASB | 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 |
| ASU 2018-07 | FASB | Compensation—Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting |
| ASU 2018-12 | FASB | Financial Services—Insurance (Topic 944): Targeted Improvements to the Accounting for Long-Duration Contracts |
| ASU 2018-13 | FASB | Fair Value Measurement (Topic 820): Disclosure Framework—Changes to the Disclosure Requirements for Fair Value Measurement |
| ASU 2019-06 | FASB | Intangibles—Goodwill and Other (Topic 350), Business Combinations (Topic 805), and Not-for-Profit Entities (Topic 958): Extending the Private Company Accounting Alternatives on Goodwill and Certain Identifiable Intangible Assets to Not-for-Profit Entities |
| ASU 2020-05 | FASB | Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities |
| ASU 2020-11 | FASB | Financial Services—Insurance (Topic 944): Effective Date and Early Application |
| ASU 2021-08 | FASB | Business Combinations (Topic 805): Accounting for Contract Assets and Contract Liabilities from Contracts with Customers |
| Statement 5 | FASB | Accounting for Contingencies |
| Statement 141R | FASB | Business Combinations (revised 2007) |

| Abbreviation used herein | Responsible party | Title |
|---|---|---|
| Statement 141 | FASB | Business Combinations |
| EITF 95-8 | FASB | Accounting for Contingent Consideration Paid to the Shareholders of an Acquired Enterprise in a Purchase Business Combination |
| EITF 02-5 | FASB | Definition of “Common Control” in Relation to FASB Statement No. 141 |
| EITF 09-4 | FASB | Seller Accounting for Contingent Consideration |
| FSP FAS 141R-1 | FASB | Accounting for Assets Acquired and Liabilities Assumed in a Business Combination That Arise from Contingencies |
| FTB 85-5 | FASB | Issues Relating to Accounting for Business Combinations, Including - Costs of Closing Duplicate Facilities of an Acquirer; Stock Transactions between Companies under Common Control; Downstream Mergers; Identical Common Shares for a Pooling of Interests; Pooling of Interests by Mutual and Cooperative Enterprises |
| CON 5 | FASB | Recognition and Measurement in Financial Statements of Business Enterprises |
| CON 8 | FASB | Conceptual Framework for Financial Reporting |
| Business Combinations AVG | AICPA | Working draft of Accounting and Valuation Guide, Business Combinations |
| Portfolio Company AVG | AICPA | Accounting and Valuation Guide, Valuation of Portfolio Company Investments of Venture Capital and Private Equity Funds and Other Investment Companies |
| Private Equity Securities AVG | AICPA | Accounting and Valuation Guide, Valuation of Privately-Held-Company Equity Securities Issued as Compensation |
| R&D AVG | AICPA | Accounting and Valuation Guide, Assets Acquired to Be Used in Research and Development Activities |
| ASR 268 | SEC | Presentation in Financial Statements of “Redeemable Preferred Stocks” |
| Regulation S-X | SEC | Financial Statement Requirements |
| SAB Topic 2.A.6 | SEC staff | Business Combinations – Acquisition Method – Debt Issue Costs |
| SAB Topic 5.DD | SEC staff | Written Loan Commitments Recorded at Fair Value Through Earnings |
| IFRS 3 | IASB | Business Combinations |

## RSM technical accounting guides

| Abbreviation used herein | Title |
|---|---|
| Our debt and equity guide | A guide to accounting for debt and equity instruments in financing transactions |
| Our financial assets guide | A guide to accounting for investments, loans and other receivables |
| Our lessee guide | A guide to lessee accounting under ASC 842 |
| Our revenue recognition guide | A guide to revenue recognition |

For a complete listing of our technical accounting guides and access to all of our financial reporting thought leadership, click here.

## Appendix F: Summary of significant changes since last edition

The following list summarizes the significant changes to this guide since our last edition:

### Chapter 1 - General

- Section 1.1.4 was moved to Appendix E
- Section 1.1.5 was moved to Appendix F

### Chapter 3 - Scope

- Section 3.4 was updated to reference the FASB issuance of an ED on joint venture formations

### Chapter 4 – Identifying business Combinations

- Question 4Q.1.3.1 was added to address the treatment on an ROU asset when applying the screen to determine whether a business was acquired

### Chapter 5 – Identifying the buyer

- Question 5Q.1.2 was updated to incorporate factors to consider when determining whether a new entity should be considered a buyer

### Chapter 7 – Initial recognition of assets, liabilities and any NCI

- Section 7.1.2 was renumbered to Section 7.2 and updated to include the new definition of assets and liabilities included in CON 8 and remove reference to a FASB proposed ASU that's no longer relevant

### Chapter 8 – Measurement of assets, liabilities and any NCI

- Section 8.1.1 was updated to include reference in the table to ASU 2021-08

### Chapter 10 – Specific application of general recognition and measurement guidance

- Section 10.3.4 was updated to reference the FASB project on credit losses for acquired financial assets
- Section 10.6.1, Section 10.8.1 and Section 10.9 were updated to remove reference to a FASB project that is no longer on the FASB's agenda
- Section 10.6.2.1 was updated for the issuance of ASU 2021-08 and to acknowledge diversity in practice in the recognition of contract liabilities prior to the adoption of ASU 2021-08
- Section 10.6.7 was updated to also address costs to fulfill a customer contract
- Section 10.7 was updated to incorporate the AICPA's issuance of a Working Draft of its Business Combinations AVG
- Section 10.12.1 and Section 10.15 were updated to include the new definition of assets and liabilities included in CON 8
- Section 10.12.2.2 was updated to reference the FASB project on software costs
- Section 10.13 was updated to remove all sections addressing ASC 840, as it is superseded, and renumber other sections
- Question 10Q.14.1 was added to address the accounting for certain accrued bonuses
- Section 10.18 was updated for the issuance of ASU 2020-11
- Section 10.19.3.2 was updated to add further considerations when determining the fair value of an NCI

### Chapter 11 – Exceptions to the general recognition and measurement guidance

- Section 11.1 was updated to include reference in the table to ASU 2021-08
- Question 11Q.2.1.1 was updated to incorporate considerations related to ASU 2021-08
- Section 11.9 was added to address acquired contract asset and liabilities after the adoption of ASU 2021-08

### Chapter 12 – Elements and results of goodwill calculation

- Section 12.8 was updated to remove reference to a FASB project that is no longer on the FASB's agenda.

### Chapter 13 – Determining what is part of the business combination

- Example 13-5 was updated to add two additional scenarios, one on arrangements with multiple triggers (Scenario B) and the other on continuing employment except in limited circumstances (Scenario D). In addition, prior Scenario B was relabeled as Scenario C.
- Section 13.5.7 was added to address certain insurance-related costs incurred related to a business combination

### Chapter 14 – Disclosures

- Section 14.2.4 was updated to address the treatment of acquired cash
- Section 14.2.5 was updated to remove discussion of the disclosures required prior to the adoption of ASC 842 and to add discussion of the disclosures required after the adoption of ASU 2021-08 to the table

### Chapter 15 – Asset acquisitions

- Section 15.1 as updated to remove reference to a FASB project that's no longer on the FASB's agenda
- Section 15.2.4 was added to address when an acquirer has a PHEI in the entity acquired
- Section 15.3 was updated to include the new definition of assets and liabilities included in CON 8

### Chapter 17 – Private-company intangible asset alternative

- Section 17.1 was updated to remove reference to a FASB project that is no longer on the FASB's agenda

### Chapter 18 – Private-company goodwill alternatives

- Section 18.1 was updated to remove reference to a FASB project that is no longer on the FASB's agenda
- Section 18.1, Section 18.2 and Section 18.5 were updated to address the goodwill triggering event alternative
- Section 18.4 was added to address the goodwill triggering event alternative

### Appendices

- Appendix A was updated to incorporate all other changes made throughout the other chapters of the guide
- Appendix B was updated to incorporate the additional disclosures required by ASU 2021-08
- Appendix C was updated to add Question CQ.4.6 to address measurement period adjustments
- Appendix D in the prior edition (Audit implications of business combinations) was deleted and replaced with a new Appendix D that addresses U.S. GAAP vs. IFRS differences relating to business combinations accounting
- Appendix E was moved from Section 1.1.4 and updated to include additional acronyms used in the guide and ASC Topics referenced as well as ASUs issued since the prior edition of the guide was published
- Appendix G was added to include certain definitions used in the guide

## Appendix G: Definitions

Several terms with specific meaning are used throughout this guide. Those terms and the corresponding definitions, based primarily on the Master Glossary of the Codification, are provided in the following table.

### Key terms and definitions

| Term | Definition |
|---|---|
| Acquiree | The business or businesses that the acquirer obtains control of in a business combination. This term also includes a nonprofit activity or business that a not-for-profit acquirer obtains control of in an acquisition by a not-for-profit entity. |
| Acquirer | The entity that obtains control of the acquiree. However, in a business combination in which a variable interest entity (VIE) is acquired, the primary beneficiary of that entity always is the acquirer. |
| Acquisition by a Not-for-Profit Entity | A transaction or other event in which a not-for-profit acquirer obtains control of one or more nonprofit activities or businesses and initially recognizes their assets and liabilities in the acquirer's financial statements. When applicable guidance in Topic 805 is applied by a not-for-profit entity, the term business combination has the same meaning as this term has for a for-profit entity. Likewise, a reference to business combinations in guidance that links to Topic 805 has the same meaning as a reference to acquisitions by not-for-profit entities. |
| Acquisition Date | The date on which the acquirer obtains control of the acquiree. |
| Beneficial Interests | Rights to receive all or portions of specified cash inflows received by a trust or other entity, including, but not limited to, all of the following:<br>a. Senior and subordinated shares of interest, principal or other cash inflows to be passed-through or paid-through<br>b. Premiums due to guarantors<br>c. Commercial paper obligations<br>d. Residual interests, whether in the form of debt or equity. |
| Business | A business is an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants. To be considered a business, an integrated set must meet the requirements in paragraphs 805-10-55-4 through 55-6 and 805-10-55-8 through 55-9 . |
| Business Combination | A transaction or other event in which an acquirer obtains control of one or more businesses. Transactions sometimes referred to as true mergers or mergers of equals also are business combinations. See also Acquisition by a Not-for-Profit Entity. |

| Term | Definition |
|---|---|
| Carryforwards | Deductions or credits that cannot be utilized on the tax return during a year that may be carried forward to reduce taxable income or taxes payable in a future year. An operating loss carryforward is an excess of tax deductions over gross income in a year; a tax credit carryforward is the amount by which tax credits available for utilization exceed statutory limitations. Different tax jurisdictions have different rules about whether excess deductions or credits may be carried forward and the length of the carryforward period. The terms carryforward, operating loss carryforward, and tax credit carryforward refer to the amounts of those items, if any, reported in the tax return for the current year. |
| Change in Accounting Principle | A change from one generally accepted accounting principle to another generally accepted accounting principle when there are two or more generally accepted accounting principles that apply or when the accounting principle formerly used is no longer generally accepted. A change in the method of applying an accounting principle also is considered a change in accounting principle. |
| Collateralized Financing Entity | A variable interest entity that holds financial assets, issues beneficial interests in those financial assets, and has no more than nominal equity. The beneficial interests have contractual recourse only to the related assets of the collateralized financing entity and are classified as financial liabilities. A collateralized financing entity may hold nonfinancial assets temporarily as a result of default by the debtor on the underlying debt instruments held as assets by the collateralized financing entity or in an effort to restructure the debt instruments held as assets by the collateralized financing entity. A collateralized financing entity also may hold other financial assets and financial liabilities that are incidental to the operations of the collateralized financing entity and have carrying values that approximate fair value (for example, cash, broker receivables, or broker payables). |
| Commencement Date of the Lease (Commencement Date) (Pending Content) | **Transition Guidance: 842-10-65-1**<br>The date on which a lessor makes an underlying asset available for use by a lessee. See paragraphs 842-10-55-19 through 55-21 for implementation guidance on the commencement date. |
| Contingency | An existing condition, situation, or set of circumstances involving uncertainty as to possible gain (gain contingency) or loss (loss contingency) to an entity that will ultimately be resolved when one or more future events occur or fail to occur. |
| Contingent Consideration | Usually an obligation of the acquirer to transfer additional assets or equity interests to the former owners of an acquiree as part of the exchange for control of the acquiree if specified future events occur or conditions are met. However, contingent consideration also may |

| Term | Definition |
|---|---|
| | give the acquirer the right to the return of previously transferred consideration if specified conditions are met. |
| Contract | An agreement between two or more parties that creates enforceable rights and obligations. |
| Contract Asset | An entity's right to consideration in exchange for goods or services that the entity has transferred to a customer when that right is conditioned on something other than the passage of time (for example, the entity's future performance). |
| Contract Liability | An entity's obligation to transfer goods or services to a customer for which the entity has received consideration (or the amount is due) from the customer. |
| Control | The direct or indirect ability to determine the direction of management and policies through ownership, contract, or otherwise.<br>The same as the meaning of controlling financial interest in paragraph 810-10-15-8. |
| Customer | A party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration. |
| Deductible Temporary Difference | Temporary differences that result in deductible amounts in future years when the related asset or liability is recovered or settled, respectively. See Temporary Difference. |
| Defensive Intangible Asset | An acquired intangible asset in a situation in which an entity does not intend to actively use the asset but intends to hold (lock up) the asset to prevent others from obtaining access to the asset. |
| Deferred Tax Asset | The deferred tax consequences attributable to deductible temporary differences and carryforwards. A deferred tax asset is measured using the applicable enacted tax rate and provisions of the enacted tax law. A deferred tax asset is reduced by a valuation allowance if, based on the weight of evidence available, it is more likely than not that some portion or all of a deferred tax asset will not be realized. |
| Deferred Tax Consequences | The future effects on income taxes as measured by the applicable enacted tax rate and provisions of the enacted tax law resulting from temporary differences and carryforwards at the end of the current year. |
| Deferred Tax Liability | The deferred tax consequences attributable to taxable temporary differences. A deferred tax liability is measured using the applicable enacted tax rate and provisions of the enacted tax law. |

| Term | Definition |
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| Direct Financing Lease (Pending Content) | **Transition Guidance: 842-10-65-1**<br>From the perspective of a lessor, a lease that meets none of the criteria in paragraph 842-10-25-2 but meets the criteria in paragraph 842-10-25-3(b).<br>**Transition Guidance: 842-10-65-5**<br>From the perspective of a lessor, a lease that meets none of the criteria in paragraph 842-10-25-2 but meets the criteria in paragraph 842-10-25-3(b) and is not an operating lease in accordance with paragraph 842-10-25-3A. |
| Equity Interests | Used broadly to mean ownership interests of investor-owned entities; owner, member, or participant interests of mutual entities; and owner or member interests in the net assets of not-for-profit entities. |
| Event | A happening of consequence to an entity. The term encompasses both transactions and other events affecting an entity. |
| Fair Value | The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. |
| Finance Lease (Pending Content) | **Transition Guidance:** 842-10-65-1<br>From the perspective of a lessee, a lease that meets one or more of the criteria in paragraph 842-10-25-2. |
| Financial Asset | Cash, evidence of an ownership interest in an entity, or a contract that conveys to one entity a right to do either of the following:<br>a. Receive cash or another financial instrument from a second entity<br>b. Exchange other financial instruments on potentially favorable terms with the second entity. |
| Financial Statements Are Available to Be Issued | Financial statements are considered available to be issued when they are complete in a form and format that complies with GAAP and all approvals necessary for issuance have been obtained, for example, from management, the board of directors, and/or significant shareholders. The process involved in creating and distributing the financial statements will vary depending on an entity's management and corporate governance structure as well as statutory and regulatory requirements. |
| Financial Statements Are Issued | Financial statements are considered issued when they are widely distributed to shareholders and other financial statement users for general use and reliance in a form and format that complies with GAAP. (U.S. Securities and Exchange Commission [SEC] registrants also are required to consider the guidance in paragraph 855-10-S99-2.) |

| Term | Definition |
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| Foreign Entity | An operation (for example, subsidiary, division, branch, joint venture, and so forth) whose financial statements are both:<br>a. Prepared in a currency other than the reporting currency of the reporting entity<br>b. Combined or consolidated with or accounted for on the equity basis in the financial statements of the reporting entity. |
| Goodwill | An asset representing the future economic benefits arising from other assets acquired in a business combination or an acquisition by a not-for-profit entity that are not individually identified and separately recognized. For ease of reference, this term also includes the immediate charge recognized by not-for-profit entities in accordance with paragraph 958-805-25-29. |
| Identifiable | An asset is identifiable if it meets either of the following criteria:<br>a. It is separable, that is, capable of being separated or divided from the entity and sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract, identifiable asset, or liability, regardless of whether the entity intends to do so.<br>b. It arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations. |
| Income Taxes | Domestic and foreign federal (national), state, and local (including franchise) taxes based on income. |
| Intangible Asset Class | A group of intangible assets that are similar, either by their nature or by their use in the operations of an entity. |
| Intangible Assets | Assets (not including financial assets) that lack physical substance. (The term intangible assets is used to refer to intangible assets other than goodwill.) |
| In Substance Nonfinancial Asset | Paragraphs 610-20-15-5 through 15-8 define an in substance nonfinancial asset. |
| Lease | An agreement conveying the right to use property, plant, or equipment (land and/or depreciable assets) usually for a stated period of time.<br>Pending Content: **Transition Guidance: 842-10-65-1**<br>A contract, or part of a contract, that conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration. |

| Term | Definition |
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| Lease Liability (Pending Content) | **Transition Guidance: 842-10-65-1**<br>A lessee's obligation to make the lease payments arising from a lease, measured on a discounted basis. |
| Lease Payments (Pending Content) | **Transition Guidance: 842-10-65-1**<br>See paragraph 842-10-30-5 for what constitutes lease payments from the perspective of a lessee and a lessor. |
| Lease Receivable (Pending Content) | **Transition Guidance: 842-10-65-1**<br>A lessor's right to receive lease payments arising from a sales-type lease or a direct financing lease plus any amount that a lessor expects to derive from the underlying asset following the end of the lease term to the extent that it is guaranteed by the lessee or any other third party unrelated to the lessor, measured on a discounted basis. |
| Lease Term | The fixed, noncancelable lease term plus all of the following, except as noted in the following paragraph:<br>a. All periods, if any, covered by bargain renewal options.<br>b. All periods, if any, for which failure to renew the lease imposes a penalty on the lessee in such amount that a renewal appears, at lease inception, to be reasonably assured.<br>c. All periods, if any, covered by ordinary renewal options during which any of the following conditions exist:<br>1. A guarantee by the lessee of the lessor's debt directly or indirectly related to the leased property is expected to be in effect.<br>2. A loan from the lessee to the lessor directly or indirectly related to the leased property is expected to be outstanding.<br>d. All periods, if any, covered by ordinary renewal options preceding the date as of which a bargain purchase option is exercisable.<br>e. All periods, if any, representing renewals or extensions of the lease at the lessor's option.<br>The lease term shall not be assumed to extend beyond the date a bargain purchase option becomes exercisable.<br>Pending Content: **Transition Guidance: ASC 842-10-65-1**<br>The noncancellable period for which a lessee has the right to use an underlying asset, together with all of the following:<br>a. Periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option<br>b. Periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option |

| Term | Definition |
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| | c. Periods covered by an option to extend (or not to terminate) the lease in which exercise of the option is controlled by the lessor. |
| Legal Entity | Any legal structure used to conduct activities or to hold assets. Some examples of such structures are corporations, partnerships, limited liability companies, grantor trusts, and other trusts. |
| Lessee (Pending Content) | **Transition Guidance: 842-10-65-1**<br>An entity that enters into a contract to obtain the right to use an underlying asset for a period of time in exchange for consideration. |
| Lessor (Pending Content) | **Transition Guidance: 842-10-65-1**<br>An entity that enters into a contract to provide the right to use an underlying asset for a period of time in exchange for consideration. |
| Leveraged Lease | From the perspective of a lessor, a lease that meets all of the conditions in paragraph 840-10-25-43(c).<br>Pending Content: **Transition Guidance: 842-10-65-1**<br>From the perspective of a lessor, a lease that was classified as a leveraged lease in accordance with the leases guidance in effect before the effective date and for which the commencement date is before the effective date. |
| Market Participants | Buyers and sellers in the principal (or most advantageous) market for the asset or liability that have all of the following characteristics:<br>a. They are independent of each other, that is, they are not related parties, although the price in a related-party transaction may be used as an input to a fair value measurement if the reporting entity has evidence that the transaction was entered into at market terms<br>b. They are knowledgeable, having a reasonable understanding about the asset or liability and the transaction using all available information, including information that might be obtained through due diligence efforts that are usual and customary<br>c. They are able to enter into a transaction for the asset or liability<br>d. They are willing to enter into a transaction for the asset or liability, that is, they are motivated but not forced or otherwise compelled to do so. |
| Merger of Not-for-Profit Entities | A transaction or other event in which the governing bodies of two or more not-for-profit entities cede control of those entities to create a new not-for-profit entity. |

| Term | Definition |
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| Mineral Rights | The legal right to explore, extract, and retain at least a portion of the benefits from mineral deposits. |
| Mutual Entity | An entity other than an investor-owned entity that provides dividends, lower costs, or other economic benefits directly and proportionately to its owners, members, or participants. Mutual insurance entities, credit unions, and farm and rural electric cooperatives are examples of mutual entities. |
| Net Investment in the Lease (Pending Content) | **Transition Guidance: 842-10-65-1**<br>For a sales-type lease, the sum of the lease receivable and the unguaranteed residual asset.<br><br>For a direct financing lease, the sum of the lease receivable and the unguaranteed residual asset, net of any deferred selling profit. |
| Noncontrolling Interest | The portion of equity (net assets) in a subsidiary not attributable, directly or indirectly, to a parent. A noncontrolling interest is sometimes called a minority interest. |
| Nonfinancial Asset | An asset that is not a financial asset. Nonfinancial assets include land, buildings, use of facilities or utilities, materials and supplies, intangible assets, or services. |
| Nonprofit Activity | An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing benefits, other than goods or services at a profit or profit equivalent, as a fulfillment of an entity's purpose or mission (for example, goods or services to beneficiaries, customers, or members). As with a not-for-profit entity, a nonprofit activity possesses characteristics that distinguish it from a business or a for-profit business entity. |
| Not-for-Profit Entity | An entity that possesses the following characteristics, in varying degrees, that distinguish it from a business entity:<br>a. Contributions of significant amounts of resources from resource providers who do not expect commensurate or proportionate pecuniary return<br>b. Operating purposes other than to provide goods or services at a profit<br>c. Absence of ownership interests like those of business entities.<br>Entities that clearly fall outside this definition include the following:<br>a. All investor-owned entities<br>b. Entities that provide dividends, lower costs, or other economic benefits directly and proportionately to their owners, members, or participants, such as mutual |

| Term | Definition |
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| | insurance entities, credit unions, farm and rural electric cooperatives, and employee benefit plans. |
| Operating Lease | From the perspective of a lessee, any lease other than a capital lease.<br>From the perspective of a lessor, a lease that meets the conditions in paragraph 840-10-25-43(d).<br>Pending Content: **Transition Guidance: ASC 842-10-65-1**<br>From the perspective of a lessee, any lease other than a finance lease.<br>From the perspective of a lessor, any lease other than a sales-type lease or a direct financing lease. |
| Orderly Transaction | A transaction that assumes exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (for example, a forced liquidation or distress sale). |
| Owners | Used broadly to include holders of ownership interests (equity interests) of investor-owned entities, mutual entities, or not-for-profit entities. Owners include shareholders, partners, proprietors, or members or participants of mutual entities. Owners also include owner and member interests in the net assets of not-for-profit entities. |
| Performance Obligation | A promise in a contract with a customer to transfer to the customer either:<br>a. A good or service (or a bundle of goods or services) that is distinct<br>b. A series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer. |
| Private Company (Pending Content) | **Transition Guidance:** 350-20-65-2<br>An entity other than a public business entity, a not-for-profit entity, or an employee benefit plan within the scope of Topics 960 through 965 on plan accounting. |
| Public Business Entity | A public business entity is a business entity meeting any one of the criteria below. Neither a not-for-profit entity nor an employee benefit plan is a business entity.<br>a. It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing). |

| Term | Definition |
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| | b. It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC.<br>c. It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer.<br>d. It has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market.<br>e. It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including notes) and make them publicly available on a periodic basis (for example, interim or annual periods). An entity must meet both of these conditions to meet this criterion.<br>An entity may meet the definition of a public business entity solely because its financial statements or financial information is included in another entity's filing with the SEC. In that case, the entity is only a public business entity for purposes of financial statements that are filed or furnished with the SEC. |
| Public Entity | A business entity or a not-for-profit entity that meets any of the following conditions:<br>a. It has issued debt or equity securities, or is a conduit bond obligor for conduit debt securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets).<br>b. It is required to file financial statements with the Securities and Exchange Commission (SEC).<br>c. It provides financial statements for the purpose of issuing any class of securities in a public market. |
| Purchased Financial Assets with Credit Deterioration (Pending Content) | **Transition Guidance: ASC 326-10-65-1**<br>Acquired individual financial assets (or acquired groups of financial assets with similar risk characteristics) that as of the date of acquisition have experienced a more-than-insignificant deterioration in credit quality since origination, as determined by an acquirer's assessment. See paragraph 326-20-55-5 for more information on the meaning of similar risk characteristics for assets measured on an amortized cost basis. |
| Pushdown Accounting | Use of the acquirer's basis in the preparation of the acquiree’s separate financial statements. |

| Term | Definition |
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| Reinsurance | A transaction in which a reinsurer (assuming entity), for a consideration (premium), assumes all or part of a risk undertaken originally by another insurer (ceding entity). For indemnity reinsurance, the legal rights of the insured are not affected by the reinsurance transaction and the insurance entity issuing the insurance contract remains liable to the insured for payment of policy benefits. Assumption or novation reinsurance contracts that are legal replacements of one insurer by another extinguish the ceding entity's liability to the policyholder. |
| Related Parties | Related parties include:<br>a. Affiliates of the entity<br>b. Entities for which investments in their equity securities would be required, absent the election of the fair value option under the Fair Value Option Subsection of Section 825-10-15, to be accounted for by the equity method by the investing entity<br>c. Trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management<br>d. Principal owners of the entity and members of their immediate families<br>e. Management of the entity and members of their immediate families<br>f. Other parties with which the entity may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests<br>g. Other parties that can significantly influence the management or operating policies of the transacting parties or that have an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests. |
| Reorganization | A way to create a master limited partnership in which all of the assets of an entity are placed into a master limited partnership and that entity ceases to exist. |
| Requisite Service Period | The period or periods during which an employee is required to provide service in exchange for an award under a share-based payment arrangement. The service that an employee is required to render during that period is referred to as the requisite service. The requisite service period for an award that has only a service condition is presumed to be the vesting period, unless there is clear evidence to the contrary. If an award requires future service for vesting, the entity cannot define a prior period as the requisite |

| Term | Definition |
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| | service period. Requisite service periods may be explicit, implicit, or derived, depending on the terms of the share-based payment award. |
| Reverse Acquisition | An acquisition in which the entity that issues securities (the legal acquirer) is identified as the acquiree for accounting purposes based on the guidance in paragraphs 805-10-55-11 through 55-15. The entity whose equity interests are acquired (the legal acquiree) must be the acquirer for accounting purposes for the transaction to be considered a reverse acquisition. |
| Right-of-Use Asset (Pending Content) | **Transition Guidance: 842-10-65-1**<br>An asset that represents a lessee's right to use an underlying asset for the lease term. |
| Sales-Type Lease | From the perspective of a lessor, a lease that meets either of the conditions in paragraph 840-10-25-43(a).<br><u>Pending Contents</u>:<br>**Transition Guidance: 842-10-65-1**<br>From the perspective of a lessor, a lease that meets one or more of the criteria in paragraph 842-10-25-2.<br>**Transition Guidance: 842-10-65-5**<br>From the perspective of a lessor, a lease that meets one or more of the criteria in paragraph 842-10-25-2 and is not an operating lease in accordance with paragraph 842-10-25-3A. |
| Securities and Exchange Commission (SEC) Filer | An entity that is required to file or furnish its financial statements with either of the following:<br>a. The Securities and Exchange Commission (SEC)<br>b. With respect to an entity subject to Section 12(i) of the Securities Exchange Act of 1934, as amended, the appropriate agency under that Section.<br>Financial statements for other entities that are not otherwise SEC filers whose financial statements are included in a submission by another SEC filer are not included within this definition. |
| Security | A share, participation, or other interest in property or in an entity of the issuer or an obligation of the issuer that has all of the following characteristics:<br>a. It is either represented by an instrument issued in bearer or registered form or, if not represented by an instrument, is registered in books maintained to record transfers by or on behalf of the issuer.<br>b. It is of a type commonly dealt in on securities exchanges or markets or, when represented by an instrument, is commonly recognized in any area in which it is issued or dealt in as a medium for investment. |

| Term | Definition |
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| | c. It either is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations. |
| Standalone Selling Price | The price at which an entity would sell a promised good or service separately to a customer. |
| Tax Consequences | The effects on income taxes—current or deferred—of an event. |
| Tax Position | A position in a previously filed tax return or a position expected to be taken in a future tax return that is reflected in measuring current or deferred income tax assets and liabilities for interim or annual periods. A tax position can result in a permanent reduction of income taxes payable, a deferral of income taxes otherwise currently payable to future years, or a change in the expected realizability of deferred tax assets. The term tax position also encompasses, but is not limited to:<br>a. A decision not to file a tax return<br>b. An allocation or a shift of income between jurisdictions<br>c. The characterization of income or a decision to exclude reporting taxable income in a tax return<br>d. A decision to classify a transaction, entity, or other position in a tax return as tax exempt<br>e. An entity's status, including its status as a pass-through entity or a tax-exempt not-for-profit entity. |
| Taxable Income | The excess of taxable revenues over tax deductible expenses and exemptions for the year as defined by the governmental taxing authority. |
| Taxable Temporary Difference | Temporary differences that result in taxable amounts in future years when the related asset is recovered or the related liability is settled. See Temporary Difference. |
| Temporary Difference | A difference between the tax basis of an asset or liability computed pursuant to the requirements in Subtopic 740-10 for tax positions, and its reported amount in the financial statements that will result in taxable or deductible amounts in future years when the reported amount of the asset or liability is recovered or settled, respectively. Paragraph 740-10-25-20 cites examples of temporary differences. Some temporary differences cannot be identified with a particular asset or liability for financial reporting (see paragraphs 740-10-05-10 and 740-10-25-24 through 740-10-25-25), but those temporary differences do meet both of the following conditions:<br>a. Result from events that have been recognized in the financial statements |

| Term | Definition |
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| | b. Will result in taxable or deductible amounts in future years based on provisions of the tax law.<br>Some events recognized in financial statements do not have tax consequences. Certain revenues are exempt from taxation and certain expenses are not deductible. Events that do not have tax consequences do not give rise to temporary differences. |
| Transaction Price | The amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties. |
| Underlying Asset (Pending Content) | **Transition Guidance: 842-10-65-1**<br>An asset that is the subject of a lease for which a right to use that asset has been conveyed to a lessee. The underlying asset could be a physically distinct portion of a single asset. |
| Unguaranteed Residual Asset (Pending Content) | **Transition Guidance: 842-10-65-1**<br>The amount that a lessor expects to derive from the underlying asset following the end of the lease term that is not guaranteed by the lessee or any other third party unrelated to the lessor, measured on a discounted basis. |
| Valuation Allowance | The portion of a deferred tax asset for which it is more likely than not that a tax benefit will not be realized. |
| Variable Interest Entity | A legal entity subject to consolidation according to the provisions of the Variable Interest Entities Subsections of Subtopic 810-10. |

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