A GUIDE TO ACCOUNTING FOR BUSINESS COMBINATIONS

Second Edition

Assurance ▪ Tax ▪ Consulting

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Executive Summary

Introduction

The current guidance on accounting for business combinations, which is captured in Topic 805 of the Codification, has been in effect since 2009. Insights we have gained as a result of the application of this guidance include the following:

- The required use of a "fair-value" model to account for business combinations has increased the involvement of valuation specialists – both related to management's accounting for a business combination and the auditor's testing of the amounts recognized.
- 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 and valuation implications.
- 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.
- The accounting for contingent consideration (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 classified as an asset/liability) is also one of the more challenging aspects of the business combination accounting guidance.

These observations and many others underscore the importance of familiarizing yourself with the business combination accounting guidance before a business combination occurs. Doing so will prepare you and allow you to plan for the accounting challenges that await. This executive summary provides you with the start you need – an overview of the accounting guidance applicable to business combinations.

To locate additional information on specific aspects of the business combination accounting guidance, refer to the table of contents. In addition, refer to Section 1.1.4 for definitions of acronyms and titles for authoritative literature references utilized throughout the guide.

Scope

A business combination occurs when the buyer obtains control of a business through a transaction or other event. The three key elements in the definition of a business combination are the following:

1. That which is being acquired must meet the definition of a ***business***. A business includes inputs and processes that are at least capable of producing outputs (i.e., outputs do not have to be part of the transferred set). In some situations, considerable judgment will need to be exercised in determining whether a business (rather than just a group of assets or net assets) was acquired by the buyer. For example, all of the inputs and processes used by the seller to produce outputs do not have to be acquired to conclude that a business has been acquired. Determining whether sufficient inputs and processes have been acquired in these situations to conclude that a business has been acquired often requires considerable judgment to be exercised.

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2. The buyer must ***obtain control*** of a business. The definition of control used for this purpose is the same definition used in determining whether a voting interest entity should be consolidated. The "usual" condition for control is a greater than 50% ownership interest in the investee (i.e., a majority ownership interest). However, control may be obtained under other circumstances as well. For example, one entity may obtain control of another entity through contract alone.

3. Control can be obtained by the buyer through a ***transaction or other event***. An "other event" may occur through no direct action of the buyer. For example, the buyer may obtain control of an investee as a result of that investee acquiring its own shares, which has the effect of increasing the buyer's ownership interest to that of a controlling interest. Assume that an investor owns 60,000 shares in a business and the business has 150,000 shares outstanding. In this situation, the investor owns a 40% interest in the business and accounts for its investment using the equity method. If the business buys or redeems 50,000 of its own shares from other investors, those shares are retired or become treasury shares and are no longer considered outstanding. As a result, the investor's ownership interest in the business increases to 60% (the investor's 60,000 shares in the business divided by 100,000 shares outstanding). This example illustrates that an investor can become a "buyer" by obtaining control without transferring consideration and without undertaking any other direct action on its own behalf and be subject to the business combination accounting guidance.

Transactions that meet the definition of a business combination include: (a) leveraged buyouts, (b) combinations between two or more mutual entities, and (c) initial consolidation of a VIE when the VIE and PB are not under common control and the VIE is a business. In addition, depending on the facts and circumstances, the acquisition of a development stage entity could meet the definition of a business combination. Even if a transaction or other event satisfies the definition of a business combination, there are specific types of transactions explicitly excluded from the scope of the business combination accounting guidance in Topic 805. Examples include combinations between not-for-profit entities and combinations between entities under common control. Accounting for mergers and acquisitions of not-for-profit entities is covered in Topic 954-805 and Topic 958-805. Accounting for combinations between entities under common control is covered in Topic 805-50.

Determining whether a transaction or other event should be accounted for as a business combination instead of an asset acquisition has significant accounting repercussions. For example:

- Goodwill is recognized in a business combination, but not in an asset acquisition;
- Acquisition costs are generally expensed as incurred and when the related services have been received by the buyer in a business combination, while the same costs are generally considered part of the cost of the assets (or net assets) in an asset acquisition; and
- Assets acquired and liabilities assumed in a business combination are measured predominantly at fair value, while assets acquired and liabilities assumed in an asset acquisition are measured by allocating the total cost of the net assets based on the fair values of the individual assets acquired and liabilities assumed.

These are but a few of the reasons why it is important to draw the appropriate conclusion about whether a business was acquired.

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It is also important to note that the definition of a business used for purposes of determining whether a business combination has occurred is also used in other accounting determinations. For example, the definition of a business discussed herein is also used in determining:

- The reporting units for purposes of goodwill impairment testing. 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. The definition of a reporting unit relies, in part, on what constitutes one level below an operating segment (i.e., a component), which relies, in part, on the definition of a business.
- Whether the guidance in Topic 810-10 on how to account for decreases in a parent's ownership interest in a subsidiary (including decreases that result in deconsolidation) applies to a particular transaction. With limited exceptions, the sale (i.e., deconsolidation) of a subsidiary or group of assets that meets the definition of a business would be accounted for using this guidance, which would likely result in the recognition of a gain or loss upon deconsolidation. The limited exceptions involve sales of ownership interests that are in-substance real estate or the conveyance of oil and gas mineral rights.
- Whether goodwill should be allocated to a portion of a reporting unit that is being disposed of for purposes of determining the gain or loss on disposal. If the portion of a reporting unit being disposed of meets the definition of a business, goodwill should be allocated to the business.

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

Overall accounting model

The overall accounting model used to account for a business combination consists of the following four steps:

1. Identify the buyer;
2. Determine the acquisition date;
3. Recognize and measure, predominantly at fair value, the assets acquired, liabilities assumed, and any noncontrolling interest; and
4. Recognize goodwill or, in rare cases, a gain from a bargain purchase.

1. Identify the buyer

The buyer is the party that gains control over the other party in the business combination. Typically, the identity of the buyer in a business combination is readily apparent as a result of considering which party is transferring cash, incurring liabilities, and (or) issuing equity interests. However, if the identity of the buyer is not readily apparent after considering these factors, then certain qualitative factors should be examined in the context of the facts and circumstances of the specific business combination to identify the buyer.

Identification of the appropriate party as the buyer in a business combination is important because it is the buyer that applies the provisions of Topic 805, and it is the target whose assets and liabilities are measured predominantly at fair value.

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2. Determine the acquisition date

The acquisition date is the date that the buyer obtains control of the target, which is usually the closing date. The acquisition date may only be different from the closing date if there is a written agreement transferring control of the target to the buyer on a date other than the closing date. Identifying 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.

3. Recognize and measure assets acquired, liabilities assumed, and any noncontrolling interest

Recognition

Assets and liabilities recognized in the accounting for a business combination must meet the definitions of assets and liabilities provided in the following paragraphs of CON 6:

> 25. Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events. [footnote omitted]
>
> 35. Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events. [footnotes omitted]

With only limited exceptions, each item acquired in a business combination that meets one of these definitions should be recognized in the accounting for the business combination. The exceptions to this general recognition principle are discussed later in this summary.

For purposes of determining whether an intangible asset should be recognized in the accounting for a business combination, the buyer must focus on whether the intangible asset: (a) arises from contractual or other legal rights or (b) is capable of both being (i) separated from the entity and (ii) sold, transferred, licensed, rented, or exchanged either on its own or combined with a related contract, identifiable asset, or liability. FASB ASC 805-20-55-11 through 45 list and discuss several types of intangible assets that should be recognized separately from goodwill. Examples of such intangible assets include:

- Assets (or liabilities) for the favorable (or unfavorable) terms of operating leases;
- Assets for acquired IPR&D; and
- Assets for customer contracts, customer relationships and (or) customer lists.

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Additional information on the recognition of certain assets and liabilities as a result of a business combination is provided in the following table:

Item	Recognition
IPR&D	Recognize as an indefinite-lived intangible asset (measured at its fair value) and test at least annually for impairment until completion or abandonment of the project. Upon completion, amortize the asset over its useful life. Upon abandonment, write-down the asset as appropriate.
Contingent consideration arrangements related to previous acquisitions in which the target was the acquirer	Recognize, measure, and subsequently account for using the same guidance that the buyer would apply to any contingent consideration involved in its acquisition of the target.
Excess of tax-deductible goodwill over goodwill for book purposes	Recognize a deferred tax asset for the excess of tax-deductible goodwill over goodwill for book purposes, which requires the use of a simultaneous equation to determine the amount of the deferred tax asset and the ultimate amount of goodwill to recognize for book purposes.
Decrease in the buyer's pre-existing deferred tax asset valuation allowance as a result of the business combination	Recognize as an income tax benefit or as a credit to contributed capital, as appropriate (i.e., do not recognize as part of the accounting for the business combination).

Measurement

The measurement principle applied in the accounting for a business combination is fair value. With only limited exceptions, the assets and liabilities recognized (including working capital accounts such as accounts receivable and payable), along with any noncontrolling interest recognized, are measured at their fair value. Even if less than 100% of the target is acquired, the assets acquired and liabilities assumed in a business combination are still recorded at 100% of their fair value (or other amount measured in accordance with Topic 805). The exceptions to the general fair value measurement principle are discussed later in this summary.

The definition of fair value and related fair value measurement guidance that should be used in the accounting for a business combination can be found in Topic 820. Use of this definition and related fair value measurement guidance requires measuring the fair value of acquired nonfinancial assets based on the "highest and best use" of that asset from a market participant's perspective. In other words, an "entity-specific value" should not be used, even for assets that the buyer does not intend to use. Use of this definition and the related fair value measurement guidance also means a separate valuation allowance is not recognized when recording accounts receivable acquired in a business combination.

Noncontrolling interest

When a partial acquisition occurs (which is discussed later in this summary), the acquisition-date fair value of the noncontrolling interest should be recognized. When identifying the instruments that should be included in the noncontrolling interest, the buyer will need to consider the target's or, in some cases, the buyer's financial instruments (or embedded features) and determine whether those instruments (or embedded features) meet the definition of a liability or equity (which can be a complex determination). The financial instruments (or embedded features) that are issued by the buyer and meet the requirements to be classified as equity as well as instruments of the target that should be classified as equity in its standalone financial statements would be considered part of the noncontrolling interest in the target.

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In general, it is not appropriate for the buyer to base the fair value of the noncontrolling interest solely on the per-share consideration transferred to obtain the controlling interest because the consideration transferred to obtain the controlling interest would typically include a control premium.

Within the consolidated balance sheet, the noncontrolling interest 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 additional guidance that could result in noncontrolling interests that include redemption features being classified as mezzanine equity (which is presented on the balance sheet between liabilities and equity).

Exceptions to overall recognition and measurement principles

The following table lists those types of assets and liabilities that are recognized and (or) measured using principles other than the general recognition and (or) measurement principles discussed earlier:

Assets or liabilities related to:	Exception to overall recognition and (or) measurement principle	Nature of exception
Contingencies (other than those involving contingent consideration and indemnifications)	Both	A contingency is recognized at its acquisition-date fair value if that fair value can be determined. For purposes of determining fair value, the guidance in Topic 820 is used. If the acquisition-date fair value of a contingency cannot be determined, then an asset or liability is recognized for the contingency if it is probable at the acquisition date that such an asset or liability exists and if its amount is reasonably estimable. The guidance in Topic 450 should be used when assessing these criteria. FASB ASC 805-20-25-19 indicates that an entity should often be able to determine the fair value of a warranty obligation. 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. An asset or liability is not recognized for a contingency in the accounting for a business combination if: (a) its fair value cannot be determined and (b) the probable and reasonably estimable criteria are not met. Instead, the contingency is disclosed and accounted for subsequent to the acquisition date in accordance with Topic 450.
Indemnification assets	Both	The recognition and measurement of indemnification assets follows the recognition and measurement of the underlying 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 would depend on the buyer's accounting for

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Assets or liabilities related to:	Exception to overall recognition and (or) measurement principle	Nature of exception
		the litigation (i.e., the indemnified item). Collectibility and contractual limitations of the indemnification should be taken into consideration in measuring the indemnification asset.
Income taxes	Both	The guidance in Topic 805-740 and Topic 740 is used to recognize and measure the income tax effects of a business combination.
Employee benefits	Both	Other applicable guidance in the Codification, such as that found in Topic 712 and Topic 715, are used to recognize and measure assets and liabilities related to the target's employee benefit offerings.
Reacquired rights (when the buyer acquires a target to which it previously granted certain rights, those reacquired rights represent an intangible asset)	Measurement	The value of reacquired rights is measured based on their remaining contractual term. Future renewals should not be taken into consideration. This is the case even if market participants would renew the underlying contract.
Share-based payment awards	Measurement	Topic 718 is used to measure the value of replacement share-based payment awards.
Assets held for sale	Measurement	Assets held for sale are measured at their fair value less costs to sell.

Classification or designation of acquired assets and assumed liabilities

There are many instances in which U.S. GAAP: (a) requires an entity to determine the classification of a transaction, instrument, or agreement (e.g., whether an investment should be classified as trading, available-for-sale, or held-to-maturity), which then dictates its accounting; or (b) allows an entity to designate a transaction, instrument, or agreement in a particular manner (e.g., when a derivative instrument has been properly designated as a hedging instrument), which then has repercussions on its accounting. In general, when leases within the scope of Topic 840 or insurance contracts within the scope of Topic 944-10 are acquired in a business combination, the classification of those leases and insurance contracts should be based on the terms, conditions, and other relevant factors in existence at their inception or, if applicable, upon their most recent modification. For all other transactions, instruments, or agreements, the buyer's classification or designation should be based on applying the relevant authoritative literature to the terms, conditions, and other relevant factors in existence on the acquisition date.

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4. Recognize goodwill or a gain from a bargain purchase

The amount of goodwill or, in rare cases, gain from a bargain purchase to be recognized in conjunction with a business combination is determined as follows:

	Consideration transferred (measured predominantly at fair value)
+	Acquisition-date fair value of any noncontrolling interest (in the case of a partial acquisition)
+	Acquisition-date fair value of the buyer's previously held equity interest in the target (in the case of a step acquisition)
=	Total (i.e., fair value of the target as a whole)
-	Net assets acquired by the buyer (which is 100% of the target's net assets measured predominantly at fair value)
=	Goodwill (if positive); Gain from a bargain purchase (if negative)

The sum of the first three elements can also be thought of as the fair value of the target as a whole and the amount of goodwill can also be thought of as the excess of the fair value of the target as a whole over the net assets acquired by the buyer (which is 100% of the target's net assets measured predominantly at fair value).

This approach to determining goodwill results in the recognition of 100% of goodwill, not just the buyer's portion of goodwill. Recognizing 100% of goodwill results from: (a) including in the fair value of the target as a whole both the fair value of any noncontrolling interest and the fair value of any previously held equity interest of the buyer and (b) recognizing 100% of the fair value (or other measured amount) of the net assets acquired by the buyer.

Consideration transferred

All consideration transferred, other than replacement share-based payment awards, is recognized in the accounting for the business combination at its acquisition-date fair value. This includes contingent consideration and equity securities transferred by the buyer to the sellers, which should reflect the value of the combined entity.

Based on the applicable authoritative literature, contingent consideration must be classified as an asset/ liability or equity on the acquisition date. In practice, it is unusual for contingent consideration to meet all of the necessary conditions that are required for equity classification.

Replacement share-based payment awards are measured using the measurement principles in Topic 718. In some cases, the value of replacement share-based payment awards under Topic 718 must be allocated to both precombination and postcombination periods. That portion allocated to the precombination period represents an element of consideration transferred in the business combination and that portion allocated to the postcombination period represents compensation cost to be recognized after the acquisition date for post-acquisition services.

Partial acquisition

A partial acquisition occurs when the buyer in a business combination acquires less than 100%, but more than 50%, of the target. In other words, the buyer acquires a controlling interest, but not a 100% interest, in the target. For example, the buyer acquires 65% of the target in a single transaction.

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When a partial acquisition occurs, the acquisition-date fair value of the noncontrolling interest (35% in the example in the preceding paragraph) should be recognized and taken into consideration in measuring the amount of goodwill or gain from a bargain purchase that should be recognized as a result of the business combination. In other words, in a partial acquisition, the acquisition-date fair value of the noncontrolling interest represents one part of the fair value of the target as a whole. Additional information related to the initial accounting for the noncontrolling interest is provided earlier in this summary.

Step acquisition

A step acquisition occurs when the buyer in a business combination has a previously held equity interest in the target and acquires an additional interest in the target that results in the buyer obtaining control. For example, on November 1, 20X9, the buyer owns a 30% equity interest in the target. On November 2, 20X9, the buyer buys an additional 35% equity interest in the target, which ultimately provides the buyer with a 65% controlling interest in the target. As a result of acquiring the additional 35% equity interest, the buyer has acquired the target for accounting purposes and must account for this acquisition as a business combination. A step acquisition is also referred to as a business combination achieved in stages.

When a step acquisition occurs, the buyer must recognize either: (a) a gain for the excess of the acquisition-date fair value of the buyer's previously held equity interest in the target over the carrying value of that interest or (b) a loss for the excess of the carrying value of the buyer's previously held equity interest in the target over the acquisition-date fair value of that interest. In general, it is not appropriate for the buyer to base the fair value of its previously held equity interest in the target solely on the per-share consideration transferred to obtain the controlling interest because the consideration transferred to obtain the controlling interest would typically include a control premium.

Bargain purchase

A bargain purchase results from the excess of net assets acquired by the buyer (which is 100% of the target's net assets measured predominantly at fair value) over the sum of: (a) consideration transferred (measured predominantly at fair value); (b) the fair value of any noncontrolling interest; and (c) the fair value of any previously held equity interest of the buyer. In the rare case in which a gain from a bargain purchase results from the buyer's accounting for a business combination, the buyer must perform a thorough self-review of: (a) the accuracy and completeness of the identifiable assets acquired and liabilities assumed and (b) the appropriateness of the procedures used to measure the individual components within each element of the goodwill calculation and the results of applying those procedures. If a gain from a bargain purchase still exists after the buyer performs this thorough self-review, then the buyer would recognize a gain from a bargain purchase in its income statement and prepare its disclosure explaining why a bargain purchase resulted from the business combination. The gain would be attributed entirely to the buyer (i.e., none of the gain would be attributed to any noncontrolling interest) and it would not be classified as extraordinary on the income statement.

Measurement period adjustments

The buyer may not be able to complete its accounting for a business combination by the time it has to issue its financial statements that include the acquisition date. If this is the case, then the buyer would recognize provisional amounts in its financial statements and would have up to one year from the acquisition date to finalize those amounts. If the buyer's accounting for a business combination reflected in its financial statements is incomplete, then the buyer must disclose that fact and identify all amounts included in its financial statements that are provisional.

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An adjustment during the measurement period is only reflected as a measurement period adjustment if it results from the buyer: (a) obtaining additional information about the facts and circumstances that existed as of the acquisition date and (b) determining that if this additional information had been known, it would have affected the recognition or measurement of some element of the business combination accounting (e.g., recognition or measurement of an acquired asset or assumed liability) as of the acquisition date. If an adjustment does not meet both of these criteria, it is not considered a measurement period adjustment and, as such, is not reflected in the accounting for the business combination.

Measurement period adjustments affect the acquisition-date accounting for the business combination as they are reflected retroactively back to the acquisition date. When financial statements that include the acquisition date are reissued, they must be adjusted to reflect the effects of any measurement period adjustments recorded since the acquisition date. While measurement period adjustments are reflected retroactively, they are not considered restatements in the negative sense.

Subsequent accounting

Once an asset or liability is recognized in the accounting for a business combination, the subsequent accounting for that asset or liability typically follows the accounting guidance otherwise applicable to those assets and liabilities. For example, property, plant and equipment recognized in the accounting for a business combination would subsequently be depreciated like any other property, plant and equipment.

Certain assets and liabilities recognized in the accounting for a business combination merit unique subsequent accounting guidance given their nature and the recognition and measurement principles applied to them in the accounting for the business combination. This subsequent accounting guidance applies only if the adjustment being considered is not a measurement period adjustment. Those items for which unique subsequent accounting guidance exists as well as a brief overview of that guidance are provided in the following table:

Item	Overview of subsequent accounting guidance
Reacquired rights	The amortization period for an intangible asset representing reacquired rights is its remaining contractual period (i.e., renewals are not considered in determining the amortization period).
Contingent assets and liabilities	A systematic and rational accounting policy based on the nature of the contingent asset or liability should be used to subsequently account for that asset or liability. In essence, the buyer must adopt an accounting policy related to its subsequent accounting for contingent assets and contingent liabilities and that accounting policy should refer to other relevant U.S. GAAP as appropriate.
Indemnification assets	Adjustments to the carrying amount of an indemnification asset follow any adjustments made to the underlying 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. Collectibility and contractual limitations of the indemnification should be taken into consideration when remeasuring an indemnification asset. Subsequent accounting adjustments to indemnification assets are reflected in income. Indemnification assets are removed from the books only upon collection, sale, or other loss of rights to the benefits provided by the indemnification.

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Item	Overview of subsequent accounting guidance
Contingent consideration	The subsequent accounting for contingent consideration depends on whether the contingent consideration is classified as an asset/liability or equity. Contingent consideration classified as equity is not remeasured in subsequent accounting periods. Contingent consideration classified as an asset/liability 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, unless the contingent consideration qualifies as a designated hedging instrument for which FASB ASC 815-20-35 requires the change in fair value to be recognized in OCI. 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 income. The line item on the income statement where the change in the fair value of contingent consideration that is a derivative should be reflected depends on the facts and circumstances.

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. With limited exceptions: (a) if the buyer still has control of the target after a change in its ownership interest (i.e., the buyer's ownership interest increases or decreases, but the buyer still maintains control), the change in ownership interest is accounted for as an equity transaction or (b) if the buyer loses control of the target after a change in its ownership interest, a gain or loss is recognized upon the deconsolidation of the target.

Part of the business combination or not part of the business combination

The buyer must determine whether there are any other relationships or transactions (perhaps occurring in the same timeframe or at the same time as the business combination) between it and the target and (or) sellers that should be accounted for separate from the business combination. Examples of such other relationships or transactions include:

- Payments made to settle pre-existing relationships between the buyer and the target;
- Payments made to the target's employees or former owners for future services;
- Payments to reimburse the target for acquisition costs paid on behalf of the buyer; and
- Payments to reimburse the target for restructuring costs incurred at the request of the buyer.

In evaluating whether other relationships or transactions between the buyer and the target and (or) sellers should be accounted for separate from the business combination, the buyer should consider the following questions:

- Why did the buyer, target, sellers, and (or) other involved parties form the relationship or enter into or modify the transaction?
- Who initiated the relationship or transaction?
- When was the relationship or transaction entered into or modified?

The purpose of these questions is to determine which party or parties benefit from the other relationship or transaction.

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In some cases, accounting for a transaction or other relationship separate from the business combination will require the buyer to recognize a gain or loss (e.g., the effective settlement of a lawsuit between the buyer and the target as a result of the business combination).

Acquisition costs are not treated as part of the consideration transferred in a business combination. These costs are expensed as incurred and when the related services have been received by the buyer unless other U.S. GAAP provides different guidance, as is the case for debt and equity issuance costs. Acquisition costs should still be recognized by the buyer even if they are paid by the target, the sellers, the buyer's parent, or another related party. If a related party is providing the acquisition services, the buyer needs to consider whether the billings from the related party for those services are comparable to market rates for those services. If one service provider provides multiple acquisition services with different accounting models, the buyer needs to consider whether the billings from that service provider have been properly allocated to the different services provided.

Disclosures

The disclosure requirements for business combinations center on satisfying 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. Many specific disclosures are required to satisfy these objectives. However, if complying with these specific disclosure requirements does not fully satisfy the stated disclosure objectives, then the buyer must provide any incremental information that would result in the full satisfaction of those objectives.

Disclosures are required for business combinations that occur: (a) during the current financial reporting period and (b) after the end of the current reporting period, but before the buyer's financial statements for that period are issued or available to be issued.

A separate disclosure objective applies to adjustments that 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. That disclosure objective requires the buyer to disclose information that enables the users of its financial statements to evaluate the financial effects of those adjustments. Again, specific disclosures are required to satisfy this objective. If this objective is not satisfied by disclosing the information required by the specific disclosure requirements, then the buyer must provide the incremental information that would result in the full satisfaction of the objective.

In addition to the disclosures required by Topic 805, there are other disclosure requirements in U.S. GAAP that might also apply to certain aspects of the accounting for a business combination. For example, given that Topic 805 requires the vast majority of assets and liabilities to be measured at fair value in the accounting for a business combination, the disclosure requirements of Topic 820 should also be taken into consideration when preparing financial statements that include a business combination.

Effective date and transition

In general, the guidance in Topic 805 was effective for business combinations with acquisition dates occurring in annual reporting periods beginning December 15, 2008 or later. In addition, the guidance in Topic 805 was typically applied on a prospective basis, with the primary exception being the accounting for changes to valuation allowances on deferred tax assets and changes to income tax positions acquired in a business combination that occurred prior to the effective date of Topic 805.

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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 Topic 805 of the Codification, which includes the guidance applicable to accounting for business combinations (see Sections 1.1.4 and 1.2). Topic 805 has been in effect since 2009. Insights we have gained as a result of the application of this guidance include the following:

- The required use of a "fair-value" model to account for business combinations has increased 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 and valuation implications (see Sections 4.1 and 4.2).
- 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 (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 classified as an asset/liability) is also one of the more challenging aspects of the business combination accounting guidance (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 Topic 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 Topic 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 Topic 805*** – Highlights the key concepts in Topic 805 that must be considered in accounting for a business combination;
- ***Appendix B: Topic 805 Disclosure Checklists and Illustration*** – Provides user-friendly disclosure checklists for Topic 805 as well as an illustration that is cross-referenced to the disclosure checklist applicable to business combinations;

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- ***Appendix C: Push-Down Accounting*** – Provides in-depth discussion of when it is appropriate for the buyer's accounting basis in the target to be pushed down to the standalone financial statements of the target; how the buyer's basis should be pushed down to the target; and how the target's financial statements might be affected by its acquisition even when push-down accounting is not applied;

- ***Appendix D: Differences Between Topic 805 and Prior Guidance*** – Discusses the significant differences between Topic 805 and the guidance in use prior to the effective date of the guidance in Topic 805; and

- ***Appendix E: Audit Implications of Business Combinations*** – Discusses issues that arise in auditing the accounting for a business combination.

1.1.3 Tips on using the guide

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

- Identify the section(s) or appendix(ces) of the guide that is (are) most relevant to your question by scanning the table of contents;

- Consult the relevant guidance in Topic 805, as the guide is a supplement to Topic 805, not a substitute for it;

- Keep in mind that this guide reflects information available as of December 15, 2011 and that the FASB's website (www.fasb.org) should be referred to for the most recent information available;

- Refer to Section 1.1.4 for definitions of acronyms and titles for literature references; and

- Use the application checklist in Appendix A to help you efficiently and effectively account for a business combination.

1.1.4 Acronyms and literature references

Numerous acronyms are used throughout this guide and references are made to numerous topics of the Codification as well as other relevant literature from the FASB, SEC, SEC staff, and AICPA. Provided in this section are: (a) a legend of the acronyms used throughout this guide and the corresponding definition; (b) background information on the Codification as well as a list of the topics of the Codification that are referred to throughout this guide and the titles of those topics; and (c) a listing of other relevant literature referred to throughout this guide, the party that issued the literature and the title of the literature.

Acronym legend

Acronym	Definition
AICPA	American Institute of Certified Public Accountants
ARO	Asset Retirement Obligation
ASC	FASB Accounting Standards Codification®
ASR	SEC Accounting Series Release
ASU	Accounting Standards Update
CON	FASB Statement of Financial Accounting Concepts
EITF	Emerging Issues Task Force
FASB	Financial Accounting Standards Board

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Acronym	Definition
FCC	Federal Communications Commission
FDIC	Federal Deposit Insurance Corporation
GAAP	Generally Accepted Accounting Principles
GAAS	Generally Accepted Auditing Standards
GASB	Governmental Accounting Standards Board
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standards
IPR&D	In-process Research and Development
NCUA	National Credit Union Administration
NYSE	New York Stock Exchange
OCI	Other Comprehensive Income
PB	Primary Beneficiary
PCAOB	Public Company Accounting Oversight Board
PCS	Postcontract Customer Support
PEG	Private Equity Group
PPM	Physician Practice Management
R&D	Research and Development
SAB	SEC Staff Accounting Bulletin
SEC	Securities and Exchange Commission
SOP	AICPA Statement of Position
U.S.	United States
VIE	Variable Interest Entity

Background on Codification and titles for topics referred to in the guide

The FASB released its ASC (also referred to as the Codification) on July 1, 2009, at which point it became the single source of authoritative GAAP in the U.S., excluding guidance issued by the SEC and the GASB. The Codification includes much of the SEC's accounting guidance (e.g., SABs); however, it is not considered the authoritative source for that guidance.

FASB ASC reference	Title
Topic 230	Statement of Cash Flows
Topic 250	Accounting Changes and Error Corrections
Topic 280	Segment Reporting

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FASB ASC reference	Title
Topic 310-20	Receivables – Nonrefundable Fees and Other Costs
Topic 310-30	Receivables – Loans and Debt Securities Acquired with Deteriorated Credit Quality
Topic 320	Investments—Debt and Equity Securities
Topic 323	Investments—Equity Method and Joint Ventures
Topic 340	Other Assets and Deferred Costs
Topic 350	Intangibles—Goodwill and Other
Topic 350-20	Intangibles—Goodwill and Other – Goodwill
Topic 350-30	Intangibles—Goodwill and Other – General Intangibles Other than Goodwill
Topic 360	Property, Plant, and Equipment
Topic 360-20	Property, Plant, and Equipment – Real Estate Sales
Topic 410-20	Asset Retirement and Environmental Obligations – Asset Retirement Obligations
Topic 420	Exit or Disposal Cost Obligations
Topic 450	Contingencies
Topic 450-20	Contingencies – Loss Contingencies
Topic 460	Guarantees
Topic 480	Distinguishing Liabilities from Equity
Topic 605-25	Revenue Recognition – Multiple-Element Arrangements
Topic 605-35	Revenue Recognition – Construction-Type and Production-Type Contracts
Topic 710	Compensation—General
Topic 712	Compensation—Nonretirement Postemployment Benefits
Topic 715-30	Compensation—Retirement Benefits – Defined Benefit Plans—Pension
Topic 715-60	Compensation—Retirement Benefits – Defined Benefit Plans—Other Postretirement
Topic 718	Compensation—Stock Compensation
Topic 740	Income Taxes
Topic 805	Business Combinations
Topic 805-10	Business Combinations – Overall
Topic 805-20	Business Combinations – Identifiable Assets, Liabilities, and Any Noncontrolling Interest
Topic 805-30	Business Combinations – Goodwill or Gain from Bargain Purchase, Including Consideration Transferred
Topic 805-40	Business Combinations – Reverse Acquisitions
Topic 805-50	Business Combinations – Related Issues

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FASB ASC reference	Title
Topic 805-740	Business Combinations – Income Taxes
Topic 810-10	Consolidation – Overall
Topic 815	Derivatives and Hedging
Topic 815-10	Derivatives and Hedging – Overall
Topic 815-15	Derivatives and Hedging – Embedded Derivatives
Topic 815-20	Derivatives and Hedging – Hedging—General
Topic 815-40	Derivatives and Hedging – Contracts in Entity's Own Equity
Topic 820	Fair Value Measurement
Topic 825-10	Financial Instruments – Overall
Topic 840	Leases
Topic 840-30	Leases – Capital Leases
Topic 845	Nonmonetary Transactions
Topic 850	Related Party Disclosures
Topic 860-50	Transfers and Servicing – Servicing Assets and Liabilities
Topic 932-360	Extractive Industries—Oil & Gas – Property, Plant, and Equipment
Topic 944	Financial Services—Insurance
Topic 944-10	Financial Services—Insurance – Overall
Topic 944-805	Financial Services—Insurance – Business Combinations
Topic 954-805	Health Care Entities – Business Combinations
Topic 958-805	Not-for-Profit Entities – Business Combinations
Topic 958-810	Not-for-Profit Entities – Consolidation
Topic 976-605	Real Estate—Retail Land – Revenue Recognition
Topic 985-20	Software – Costs of Software to Be Sold, Leased, or Marketed
Topic 985-605	Software – Revenue Recognition

Other relevant literature

Other literature	Issued by	Title
ASU 2011-04	FASB	Fair Value Measurement (Topic 820) – Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs
ASU 2011-10	FASB	Property, Plant, and Equipment (Topic 360) – Derecognition of in Substance Real Estate—a Scope Clarification

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Other literature	Issued by	Title
Statement 5	FASB	Accounting for Contingencies
Statement 123R	FASB	Share-Based Payment (revised 2004)
Statement 141R	FASB	Business Combinations (revised 2007)
Statement 141	FASB	Business Combinations
Statement 160	FASB	Noncontrolling Interests in Consolidated Financial Statements
Statement 164	FASB	Not-for-Profit Entities: Mergers and Acquisitions
EITF 02-5	FASB	Definition of "Common Control" in Relation to FASB Statement No. 141
EITF 09-4	FASB	Seller Accounting for Contingent Consideration
CON 6	FASB	Elements of Financial Statements
SOP 03-3	AICPA	Accounting for Certain Loans or Debt Securities Acquired in a Transfer
R&D Practice Aid	AICPA	Assets Acquired in a Business Combination to Be Used in Research and Development Activities: A Focus on Software, Electronic Devices, and Pharmaceutical Industries
ASR 268	SEC	Presentation in Financial Statements of "Redeemable Preferred Stocks"
Regulation S-X	SEC	Financial Statement Requirements
SAB Topic 2A6	SEC staff	Business Combinations – Acquisition Method – Debt Issue Costs
SAB Topic 5J	SEC staff	New Basis of Accounting Required in Certain Circumstances
SAB Topic 5DD	SEC staff	Written Loan Commitments Recorded at Fair Value Through Earnings
SAB 54	SEC staff	Push Down Basis of Accounting Required in Certain Limited Circumstances
SAB 73	SEC staff	Push Down Basis of Accounting-Required in Certain Limited Circumstances
SAB 112	SEC staff	Update of Codification of Staff Accounting Bulletins
IFRS 3	IASB	Business Combinations

1.1.5 Updates and enhancements incorporated into this edition of the guide

This is the second edition of the guide and the content is based on information available as of December 15, 2011. The first edition of the guide was based on information available as of October 2008. Numerous updates and enhancements have been made to the guide since the first edition. Some of these updates and enhancements relate to the fact that Topic 805 has been effective since 2009 and that the Codification was released after the first edition of the guide was issued. For example, updates were made to replace all authoritative literature references with the appropriate Codification references. For another example, updates were made to remove discussion of the guidance in use prior to the effective date of the guidance in Topic 805. However, a high-level discussion of the significant differences between Topic 805 and the guidance in use prior to its effective date is provided in Appendix D.

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Other updates and enhancements to the guide relate to guidance issued by various standard-setters subsequent to the issuance of Statement 141R (which formed the basis for Topic 805 as discussed in Section 1.2). Some of those updates and enhancements include the following:

- ***Mergers and acquisitions of not-for-profit entities.*** Statement 141R initially excluded mergers and acquisitions of not-for-profit entities from its scope. Subsequently, the FASB issued Statement 164, which provided guidance on how to account for mergers and acquisitions of not-for-profit entities. This guidance is discussed briefly in Section 3.3.

- ***Preacquisition contingencies.*** The model used to account for contingencies acquired in a business combination (i.e., preacquisition contingencies) that was initially included in Statement 141R would have recorded contingencies such as those related to litigation at their fair value in the accounting for a business combination. In addition, it included a complex subsequent accounting model for such contingencies. Given the resounding negative feedback the FASB received on this model, they subsequently replaced it. The replacement model, which has essentially been in place since Topic 805 became effective, is discussed and illustrated in Section 11.2.

- ***Defensive intangible assets.*** Applying the guidance in Topic 805 and Topic 820 may result in the buyer recognizing an intangible asset even if the buyer does not intend to use that asset. These assets are sometimes considered defensive intangible assets. After Statement 141R was issued, an EITF issue provided a definition for a defensive intangible asset as well as guidance related to certain issues that may be encountered in the initial and subsequent accounting for such an asset. This definition and guidance is discussed in Section 10.18.

- ***Changes to the fair value measurement guidance in Topic 820.*** In May 2011, the FASB issued ASU 2011-04, which made changes to the fair value measurement guidance in Topic 820. Given that applying the guidance in Topic 820 is an integral part of properly accounting for a business combination, information about ASU 2011-04 and its effects on the accounting for a business combination have been incorporated in various sections of the guide as discussed in Section 8.1.

- ***Effects of business combination accounting on equity method accounting.*** The underlying concept for the equity method of accounting is that of a one-line consolidation. As that concept was implemented in practice over time, analogies were often made to the guidance that preceded Statement 141R. When Statement 141R was issued, questions arose regarding whether the changes brought about by Statement 141R should result in corollary changes to the equity method of accounting as it was being applied in practice. Many of these questions were addressed in an EITF issue, the guidance from which is discussed in Section 16.1.

- ***Accounting for decreases in the buyer's ownership interest after gaining control of the target.*** The FASB issued Statement 160 at the same time it issued Statement 141R. Statement 160 addressed various matters related to the accounting for a noncontrolling interest, including how the buyer should account for decreases in its ownership interest after it gains control of the target. After Statement 160 was issued, questions arose with respect to the interaction of its guidance and the guidance applicable to the sale of in-substance real estate and the conveyance of oil and gas mineral rights. The clarification provided by the FASB on this interaction is discussed in Section 17.1.

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Most of the other updates and enhancements to the guide relate to questions and issues that have arisen as the guidance in Topic 805 has been applied in practice. The topics into which many of these questions and issues fall have been listed in the following table along with the section of the guide that has been updated, enhanced or created to address these questions and issues:

Topic	Section
Identifying entities under common control and the accounting model that applies to transactions between entities under common control	3.2
Accounting for one joint venturer's acquisition of the other joint venturer's interest	3.4
Additional factors to consider in determining whether a business was acquired	4.1.2
Accounting for customer contracts and customer relationships, including: (a) estimating the fair value of both; (b) amortizing customer relationship intangible assets; and (c) whether a customer relationship intangible asset exists for a pre-existing relationship between the buyer and the target	10.6
Subsequent accounting for R&D assets related to computer software to be sold, leased, or otherwise marketed	10.7.2
Initial and subsequent accounting for construction contracts acquired in a business combination	10.10
Measuring working capital accounts at fair value, including additional considerations related to measuring accounts receivable and accounts payable	10.14
Recognizing deferred revenue for the legal performance obligations the target has to its customers	10.15
Excluding a straight-line rent liability from the accounting for the business combination	10.16
Subsequently accounting for acquired accounts or loans receivable with deteriorated credit quality	10.17
Identifying, measuring and presenting any noncontrolling interest that exists after a business combination	10.20
Classifying subsequent changes in an indemnification asset within the income statement	11.3.3
Accounting for the income tax effects of a business combination, including deferred taxes related to contingent consideration and other contingencies as well as acquisition costs	11.4
Estimating the fair value of equity securities transferred as consideration	12.3.3
Accounting for contingent consideration, including: (a) balance-sheet classification; (b) measurement (both initial and subsequent); (c) adjustments to amounts previously recognized; (d) cash flow statement classification when paid; (e) goodwill impairment considerations when the contingent liability reflected in consideration transferred is much less than the amount ultimately paid; and (f) the target's contingent consideration liabilities from acquisitions in which it was the acquirer	12.4
Accounting for contingent consideration by the seller	12.4.10
Measuring the fair value of the previously held equity interest when the business combination occurs without the transfer of consideration	12.5
Measuring the previously held equity interest in a step acquisition	12.6.2

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Topic	Section
Recognizing and disclosing provisional amounts and recording measurement period adjustments	12.7
Accounting for working capital adjustments	12.9
Determining whether arrangements with employees and (or) sellers of the target should be reflected within the business combination accounting (e.g., as consideration transferred or an assumed liability) or separate from the business combination accounting (e.g., as compensation expense or another cost)	13.3
Accounting for acquisition costs, including: (a) when those costs are paid by the seller or a related party; (b) when those costs represent fees for multiple services; (c) when the acquisition services are provided by a related party; and (d) where the payment for those costs should be classified on the income statement and cash flow statement	13.5
Determining whether restructuring activities should be accounted for within or separate from the accounting for the business combination	13.6
Disclosing gains from bargain purchases	14.2.3
Determining whether the fair value disclosures in Topic 820 apply to fair value measurements made in connection with the accounting for a business combination	14.7

When a business combination occurs, questions related to whether push-down accounting may or should be applied to the target's standalone financial statements often arise. As a result, another enhancement was the inclusion of Appendix C in the guide, which addresses many of the questions and issues that arise in push-down accounting, such as when is applying push-down accounting appropriate (which is illustrated using a flowchart), how is push-down accounting applied, and how might the target's financial statements be affected by its acquisition even if push-down accounting is not applied (e.g., through the push down of acquisition debt).

The updates and enhancements discussed in this section resulted in corresponding updates and enhancements to the application checklist in Appendix A.

1.2 Background information on Topic 805

Statement 141R was issued by the FASB in late 2007. This standard fundamentally affected how virtually all companies account for mergers or acquisitions of businesses (see Appendix D). 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 step toward convergence of U.S. GAAP and IFRS.

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 were codified in Topic 805.

The guidance in Topic 805 was effective starting with business combinations with acquisition dates that occurred in annual reporting periods beginning December 15, 2008 or later. As a result, for the vast majority of companies, the guidance in Topic 805 went into effect for their annual reporting periods that began in 2009. For example, for a calendar year-end company, the standard went into effect on January 1, 2009 and for a June 30th year-end company, the standard went into effect on July 1, 2009.

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The guidance in Topic 805 was generally applied on a prospective basis. This means that the subsequent accounting for items involved in the accounting for a business combination whose acquisition date fell prior to the effective date of Topic 805 should follow the guidance in effect prior to the effective date of Topic 805. One exception to prospective transition relates to the accounting for changes to valuation allowances on deferred tax assets and changes to income tax positions acquired in a business combination that occurred prior to the effective date of Topic 805. This exception is discussed in more detail in Section 11.4.8.

2.1 Definition of a business combination

The "Master Glossary" of the Codification defines a business combination as "A transaction or other event in which an acquirer obtains control of one or more businesses." Determining whether the buyer has obtained a controlling financial interest requires reference to the guidance in FASB ASC 810-10-15-8, which states:

> 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.

Generally, if a transaction or other event satisfies the definition of a business combination and the related, necessary condition for control, then the buyer 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 and condition of control that are, nonetheless, explicitly excluded from the scope of Topic 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.

As discussed previously, a transaction or other event is only accounted for as a business combination using the acquisition method if the buyer obtains control of the target. While FASB ASC 810-10-15-8 indicates that the "usual" condition for control is a greater than 50% ownership interest in the investee, control may be obtained under other circumstances as well. For example, one entity may obtain control of another entity through contract alone (see Section 3.1.2).

Use of the acquisition method is only appropriate in circumstances in which one entity gains control over another entity. In other words, 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. As discussed in Section 17.1, this increase in the parent's ownership interest should be accounted for as an equity transaction. Topic 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 Section 17.1.

2.2 Key steps in applying the acquisition method

The acquisition method is the approach that must be used to account for a business combination that: (a) meets the definition of a business combination (see Section 2.1) and (b) falls within the scope of Topic 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 section(s) or chapter(s) in this guide that provide additional guidance on that step, are:

Step 1: Identify the buyer (see Section 5.1);

Step 2: Determine the acquisition date (see Section 6.1);

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Step 3: Recognize and measure the acquired identifiable assets and assumed liabilities (see Chapters 7 through 11); and

Step 4: Recognize and measure goodwill or the gain from a bargain purchase (see Chapter 12).

3.1 Scope of transactions affected by Topic 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 Topic 805. Some of these transactions or other events, which might meet the definition of a business combination, are specifically excluded from the scope of Topic 805. Listed in the following table are various transactions and other events along with an indication as to whether the acquisition method in Topic 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	Entry for "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)	805-10-55-2(e)
The formation of a joint venture	No (Section 3.4)	805-10-15-4(a)
An acquisition of an asset or group of assets (i.e., not the acquisition of a business, as defined)	No (Section 15.1)	805-10-15-4(b)
A combination between entities under common control	No (Section 3.2)	805-10-15-4(c)
Mergers and acquisitions of not-for-profit entities	Section 3.3	954-805, 958-805 and 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 FASB ASC 958-810-25	No	805-10-15-4(e)
A reverse acquisition	Yes (Section 5.2)	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)	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)	810-10-30-1
The initial consolidation of a VIE that does not meet the definition of a business	Partially (Section 3.1.3)	810-10-30-3

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Transaction or other event	Does the acquisition method apply?	Where in the Codification is this transaction or other event discussed?
A combination between mutual entities (Note 1)	Yes	805-30-30-3 and 805-30-55-3 through 5
A leveraged buyout	Yes	Note 2
An exchange of a business for a business	Yes	805-10-55-2(a)

Note 1: 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."

Note 2: Statement 141R superseded the guidance that was applicable to leveraged buyouts. As a result of the removal of this guidance, leveraged buyouts became subject to the same guidance as other types of acquisitions. As such, the guidance in Topic 805 is used to determine: (a) whether the buyer has gained control over the target in a leveraged buyout and (b) the amounts at which the acquired assets and liabilities, as well as any noncontrolling interest, should be recognized in a leveraged buyout.

3.1.2 Business combination achieved without transferring consideration

Topic 805 explicitly includes within its scope business combinations that are achieved without the transfer of consideration. For example, a business combination may occur as a result of a management agreement between a PPM entity and a physician practice. The management agreement must be analyzed in the context of the definition of a business combination provided in Topic 805 to determine whether the PPM entity has acquired the physician practice for accounting purposes. Other examples of business combinations that are achieved without the transfer of consideration include when an investor that 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 buy-back. 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 its "acquisition" of 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 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, then the acquisition method is not applied (in whole or in part) to the initial consolidation of the VIE. Instead, FASB ASC 810-10-30-1 uses a model that relies on the carryover bases of the assets, liabilities, and noncontrolling interest involved in the acquisition.

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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 4.1.1). If the VIE meets the definition of a business, then the whole of Topic 805 applies to the initial consolidation of that VIE. If the VIE does not meet the definition of a business, then FASB ASC 810-10-30-4 requires the use of some, but not all, of the requirements in Topic 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 Topic 805.
- The PB recognizes a gain or loss as follows:

	Fair value of the consideration paid
+	Fair value of the noncontrolling interest
+	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 Topic 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 in this situation, the PB would not recognize goodwill, but would instead recognize a gain or loss as a result of the initial consolidation.

3.2 Entities under common control

As noted in the table in Section 3.1.1, the acquisition method is not applied to combinations between entities under common control. While that scope exclusion is included in Topic 805, a definition of what constitutes "common control" is not provided in Topic 805 or elsewhere in the authoritative accounting literature. The 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.

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- ***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. If 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. If 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.

If a combination occurs between entities under common control, consideration must be given to 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.

If the combination is an asset transfer that does not result in a change in the reporting entity, then the combination is accounted for prospectively as a transfer of assets. If the combination is a transfer of net assets that 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 Topic 805-50 that is under the heading of "Transactions Between Entities Under Common Control." Determining whether there has been a change in reporting entity requires a complete understanding of the facts and circumstances and an analysis of those facts and circumstances in the context of the guidance in Topic 250 that addresses a change in the reporting entity.

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

- Recognizing the carrying amounts of the net assets transferred in its accounting for the combination; and
- Combining the financial statements of the entities under common control for all periods presented and eliminating any intercompany balances and transactions.

This approach is similar to the pooling-of-interests method that was used to account for certain business combinations prior to it generally being eliminated as a result of the issuance of Statement 141 in 2001. Additional procedural guidance on how to account for a combination of entities under common control is provided in the relevant sections of Topic 805-50. In addition, the disclosure requirements in FASB ASC 805-50-50 that are applicable to transactions between entities under common control are included in Section II of Appendix B.

3.3 Not-for-profit entities

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

- 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. Topic 958-805 provides guidance on how to make this determination.
- A not-for-profit entity accounts for a merger using the carryover method. The carryover method is similar to (but not the same as) the pooling-of-interests method. Topic 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 Topic 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. Topic 958-805 provides guidance on the acquisition method to be applied by not-for-profit entities.

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 Topic 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 Topic 805, when JV was formed, neither Joint Venturer A nor Joint Venturer B accounted for its formation using the acquisition method. 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 Topic 805. Joint Venturer A applies the acquisition method to account for

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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.

4.1 Determining whether a business was acquired

4.1.1 General

The "Master Glossary" of the Codification 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 (e.g., an asset purchase or a stock purchase) does not determine whether the buyer bought a business. Determining whether the buyer bought a business requires considering the nature of the inputs, processes, and outputs acquired. FASB ASC 805-10-55-4 defines inputs, processes, and outputs as follows:

> **Input:** Any economic resource that creates, or has the ability to create, outputs when one or more processes are applied to it.
>
> **Process:** Any system, standard, protocol, convention, or rule that when applied to an input or inputs, creates or has the ability to create outputs.
>
> **Output:** The result of inputs and processes applied to those inputs that provide or have the ability to provide a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants.

None of these items can be considered in a vacuum as the importance of each is tied to the others. For example, the importance of the buyer acquiring inputs is tied to whether processes can be applied to those inputs to produce outputs. Similarly, the importance of the buyer acquiring outputs, or the ability to produce outputs, is tied to whether the outputs result from application of the acquired processes to the acquired inputs. And, the importance of the buyer acquiring processes is evident in the fact that processes are needed to convert the acquired inputs to outputs. If the buyer concludes that it has acquired inputs, processes, and either outputs or the ability to produce outputs, then the buyer has acquired a business.

If what the buyer has purchased does not constitute a business, then it is accounted for as an asset acquisition. 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 discussed in Section 15.1.

4.1.2 Questions that may arise in applying the definition of a business

Some questions that may arise in applying this definition of a business include:

- ***Must the acquired inputs and processes already be generating outputs for the set to be considered a business?*** No. If the acquired inputs and processes are already generating outputs, then the set constitutes a business. If the acquired inputs and processes are not already generating outputs, then the question becomes whether those inputs and processes are capable of producing outputs. If they are, then the set constitutes a business. If they are not, then the set does not constitute a business.

- ***Must the buyer have acquired all of the inputs and processes used by the seller to produce outputs?*** No. All of the inputs and processes used by the seller to produce outputs do not have to be acquired to conclude that a business has been acquired. Determining whether a business has been acquired is a matter of judgment. The level of judgment required to determine whether a business has been acquired

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increases when all of the inputs and processes needed to produce outputs have not been acquired. Some of the questions that should be considered in this regard include:

- ***How replaceable (or easily acquirable) are the missing inputs and processes from a market participant's perspective?*** If it would be difficult for a market participant to replace or acquire the inputs and processes that were not acquired, that would be indicative of a business having not been acquired. If it would not be problematic for a market participant to replace or acquire the inputs and processes that were not acquired, that would be indicative of a business having been acquired.

- ***Does the buyer already have some of the inputs or processes that can be used with the acquired inputs and processes to produce outputs?*** The determination as to whether a business has been acquired should be made from the perspective of a market participant. However, considering whether the buyer already has some of the inputs or processes that can be used with the acquired inputs and processes to produce outputs may help determine how replaceable or easily acquirable the missing inputs and processes are from a market participant's perspective.

- ***How substantive are the inputs and processes acquired in relation to the outputs produced (or that can be produced)?*** The acquisition of a business must involve the acquisition of at least some processes. We believe that if only nonsubstantive processes have been acquired, then it is likely that a business has not been acquired. By the same token, we believe that if at least some substantive processes have been acquired, then it is at least possible that a business has been acquired. Whether a process is substantive is a matter of judgment. Exercising judgment in this area would require a full understanding of what was acquired and what is necessary to produce the outputs. The analysis and conclusions as to how substantive the acquired inputs and processes are should be consistent with other related information, such as the buyer's internal communications or external press releases discussing the acquisition.

- ***Will the acquired inputs and processes ultimately produce the same outputs that were produced prior to their acquisition?*** It is indicative that a business has been acquired if the acquired inputs and processes will ultimately produce the same outputs (e.g., goods and [or] services) that were produced by the seller before the acquisition. Given that the production of goods and (or) services results in cash flows, one factor to consider in determining whether the outputs are the same before and after the acquisition is whether the cash flows are the same before and after the acquisition. When cash flows are comparable before and after the acquisition, the presumption would be that a business was acquired.

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

- ***Is a development stage enterprise considered a business?*** It depends on the facts and circumstances. The fact that the buyer must only be capable of producing outputs with the inputs and processes acquired introduces the possibility that a development stage enterprise could be considered a business. Questions to consider in determining whether a development stage enterprise is a business include:

  - Has the enterprise started its planned principal activities?

  - Does the enterprise have inputs and related processes, such as employees and (or) intellectual property?

  - Does the enterprise have a plan in place that will result in the production of outputs?

  - Does the enterprise have the ability to attract viable customers for its eventual outputs?

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Affirmative answers to all of these questions are not necessary to conclude that a development stage enterprise is a business. By the same token, affirmative answers to all of these questions should not automatically lead to a conclusion that a development stage enterprise is a business. All of the relevant facts and circumstances should be considered in determining whether a development stage enterprise is a business.

- ***If the acquired activities were either not operated as a business by the seller or are not expected to be operated as a business by the buyer, does that affect the determination as to whether those activities constitute a business?*** No. The fact that the seller did not, and (or) the buyer does not plan to, operate the acquired activities as a business has no bearing on whether those activities constitute a business. Whether a business exists is determined from a market participant's perspective.

- ***How does the presence (or absence) of goodwill affect the determination as to whether a business is being acquired?*** As discussed in Section 12.1, goodwill is a residual that results from the excess of: (a) the sum of consideration transferred, any noncontrolling interest in the target after the acquisition, and the buyer's previously held equity interest in the target over (b) the net assets acquired (measured predominantly at fair value). The absence of goodwill does not affect the determination as to whether a business is being acquired, whereas, in the absence of contrary evidence, the presence of goodwill creates a presumption that a business is being acquired.

- ***How does the absence of liabilities affect the determination as to whether a business is being acquired?*** While businesses typically have liabilities, the absence of such does not automatically result in a conclusion that something other than a business has been acquired.

- ***Could the purchase of an individual franchise by the franchisor be considered a business?*** Yes. It is possible that an individual franchise meets the definition of a business. The components of the franchise being purchased should be analyzed to determine whether they include significant inputs, processes, and outputs or the ability to produce outputs. If the franchise meets the definition of a business, then the purchase of it should be treated as a business combination for accounting purposes.

- ***Could the acquisition of an outsourcing arrangement represent the acquisition of a business?*** Yes. It is possible that the acquisition of an outsourcing arrangement represents the acquisition of a business.

Example 4-1: Radio broadcasting industry

Company A purchases an FCC license for a radio station and the related radio tower from Company B. Company A also purchases: (a) the portion of Company B's workforce that has knowledge of how to operate the radio station and the related radio tower, (b) contracts with suppliers (e.g., advertisers), and (c) the systems, policies, and procedures used to operate the radio station including the radio programming. Immediately after the purchase closes, Company A dismisses the Company B workforce and discontinues use of Company B's systems, policies, and procedures. Company A is adequately prepared to get the radio station up and operating by using existing Company A employees as well as its own established systems, policies, and procedures.

Company A's analysis of whether what it acquired from Company B is a business consists of the following:

- ***Did Company A purchase inputs?*** Yes. The radio station and related radio tower are capable of broadcasting the radio programming when one or more processes are applied to it. Other substantive inputs acquired by Company A include the workforce of Company B dedicated to operating the radio station as well as the contracts Company B has with its suppliers.

- ***Did Company A purchase processes?*** Yes. The knowledge the acquired workforce has on how to operate the radio station is a process acquired by Company A. In addition, Company A also purchased the systems,

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policies, and procedures used to operate the radio station. The knowledge of the workforce and the systems, policies, and procedures represent processes because when combined with the radio station, related radio tower and the contracts with suppliers (i.e., the inputs purchased by Company A), Company A is capable of broadcasting the radio programming and generating income. The fact that Company A immediately dismisses the workforce formerly of Company B and discontinues use of Company B's systems, policies, and procedures does not change the fact that they initially purchased these processes.

- ***Did Company A purchase outputs or the ability to create outputs?*** Yes. When the acquired processes are used together with the acquired inputs, Company A is capable of broadcasting the radio programming, which will provide a return to the investors in Company A.

Based on the analysis summarized in the preceding bullet points, Company A would likely conclude that it purchased a business from Company B as the purchase included substantive inputs, processes, and outputs.

Example 4-2: Real estate industry

Company E purchases a building from Company F (an independent third party). The building is several years old and fully-occupied with over 50 existing retail tenants. In addition to the building and existing leases, Company E also assumes the maintenance contracts and acquires the leasing information systems for the building. The portion of Company F's workforce that is dedicated to the operations of the building will become part of Company E's workforce as part of Company E's purchase of the building.

Company E's analysis of whether what it acquired from Company F is a business consists of the following:

- ***Did Company E purchase inputs?*** Yes. Company E purchased the building as well as the leases with existing tenants, the maintenance contracts with existing suppliers, and the leasing information systems associated with the building. In addition, Company E also "purchased" the portion of the workforce dedicated to operating the building it is purchasing from Company F.

- ***Did Company E purchase processes?*** Yes. Company E purchased significant processes related to the operation of the building, including those processes and systems associated with managing the current portfolio of leases and maintaining the building.

- ***Did Company E purchase outputs or the ability to create outputs?*** Yes. The inputs and processes purchased by Company E currently produce outputs (e.g., rental income, maintenance expense, and an overall return on the rental property).

Based on the analysis summarized in the preceding bullet points, Company E concludes that it likely has purchased a business. It appears that Company E purchased substantive inputs and significant accompanying processes that would be capable of providing a return to Company E, which would satisfy the definition of a business.

4.1.3 Other guidance that relies on the definition of a business used in Topic 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 Topic 350;

- What constitutes a business for purposes of a scope exception to the guidance on variable interest entities included in Topic 810-10;

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- Whether the guidance in Topic 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 17.1); and
- Whether a specific type of transaction is a spinoff.

4.2 Timing of determining whether a business was acquired

The buyer should determine whether or not it has acquired a business as early in the acquisition process as possible, perhaps even as early as the due diligence and financial feasibility period. 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 discussed 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 and (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 value 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 10.5]).

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 external valuation specialists engaged to assist in the identification and (or) 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.

5.1 Identifying the buyer

5.1.1 General

With the exception of business combinations in which a VIE is acquired, the buyer in a business combination is the combining entity that gains control over the other combining entity(ies). For purposes of determining whether an entity has obtained control of the target, the guidance in FASB ASC 810-10-15-8 is used. This guidance relies on the notion of majority ownership interest to determine who controls an entity (see Section 2.1). For business combinations in which a VIE is acquired, the PB is automatically considered the buyer. The identity of the PB is determined using the relevant guidance in FASB ASC 810-10-25.

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If, after applying the appropriate guidance, it is not clear which of the combining entities is the buyer, other factors should be taken into consideration. For example, the buyer in a business combination effected primarily through the transfer of cash or equity is usually the combining entity that: (a) transfers cash, transfers other assets, or incurs liabilities and (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 effected 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 make-up of the majority of the combined entity's governing body;
- Provides a dominant portion of the combined entity's management team;
- Pays a premium to acquire equity interests of the target; and (or)
- Dominates in terms of relative size (e.g., has the most assets, revenues, or earnings of the combining entities).

5.1.2 Questions that may arise in applying guidance on identifying the buyer

Additional questions that may arise in determining which of the combining entities in a business combination is the buyer include:

- ***Are there additional factors to consider in determining the buyer 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.
- ***If a new entity is formed to achieve a business combination, 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 the business combination), then the new entity should not be considered the buyer. In that situation, one of the pre-existing combining entities should be identified as the buyer. If there is substance behind forming the new entity (i.e., it transfers cash, transfers other assets, or incurs liabilities to effect the business combination), then the new entity could potentially be considered the buyer.
- ***Can one of the combining entity(ies) 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.

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- ***Does Topic 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 would be used in identifying the buyer in a combination involving mutual entities as would be 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, Topic 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 same entity as both the legal and 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 FASB 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).

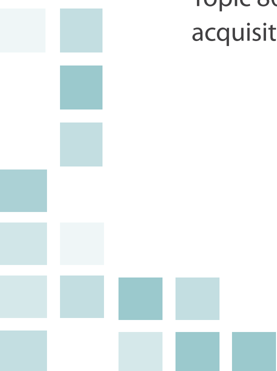
In summary, a reverse acquisition exists when the buyer for accounting purposes is the target for legal purposes and the target for accounting purposes is the buyer for legal purposes. The basic model in Topic 805 applies to reverse acquisitions in the same manner as it applies to other acquisitions. 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;

- Adjusts the amount of legal capital in the consolidated financial statements to reflect the legal capital of the accounting target (i.e., the legal capital reflected in the consolidated financial statements must be consistent with that of the legal buyer [which is the accounting target]); and

- Measures the noncontrolling interest using the precombination carrying amounts of the accounting buyer's net assets and the noncontrolling interest'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 Topic 805-40 along with a comprehensive example that covers the unique aspects of accounting for a reverse acquisition.



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6.1 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.

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).

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General Guidance on Recognition and Measurement of Assets Acquired, Liabilities Assumed, and Noncontrolling Interest

7.1 Initial recognition of assets, liabilities, and any noncontrolling interest

7.1.1 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 noncontrolling interest 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 Section 7.1 applies to the initial recognition of most assets acquired and liabilities assumed in a business combination. 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 situations for which Topic 805 provides guidance related to the subsequent accounting for an asset acquired or a liability assumed in a business combination. In addition, there are exceptions to the initial recognition guidance provided in Topic 805. In other words, there are situations 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 Topic 805 provides: (a) exceptions to its initial recognition guidance and (or) (b) subsequent accounting guidance. The table also indicates where additional discussion on these subjects can be found in this guide.

Assets or liabilities related to:	Topic 805 provides an exception to its initial recognition guidance	Topic 805 provides subsequent accounting guidance	Additional discussion
Contingencies	X	X	Section 11.2
Indemnifications	X	X	Section 11.3
Income taxes	X		Section 11.4
Employee benefits	X		Section 11.5
Reacquired rights		X	Section 11.6

General discussion on the subsequent accounting for assets and liabilities recognized in the accounting for a business combination is provided in Section 8.2.

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7.1.2 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 CON 6, which provides the following definitions of assets and liabilities:

> 25. Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events. [footnote omitted]
>
> 35. Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events. [footnotes omitted]

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. 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).

7.1.3 Part of business combination or separate transaction?

It is also 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 later in this guide (see Chapter 13).

8.1 Initial measurement of assets, liabilities, and any noncontrolling interest

8.1.1 General

The overall measurement principle applicable to the accounting for business combinations calls for the use of fair value to initially measure: (a) identifiable assets acquired and liabilities assumed and (b) any related noncontrolling interest in the target. However, for a variety of reasons, there are several exceptions to this overall measurement principle. In other words, certain assets acquired and liabilities assumed are measured at something other than fair value. These exceptions are listed in the next table and discussed in more detail in later sections of the guide.

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 Topic 805 provides subsequent accounting guidance. The table that follows lists these

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acquired assets and assumed liabilities as well as: (a) those acquired assets and assumed liabilities for which Topic 805 provides exceptions to its initial fair value measurement principle and (b) where additional discussion on the accounting for these acquired assets and assumed liabilities can be found in the guide.

Assets or liabilities related to:	Topic 805 provides an exception to its initial fair value measurement principle	Topic 805 provides subsequent accounting guidance	Additional discussion
Contingencies	X	X	Section 11.2
Indemnifications	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
Assets held for sale	X		Section 11.8

8.1.2 Definition of fair value

For purposes of the fair value measurements that must take place 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." Topic 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 noncontrolling interest that remains after the business combination.

In May 2011, the FASB issued ASU 2011-04. This ASU was issued as a result of the FASB's and IASB's efforts to converge their guidance on fair value measurements. While ASU 2011-04 includes many changes to Topic 820, only some of those changes modify its requirements. Most of the changes just clarify the requirements of Topic 820 to make them consistent with: (a) the FASB's original intent with respect to those requirements and (b) how those requirements have been implemented in practice. In addition, a significant number of the changes to Topic 820 were made to conform the grammar, style, and organization of the requirements in Topic 820 to the corresponding requirements in IFRS.

The aspects of ASU 2011-04 that are particularly relevant to fair value measurements made in connection with the accounting for a business combination are discussed elsewhere in this guide, including:

- Section 10.4 discusses the highest and best use concept;
- Section 10.14.2 discusses the highest and best use concept and the in-use and in-exchange valuation premises as they relate to accounts receivable;
- Section 10.20.3 and Section 12.6.2 discuss including premiums and discounts in fair value measurements;
- Section 12.3.3 discusses measuring the fair value of an entity's own equity securities; and
- Section 14.7 discusses the applicability of fair value disclosures to items acquired in a business combination.

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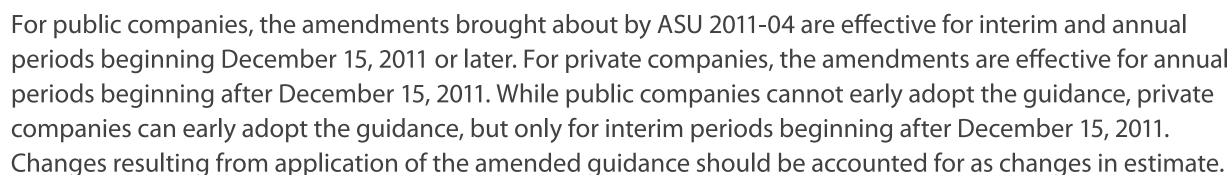

For public companies, the amendments brought about by ASU 2011-04 are effective for interim and annual periods beginning December 15, 2011 or later. For private companies, the amendments are effective for annual periods beginning after December 15, 2011. While public companies cannot early adopt the guidance, private companies can early adopt the guidance, but only for interim periods beginning after December 15, 2011. Changes resulting from application of the amended guidance should be accounted for as changes in estimate.

8.2 Subsequent accounting guidance

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

- Contingencies (see Section 11.2.4);
- Indemnifications (see Section 11.3.3);
- Reacquired rights (see Section 11.6.3); and
- 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, FASB ASC 350-30-35-17A provides subsequent accounting guidance for R&D intangible assets recognized in conjunction with a business combination (see Section 10.7.2). 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 share-based payment awards granted by the buyer in a business combination in which the awards are treated as compensation instead of consideration should follow the guidance in Topic 718. In addition, the subsequent accounting for insurance or reinsurance contracts acquired in a business combination should follow the guidance in Topic 944 (see Section 10.13).

9.1 Buyer's classification or designation of acquired assets and assumed liabilities

9.1.1 General

There are numerous examples in U.S. GAAP in which an entity must determine the classification for a transaction, 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 transaction, 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 securities. Topic 320 requires investments that fall within its scope to be classified as trading, available-for-sale, or held-to-maturity, as those terms are defined. The accounting for 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, Topic 815 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.

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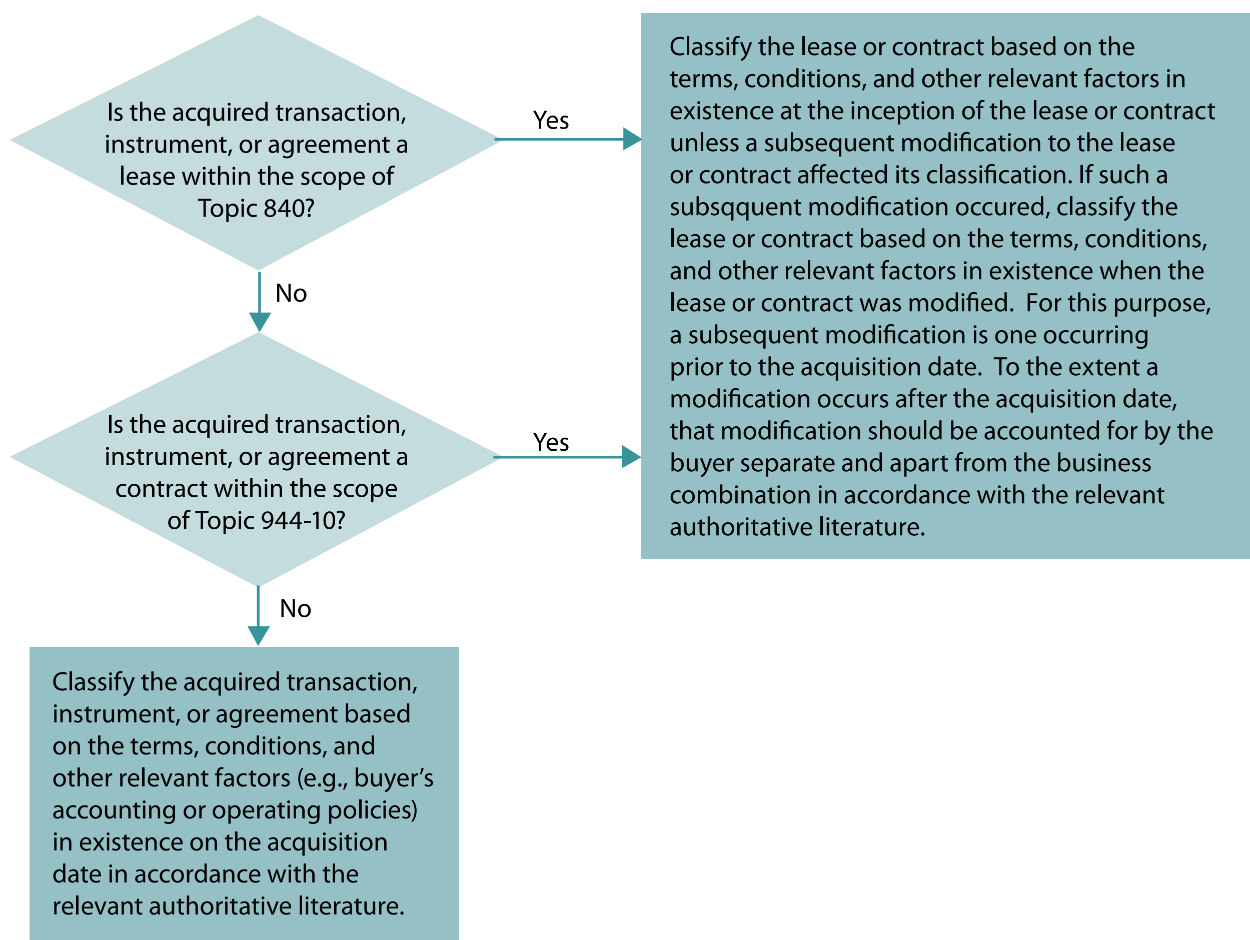
When a previously classified or designated transaction, instrument, or agreement is acquired in a business combination, the question arises regarding how the transaction, instrument, or agreement should be classified or designated by the buyer on the acquisition date for purposes of the post-acquisition-date accounting. The flowchart that follows illustrates how to answer that question and indicates that, to a certain extent, the answer to the question depends on the nature of the transaction, instrument, or agreement to be classified or designated.

9.1.2 Flowchart for buyer's classification or designation of certain acquired transactions, instruments or agreements



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9.1.3 Other items for which to consider reclassification or redesignation

Other examples of transactions, 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 Topic 815 and whether those embedded derivatives should be separated from the host contract;
- Those involving derivatives within the scope of Topic 815 that previously qualified for the normal purchases and normal sales exception and whether they continue to qualify for that exception post-acquisition;
- Those within the scope of Topic 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 topic;
- Those involving the fair value hedge of a fixed-rate asset or liability in which the shortcut method was used and whether the shortcut method may continue to be used post-acquisition;
- Those involving multiple-element arrangements within the scope of Topic 605-25 and Topic 985-605 and whether the multiple deliverables in those arrangements should be bundled together or separated for accounting purposes; and
- Those involving an asset or asset group that meets the criteria under Topic 360 to be considered held-for-sale and whether it should continue to be considered held-for-sale post-acquisition (see Section 11.8).

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Specific Application of General Recognition and (or) Measurement Guidance

10.1 Application of general recognition and measurement principles

Topic 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 in this guide:

Context	Additional discussion
Intangible assets, in general	Section 10.2 Section 10.3
Fair value of assets based on highest and best use	Section 10.4
Assembled workforce	Section 10.5
Customer contracts and customer relationships	Section 10.6
R&D	Section 10.7
Anticipated restructuring activities involving target	Section 10.8
Servicing rights	Section 10.9
Construction contracts	Section 10.10
Operating leases	Section 10.11
Capital leases in which target is the lessee	Section 10.12
Insurance and reinsurance contracts	Section 10.13
Working capital accounts	Section 10.14
Deferred revenue	Section 10.15
Straight-line rent liability	Section 10.16
Accounts or loans receivable with deteriorated credit quality	Section 10.17
Defensive intangible assets	Section 10.18
AROs	Section 10.19
Noncontrolling interest	Section 10.20

10.2 Identification of intangible assets that are separate from goodwill

10.2.1 General

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 post-acquisition accounting because goodwill is not amortized, while finite-lived intangible assets are amortized.

An asset is identifiable if it satisfies one or both of two criteria focused on the following: (1) the separability of the asset (see Section 10.2.2) and (or) (2) the contractual-legal nature of the asset (see Section 10.2.3).

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10.2.2 Separability 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.

10.2.3 Contractual-legal criterion

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.

10.2.4 Questions that may arise in applying these criteria

Some questions that may arise in applying the separability and contractual-legal criteria include:

- ***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.

- ***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. The fact that the buyer was not involved in those exchanges does not factor into the determination as to whether the intangible asset is separable, nor does the fact that those exchanges occur infrequently. However, exchange transactions are not necessarily the only support that could be used as the basis for meeting the separability criterion.

- ***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 would typically (or only) be 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 and the deposit liabilities were later sold, a gain would likely result from that sale. Recognition of such a gain (or the amount of the gain recognized) would not be appropriate given that something of value (depositor relationship) has also been given up in the exchange.

- ***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 FASB 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.

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- ***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).

10.2.5 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 is the lessee in an operating lease that has favorable (or better than market) terms and the lease agreement does not allow transfer of the lease through either sale or sublease.	Yes. When Buyer acquires Target, an identifiable intangible asset related to the favorable terms of the lease is recognized because the contractual-legal criterion is met. The lease agreement is a contract and the intangible asset arises from that contract. This is the case even though Buyer cannot transfer the lease. For additional discussion on the accounting for operating leases acquired in a business combination, see Section 10.11.
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.
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. In addition, if the terms of the licenses are favorable compared to market, then an identifiable intangible asset is recognized for those licenses because the contractual-legal criterion is met. The licenses represent contractual rights and intangible assets arise from those rights. If the terms of the licenses are unfavorable compared to market, then a liability is recognized. To the extent an intangible asset for the licenses should be recognized, it should typically be recognized separate from the intangible asset for the patent because the amortization period and (or) method 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. 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.

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

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

10.3 Application of recognition guidance to other intangible assets

10.3.1 Types of intangible assets and whether they are separately identifiable

Various other sections in this guide discuss several specific types of intangible assets that should be recognized in connection with the accounting for a business combination. FASB ASC 805-20-55-11 through 45 list and discuss several other types of intangible assets that meet either the separability or contractual-legal criterion and, therefore, can be recognized as identifiable intangible assets in the accounting for a business combination. The table that follows includes: (a) the potential identifiable intangible assets listed and discussed in those and other paragraphs of Topic 805-20; (b) the criterion that supports recognition of the intangible asset (as appropriate); and (c) the paragraph(s) in Topic 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.

Potential identifiable intangible asset acquired by buyer	Does an identifiable intangible asset exist?	Which criterion typically supports identifiability of asset?	Relevant paragraphs in Topic 805-20
Trademarks, trade names, service marks, collective marks, and certification marks that are legally protected (see Section 10.2.5)	Yes	Contractual-Legal	55-16 thru 18
Trademarks, trade names, service marks, collective marks, and certification marks that are not legally protected, but that are separable	Yes	Separability	55-16 thru 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	Contractual-Legal	55-14
Customer lists that are separable (see Section 10.2.5)	Yes	Separability	55-4, 55-21
Order or production backlog (see Section 10.6.2)	Yes	Contractual-Legal	55-22
Customer contracts and contractual customer relationships (see Section 10.6.2)	Yes	Contractual-Legal	55-23 thru 25, 55-52 thru 57
Noncontractual customer relationships that are separable (see Section 10.6.3)	Yes	Separability	55-27, 55-55
Prospective contracts with potential new customers (see Section 10.6.3)	No	Neither	55-7

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Potential identifiable intangible asset acquired by buyer	Does an identifiable intangible asset exist?	Which criterion typically supports identifiability of asset?	Relevant paragraphs in Topic 805-20
Plays, operas, and ballets under copyright	Yes	Contractual-Legal	55-29 thru 30
Books, magazines, newspapers, and other literary works under copyright	Yes	Contractual-Legal	55-29 thru 30
Musical works such as compositions, song lyrics, and advertising jingles under copyright	Yes	Contractual-Legal	55-29 thru 30
Pictures and photographs under copyright	Yes	Contractual-Legal	55-29 thru 30
Video and audiovisual material under copyright, including motion pictures or films, music videos, and television programs	Yes	Contractual-Legal	55-29 thru 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, whether the target is the lessee or the lessor (see Sections 10.11 and 10.12)	Yes	Contractual-Legal	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, such as mortgage servicing contracts, that are contractually separate from the financial assets to which they relate	Yes	Contractual-Legal	55-33 thru 35
Servicing contracts, such as mortgage servicing contracts, that are not contractually separate from the financial assets to which they relate (see Section 10.9)	No	Neither	55-35
Employment contracts	Yes	Contractual-Legal	55-36
Use rights such as drilling, water, air, timber cutting, and route authorities	Yes	Contractual-Legal	55-37
Patented technology (see Section 10.2.5)	Yes	Contractual-Legal	55-38

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Potential identifiable intangible asset acquired by buyer	Does an identifiable intangible asset exist?	Which criterion typically supports identifiability of asset?	Relevant paragraphs in Topic 805-20
Computer software and mask works under patent or copyright	Yes	Contractual-Legal	55-40 thru 41
Unpatented technology that is separable	Yes	Separability	55-38
Unpatented technical expertise or "know-how" that is separable (see Section 10.2.5)	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 thru 43
Trade secrets, such as secret formulas, processes, and recipes, that are legally protected	Yes	Contractual-Legal	55-44 thru 45
Trade secrets, such as secret formulas, processes, and recipes, that are not legally protected, but that are separable	Yes	Separability	55-44 thru 45
IPR&D that is separable	Yes	Separability	30-6
Assembled workforce (see Section 10.5)	No	Neither	55-6

Recognition of intangible assets in conjunction with the accounting for insurance or reinsurance contracts acquired in a business combination is discussed in Section 10.13.

10.3.2 Questions that may arise in identifying other intangible assets

Questions that may arise related to certain of these identifiable intangible assets include:

- ***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.

- ***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.

- ***Could some of the items in this list result in a liability being recognized instead of an identifiable intangible asset?*** Yes. Examples of liabilities that could arise from items on this list are unfavorable operating leases and unfavorable customer contracts.

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

As discussed in Section 8.1.2, the FASB issued ASU 2011-04 in May 2011. This ASU amends the guidance in Topic 820 on the subject of highest and best use. Guidance on the subject of highest and best use both before and after the effective date of ASU 2011-04 is discussed in this section. Refer to Section 8.1.2 for the effective date and transition guidance applicable to ASU 2011-04.

When estimating the fair value of an asset to be recognized in the accounting for a business combination, the guidance in Topic 820 should be used. Topic 820 provides guidance on what the definition of fair value means in the context of different situations. One of these situations is whether the fair value of an 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:

Before ASU 2011-04	After ASU 2011-04
In broad terms, the use of an asset by market participants that would maximize the value of the asset or the group of assets within which the asset would be used.	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.

The changes to the definition of highest and best use brought about by ASU 2011-04 are not expected to have a significant effect on how that definition is applied in practice to ***nonfinancial*** assets. However, the changes might have an effect on how the fair values of certain ***financial*** assets are estimated in practice. Prior to the changes, it might have been appropriate to make a case that a financial asset had alternative uses. After the changes, it would no longer be appropriate to make that case because the changes clearly indicate that financial assets do not have alternative uses. Refer to Section 10.14.2 for additional discussion regarding the effects of the highest and best use concept no longer applying to accounts receivable.

Topic 820 clearly indicates the fair value of an 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 Topic 820 on the buyer's intended use of the asset:

FASB ASC 820-10-35-10 (pre ASU 2011-04)	FASB ASC 820-10-35-10C (amended for ASU 2011-04)
Highest and best use is determined based on the use of the asset by market participants, even if the intended use of the asset by the reporting entity is different.	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.

The presumption added by ASU 2011-04 (i.e., that an entity's current use of a nonfinancial asset is its highest and best use unless there is evidence to the contrary) is not expected to have a significant effect on how the highest and best use of a nonfinancial asset is being determined in practice.

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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 10.18.

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 Topic 820 to illustrate the highest and best use concept deal with land acquired in a business combination (specifically, FASB ASC 820-10-55-30 through 31) (see Example 10-1) and IPR&D acquired in a business combination (specifically, FASB ASC 820-10-55-32) (see Example 10-2).

Example 10-1: Land acquired in a business combination

Facts:	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 and 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.
Question:	What is the highest and best use of the acquired land?
Answer:	Continued use of the land by Buyer as the location for the manufacturing facility could be the highest and best use of that land. However, Buyer must also consider whether demolition of the manufacturing facility and rezoning of the land for residential use is the highest and best use of that land. Even though Buyer has no intention of undertaking these activities, Buyer must still consider that alternative in determining the fair value of the land in this scenario because it is reasonable to expect that a market participant would undertake the demolishing and rezoning activities if it would result in the land having a higher value. The fair value under both scenarios (and potentially other scenarios) would 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 would need 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 could be exercised by a market participant with respect to this land. The highest of these fair values would be considered the highest and best use of the land from the perspective of the market participant. **How is this analysis and (or) answer affected by ASU 2011-04?** The analysis is affected by ASU 2011-04 only in that there would be a presumption that the land's highest and best use is its current use as part of the manufacturing operation. However, that presumption would be overcome because there are market factors indicating that market participants would use the asset differently to maximize its value. Once the presumption is overcome, the remaining analysis and answer would be the same both before and after the effective date of ASU 2011-04.

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Key Points:	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. 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

Facts:	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.
Question:	What is the highest and best use of the acquired IPR&D project?
Answer:	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); and 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 would also need 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 would typically represent the highest and best use of the acquired IPR&D project.
Key Points:	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. In addition, 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, in 2001, the AICPA issued the R&D Practice Aid that provides helpful information on valuing acquired R&D projects. The R&D Practice Aid is in the process of being updated by the AICPA to reflect all of the relevant authoritative literature issued since 2001 (e.g., Topics 805 and 820). In connection with that process, the AICPA issued a working draft of AICPA Accounting and Valuation Guide, "Assets Acquired to Be Used

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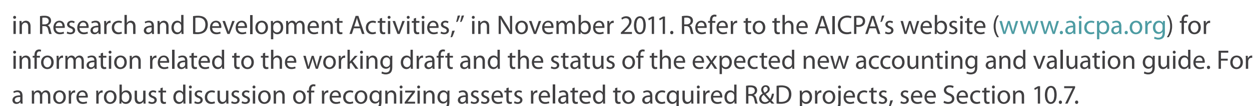

in Research and Development Activities," in November 2011. Refer to the AICPA's website (www.aicpa.org) for information related to the working draft and the status of the expected new accounting and valuation guide. For a more robust discussion of recognizing assets related to acquired R&D projects, see Section 10.7.

Examples 10-1 and 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).

10.5 Application of recognition guidance to an assembled workforce

FASB 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 that business combination or serves to reduce any gain from a bargain purchase that might be 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 asset acquisitions, see Section 15.1. For discussion on the definition of a business, see Section 4.1.

10.6 Application of recognition and measurement guidance to customer contracts and customer relationships

10.6.1 General

The approach used to determine whether an identifiable intangible asset exists for a customer relationship differs depending on whether the customer relationship is contractual or noncontractual. Both types of customer relationships and whether they represent identifiable intangible assets are discussed in Sections 10.6.2 and 10.6.3.

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10.6.2 Recognition of customer contracts and contractual customer relationships

The buyer in a business combination should recognize separate identifiable intangible assets, if they exist, for both the target's order or production backlog (which is a backlog of purchase and sale orders) and the target's customer contracts. While these items may or may not be separable, they still represent identifiable intangible assets because they satisfy the contractual-legal criterion. In addition, the buyer must also consider whether it would be appropriate to recognize a separate identifiable intangible asset for the customer relationships related to these items.

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 customer relationships. 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 10.11.1).

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 that arise from a contract. As a result, the contractual-legal criterion has been met for these customer relationships and, accordingly, separate identifiable intangible assets should be recognized for those customer relationships.

Questions that may arise in applying this guidance include:

- ***Could an identifiable intangible asset exist for contractual customer relationships even if there is not an open contract or order or production backlog on the acquisition date?*** Yes. The theory is based on whether, in practice, the target has a history of establishing contracts, including sales or purchase orders, with its customers. The fact that there are not open contracts or an order or production backlog at the acquisition date should not automatically lead to the conclusion that no contractual customer relationship intangible assets exist.

- ***Should the identifiable intangible assets related to the customer contracts or order or production backlog be recognized separately from any identifiable intangible assets for the related customer relationships?*** Yes. In many cases, the identifiable intangible assets related to the customer contracts or order or production backlog and the customer relationships will have different useful lives and (or) amortization patterns. In those cases, separate identifiable intangible assets would be recognized.

- ***Does an identifiable intangible asset exist for customer contracts or order or production backlog even if those contracts or backlog cannot be transferred by the target?*** Yes. Because the customer contracts and production backlog satisfy the contractual-legal criterion, they do not need to be separable.

- ***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 cancelled by the customer. However, the fact that the order or production backlog is cancelable would likely affect the fair value estimate of the order or production backlog.

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Example 10-3: Customer contract and contractual customer relationship intangible assets

Facts	Does a customer contract intangible asset exist?	Does a contractual customer relationship intangible asset exist?
Scenario A: Buyer acquires Target on December 31, 20X8. Buyer determines that the acquisition of Target should be accounted for as a business combination. Target has a favorable contract with Customer that runs from July 1, 20X7 to June 30, 20X9. Target expects Customer to renew the contract for another two-year period.	Yes. The contract with Customer satisfies the contractual-legal criterion. The expectation that Customer will renew the contract factors into the measurement of the customer contract intangible asset.	Yes. The customer relationship arises out of the contract with Customer. As such, the contractual-legal criterion is satisfied with respect to the contractual customer relationship intangible asset. The fair value of, or amortization period for, the contractual customer relationship intangible asset would likely be affected by the expectation that Customer will renew the contract.
Scenario B: Same as Scenario A, except Target does not expect Customer to renew the contract.	Yes. The contract with Customer satisfies the contractual-legal criterion. The expectation that Customer will not renew the contract factors into the measurement of the customer contract intangible asset, not whether the asset is recognized.	Yes. The customer relationship arises out of the contract with Customer. As such, the contractual-legal criterion is satisfied with respect to the contractual customer relationship intangible asset. The fair value of, or amortization period for, the contractual customer relationship intangible asset would likely be affected by the expectation that Customer will not renew the contract. In comparison to Scenario A, this would likely lead to a lower fair value and shorter amortization period for the contractual customer relationship intangible asset.
Scenario C: Same as Scenario A, except that Customer may cancel the contract with Target at any time.	Yes. The contract with Customer satisfies the contractual-legal criterion. The fact that the contract is cancellable by Customer factors into the fair value measurement of the customer contract intangible asset, not whether the asset is recognized.	Yes. The customer relationship arises out of the contract with Customer. As such, the contractual-legal criterion is satisfied with respect to the contractual customer relationship intangible asset. The fair value of, or amortization period for, the contractual customer relationship intangible asset would likely be affected by the expectation that Customer will renew the contract.
Scenario D: Buyer acquires Target on December 31, 20X8. Buyer determines that the acquisition of Target should be accounted for as a business combination. Target had a contract with Customer that ran from December 1, 20X7 to November 30, 20X8. While	No. There is not a contract in place at December 31, 20X8. As such, a customer contract intangible asset does not exist.	Yes. The contractual customer relationship intangible asset arises out of: (a) Target's practice of establishing a contract with Customer and (b) the contract satisfying the contractual-legal criterion even though the contract is not in existence at the acquisition date.

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Facts	Does a customer contract intangible asset exist?	Does a contractual customer relationship intangible asset exist?
Target has a long-standing practice of entering into a new contract with Customer upon expiration of an old contract, it has not signed a new contract with Customer by December 31, 20X8.		
Scenario E: Buyer acquires Target on December 31, 20X8. Buyer determines that the acquisition of Target should be accounted for as a business combination. Target is in the process of negotiating a contract with Client, who is a prospective customer (i.e., not previously a customer of Target).	No. There is not a contract in place at December 31, 20X8. As such, a customer contract intangible asset does not exist.	No. A contractual customer relationship intangible asset does not exist because a contract between Target and Client does not exist at the acquisition date and Target does not have a history or practice of establishing a contract with Client.

Note: These scenarios are written from the perspective of accounting for customer contract and contractual customer relationship intangible assets acquired in a business combination. The same analyses and conclusions would be reached if the scenarios were written from the perspective of accounting for these types of intangible assets acquired in a transaction other than a business combination.

FASB ASC 805-20-55-52 through 57 includes additional examples that illustrate how to determine whether an intangible asset should be recognized for customer relationships – both those arising from customer contracts and those arising from a backlog of sales or purchase orders from customers. In addition, for discussion on accounting for customer lists acquired in a business combination, see Section 10.2.5.

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 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 FASB 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 would not be considered a separately identifiable intangible asset, which would result in the related value of that walk-up customer base effectively being included in goodwill.

As discussed previously, 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.

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10.6.4 Fair value measurement

Determining whether it is appropriate to recognize an identifiable intangible asset for a customer contract or customer relationship acquired in a business combination is only one part of the process to account for these assets. Another part of the process, if an identifiable intangible asset does, in fact, exist, involves determining the fair value of that customer contract or customer relationship.

While there may be situations in which there is an active market price for certain customer contracts (e.g., certain commodities contracts), in most cases there will not be an active market price for either a customer contract or a customer relationship intangible asset. The lack of an active market price results in the buyer needing to use a valuation technique to determine the fair value of the customer contract or customer relationship intangible asset. The nature of the customer contract or the customer relationship can add complexity to identifying the appropriate valuation technique and (or) applying that valuation technique properly. As a result, it is often recommended that the buyer involve a valuation specialist in estimating the fair value of a customer contract or a customer relationship intangible asset.

One of the many benefits to utilizing a valuation specialist in estimating the fair value of a customer contract or customer relationship intangible asset would be the ability to objectively reflect the perspective of a market participant in the fair value measurement. Consider a situation in which the target is the primary provider of a product and, because of that, a market participant would have much higher production and (or) fulfillment costs than the target. Also, assume a customer relationship intangible asset exists in this situation because the target has a contract to sell a significant amount of this product to a customer. 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 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 customer relationship intangible asset in this situation, the asset would be overvalued by the buyer, which would result in understating goodwill. A valuation specialist would assist the buyer in making sure that the fair value measurement of the target's customer contract and customer relationship intangible assets reflect a market participant's perspective.

10.6.5 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 period to use to amortize the asset. When doing so, the buyer should make sure the assumptions it is making with respect to the amortization method and period are consistent with the assumptions it used in estimating the fair value of the customer relationship intangible asset. For example, if the valuation method used to estimate the fair value of the customer relationship intangible asset ascribed proportionally more value to the customer relationship intangible asset earlier in its life, the amortization method should generally result in proportionally more of the asset being amortized (i.e., proportionally 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 period used to amortize that asset.

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 7.1.2, the initial basis for recognizing intangible assets in the accounting for a business combination is the definition of an asset included in paragraph 25 of CON 6.

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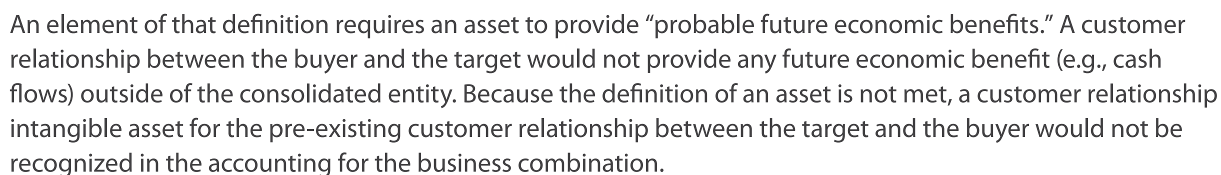

An element of that definition requires an asset to provide "probable future economic benefits." A customer relationship between the buyer and the target would not provide any future economic benefit (e.g., cash flows) outside of the consolidated entity. Because the definition of an asset is not met, a customer relationship intangible asset for the pre-existing customer relationship between the target and the buyer would not be recognized in the accounting for the business combination.

10.7 Application of recognition guidance to R&D

10.7.1 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 7.1.2). This is the case even if the IPR&D: (a) has no alternative future use and (or) (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.

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 7.1.2). The asset definition relied upon for this purpose is found in paragraph 25 of CON 6, which indicates: "Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events." [footnote omitted] The FASB concluded that the nature of IPR&D does, in fact, represent "probable" future economic benefits as that phrase is used in CON 6. 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. While there are significant judgments and estimates involved in measuring the fair value of IPR&D that affect the reliability of the fair value measurement, those judgments and estimates do not render the fair value measurement unreliable.

The difficulty of measuring the fair value of IPR&D has been dealt with in practice for some time. In fact, in 2001, the AICPA issued the R&D Practice Aid, which provides helpful information on valuing acquired IPR&D projects. This practice aid is in the process of being updated by the AICPA. In connection with that process, the AICPA issued a working draft of AICPA Accounting and Valuation Guide, "Assets Acquired to Be Used in Research and Development Activities," in November 2011. Refer to the AICPA's website (www.aicpa.org) for information related to the working draft and the status of the expected new 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 in Section 10.4.

10.7.2 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.

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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. FASB ASC 360-10-35-47 through 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.

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

Based on the guidance discussed earlier in Section 10.7.1, 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 FASB 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." If technological feasibility has been established, then 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 Topic 985-20. If 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 would be 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 Topic 985-20 and any qualifying costs incurred after reaching technological feasibility would be capitalized as part of that asset.

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 would 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.

10.7.3 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 post-acquisition R&D costs does not serve to increase the related R&D intangible asset.

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10.8 Application of recognition guidance to anticipated restructuring activities involving 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 7.1.2). The liability definition relied upon for this purpose is that found in paragraph 35 of CON 6: "Liabilities are probable21 future sacrifices of economic benefits arising from present obligations22 of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events." Footnotes 21 and 22 of CON 6 elaborate on what "probable" and "obligations" mean in the context of the definition of a liability:

> [21] *Probable* is used with its usual general meaning, rather than in a specific accounting or technical sense (such as that in Statement 5, par. 3 [*FASB ASC 450-20-25-2*]), and refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved (*Webster's New World Dictionary*, p. 1132). Its inclusion in the definition is intended to acknowledge that business and other economic activities occur in an environment characterized by uncertainty in which few outcomes are certain (pars. 44-48). [*Codification reference added*]
>
> [22] *Obligations* in the definition is broader than legal obligations. It is used with its usual general meaning to refer to duties imposed legally or socially; to that which one is bound to do by contract, promise, moral responsibility, and so forth (*Webster's New World Dictionary*, p. 981). It includes equitable and constructive obligations as well as legal obligations (pars. 37-40).

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 Topic 420 should be followed. For this purpose, Topic 420 also relies on the definition of a liability in paragraph 35 of CON 6, except when one-time termination benefits are involved. Except for those one-time termination benefits, a liability of the buyer would not exist at the acquisition date under Topic 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, Topic 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 Topic 420 that must be met by the buyer prior to recognizing a liability are as follows:

- Commit to a plan that has been appropriately agreed upon;
- Identify specific information about the employees that may be subject to termination, including the number of employees that are expected to be terminated;
- Determine the termination benefits to be provided to affected employees;
- Provide a clear and sufficient explanation of those benefits such that the employees that may be subject to termination appreciate the nature of the benefits they would receive if terminated under the plan;

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- Indicate that significant changes to, or withdrawal of, the plan will not occur; and
- 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).

10.9 Application of recognition and measurement guidance to servicing rights

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.

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

While a separate identifiable intangible asset is not recognized for servicing rights that have not been contractually separated from the related financial asset, the existence of those servicing rights does have an effect on the fair value of the related financial asset. In other words, the fair value of a financial asset with servicing rights will have a different fair value than the same financial asset without servicing rights.

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 SAB Topic 5DD. This SAB topic, which indicates the following, is codified in FASB ASC 815-10-S99-1:

> The staff believes that, consistent with Subtopic 860-50 and 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 paragraphs 860-50-30-1 through 30-2, 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]

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10.10 Application of recognition guidance to construction contracts

10.10.1 Applicability

Section 10.10 addresses the business combination accounting and subsequent accounting for customer contracts that fall within the scope of Topic 605-35.

10.10.2 Business combination accounting

When the buyer in a business combination buys a target that has customer contracts that fall within the scope of the construction-type contract accounting guidance in Topic 605-35, the buyer should recognize an asset or a liability for the customer contract. Such asset or liability should be measured at its fair value in accordance with Topic 820. This fair value estimate is performed independent of whether a customer contract was or will be accounted for using the completed contract method or the percentage-of-completion method. In other words, the fair value of the asset or liability is not affected by the method used to account for the contract before or after the acquisition.

10.10.3 Subsequent accounting

The subsequent accounting for any asset or liability recognized in the accounting for a business combination for an in-progress customer contract that falls within the scope of Topic 605-35 depends on the accounting method used to account for the customer contract after the acquisition date. Generally, under the completed contract method, the asset or liability is removed from the books when the contract is completed. In removing the contract asset or liability from the books, revenue is debited (for removal of an asset) or credited (for removal of a liability). Generally, under the percentage-of-completion method, the asset or liability is amortized into revenue (as either a debit [for amortization of an asset] or credit [for amortization of a liability]) based on the percentage complete.

The buyer in a business combination must determine whether the target's customer contracts should be accounted for after the acquisition date using the percentage-of-completion method or the completed contract method. The buyer does not have a free choice between these methods. The facts and circumstances surrounding each contract considered in the context of the guidance in Topic 605-35 would determine the method that should be applied to a particular customer contract. The method used after the acquisition date may or may not be the same method used by the target prior to the acquisition date.

In applying either the completed contract method or the percentage-of-completion method after the acquisition date, the amount of revenue recognized is going to be based on the amount to be billed to the customer after the acquisition date. Revenues recognized after the acquisition date will also be affected by any asset or liability recognized for the contract in the accounting for the business combination. In addition, the amount recognized in cost of sales and the percentage complete (under the percentage-of-completion method) is based on the estimate of the costs to complete the contract after the acquisition date and the costs incurred to complete the contract after the acquisition date. To the extent an estimate of costs to complete is used as an input in determining the fair value of the contract, then that estimate should be determined from a market participant's perspective. The estimated costs to complete for purposes of accounting for the contract after the acquisition date should be based on entity-specific cost estimates.

The amounts billed to the customer and the amount of costs incurred prior to the acquisition date do not directly affect the accounting for the contract after the acquisition. However, these amounts do indirectly affect the amount of revenue recognized after the acquisition date because the amounts billed and costs incurred prior to the acquisition date would be taken into consideration in estimating the fair value of the contract asset or

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contract liability recognized in the accounting for the business combination. The derecognition of this contract asset or contract liability affects the amount of revenue recognized after the acquisition date as previously discussed.

The total amount of revenue and cost of sales recognized over the term of each contract that remains after the acquisition date is the same regardless of whether the completed contract or percentage-of-completion method is used. In addition, the total amount of revenue recognized on each customer contract after the acquisition date is the total post-acquisition billings to the customer: (a) less the fair value of any asset recognized for the contract in the accounting for the business combination or (b) plus the fair value of any liability recognized for the contract in the accounting for the business combination.

Example 10-4: Construction contract acquired in a business combination

The following example illustrates the journal entries that may result from the acquisition of a target that has contracts that should be accounted for using either the completed contract method or the percentage-of-completion method. 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.

Facts: Buyer acquired Target on January 1, 20X1. Both Buyer and Target are construction contractors. The construction contracts Buyer and Target enter into with their customers fall within the scope of Topic 605-35. As of January 1, 20X1, Target only had one open contract with a 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	-
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	-
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's fair value	360,000	Note 2	Note 2

Note 1: The post-acquisition 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 construction contract asset or liability recognized on the acquisition date.

Note 2: The fair value of the customer contract only needs 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 what method is used to account for the customer contract after the acquisition.

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. 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 post-acquisition-date accounting for the contract. As such, that estimate needs to be re-assessed as of every reporting date after the acquisition date.

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Analysis: After its acquisition of Target, Buyer must determine whether Target's customer contract should be accounted for using the percentage-of-completion method or the completed contract method. Buyer would make this determination by considering the same factors it would consider in determining whether any of its own construction contracts should be accounted for using the percentage-of-completion method or the completed contract method. The facts and circumstances surrounding the contract considered in the context of the guidance in Topic 605-35 would determine the method that should be applied.

The entries that Buyer would make with respect to Target's customer contract follow. Two scenarios are presented: (1) Buyer concludes that the completed contract method should be applied to Target's customer contract subsequent to the acquisition date and (2) Buyer concludes that the percentage-of-completion method should be applied to Target's customer contract subsequent to the acquisition date.

Recognition of intangible construction contract asset on January 1, 20X1 (the acquisition date):

	Scenario 1: Completed contract		Scenario 2: Percentage-of-completion	
	Debit	Credit	Debit	Credit
Intangible construction contract asset	$360,000		$360,000	
Goodwill (Note 1)		$360,000		$360,000

Note 1: For purposes of this example, assume that Buyer recognized goodwill in its accounting for the business combination in excess of the fair value of the intangible construction contract asset. The entry to record goodwill recognized in a business combination would include many other components. This credit to goodwill is only shown to illustrate the fact that recognizing an intangible construction contract asset would effectively reduce the amount of goodwill ultimately recognized in the accounting for the business combination.

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

	Scenario 1: Completed contract		Scenario 2: Percentage-of-completion	
	Debit	Credit	Debit	Credit
Deferred contract costs (Note 1)	$300,000			
Cost of sales (Note 1)			$300,000	
Accounts payable (Note 4)		$300,000		$300,000
Accounts receivable (Note 4)	$800,000		$800,000	
Deferred contract billings (Note 2)		$800,000		$50,000
Revenue (Note 2)				750,000
Revenue			$270,000	
Intangible construction contract asset (Note 3)				$270,000

Note 1: In this situation: (a) the completed contract method requires deferral of the contract costs incurred during the quarter while (b) the percentage-of-completion method requires recognition of the contract costs incurred during the quarter as cost of sales.

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Note 2: In this situation: (a) the completed contract method requires deferral of the contract billings that occurred during the quarter while (b) the percentage-of-completion method requires recognition of revenue based on the percentage complete. The percentage complete as of March 31, 20X1 is 75% (costs incurred during the quarter [$300,000]/total costs expected to be incurred after the acquisition date [$400,000]). The amount of revenue to be recognized in the quarter ending March 31, 20X1 (exclusive of the effects of amortizing the intangible construction contract asset, which is discussed in Note 3) is $750,000 (percentage complete [75%] * total amount to be billed to the customer after the acquisition date [$1,000,000]).

Note 3: In this situation: (a) the completed contract method will result in removing the intangible construction contract asset from the books when the contract is closed out while (b) the percentage-of-completion method will result in amortizing the intangible construction contract asset as a reduction of revenue based on the percentage complete. The amount of the intangible construction contract asset amortized in the quarter ending March 31, 20X1 is $270,000 (percentage complete [75%] * intangible construction contract asset recognized in the accounting for the business combination [$360,000]).

Note 4: 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):

	Scenario 1: Completed contract		Scenario 2: Percentage-of-completion	
	Debit	Credit	Debit	Credit
Deferred contract costs (Note 1)	$100,000			
Cost of sales (Note 1)			$100,000	
Accounts payable (Note 4)		$100,000		$100,000
Accounts receivable (Note 4)	$200,000		$200,000	
Deferred contract billings (Note 2)		$200,000	50,000	
Revenue (Note 2)				$250,000
Revenue			$90,000	
Intangible construction contract asset (Note 3)				$90,000

Note 1: In this situation: (a) the completed contract method requires deferral of the contract costs incurred during the quarter while (b) the percentage-of-completion method requires recognition of the contract costs incurred during the quarter as cost of sales.

Note 2: In this situation: (a) the completed contract method requires deferral of the contract billings that occurred during the quarter while (b) the percentage-of-completion method requires recognition of revenue based on the percentage complete. Because the project is complete at June 30, 20X1, the amount of revenue recognized under the percentage-of-completion method in the quarter ending June 30, 20X1 (exclusive of the effects of amortizing the intangible construction contract asset, which is discussed in Note 3) is $250,000, which is the difference between the total amount billed to the customer after the acquisition date ($1,000,000) and the amount of billings recognized as revenue in the previous quarter ($750,000). Of this amount, $50,000 was previously reflected in the Deferred Contract Billings account. As such, that account is reduced by $50,000 in the quarter ending June 30, 20X1.

Note 3: In this situation: (a) the completed contract method will result in removing the intangible construction contract asset from the books when the contract is closed out while (b) the percentage-of-completion method will result in amortizing the intangible construction contract asset as a reduction of revenue based on the percentage complete. Because the project is complete at June 30, 20X1, the amount of the intangible construction contract asset that is amortized as a reduction of revenue under the percentage-of-completion method in the quarter ending June 30, 20X1 is the difference between the intangible construction contract asset recognized in the accounting for the business combination ($360,000) less the amount of the asset amortized in the previous quarter ($270,000).

Note 4: 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.

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Entries necessary to close out the accounting under the completed contract method in the quarter ending June 30, 20X1:

	Scenario 1: Completed contract	
	Debit	Credit
Cost of sales	$400,000	
Deferred contract costs		$400,000
Deferred contract billings	$1,000,000	
Revenue		$1,000,000
Revenue	$360,000	
Intangible construction contract asset		$360,000

Overall effects:

The following table illustrates that the total amount of revenue and cost of sales recognized over the term of the contract that remains after the acquisition date is the same regardless of whether the completed contract or percentage-of-completion method is used subsequent to the acquisition date:

	Quarter ending March 31, 20X1	Quarter ending June 30, 20X1	Total since acquisition date
Revenue			
Completed contract method	-	$640,000	$640,000
Percentage-of-completion method	$480,000	160,000	640,000
Cost of sales			
Completed contract method	-	400,000	400,000
Percentage-of-completion method	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 ($1,000,000) less the fair value recognized for the intangible construction contract asset ($360,000).

10.11 Application of recognition and measurement guidance to operating leases

10.11.1 General

To the extent the target has operating leases that are being 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

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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 ("at market" if the target is either the lessee or lessor). The accounting implications of these potential outcomes are as follows:

- ***Favorable:*** An intangible asset is recognized for the operating lease in the business combination.
- ***Unfavorable:*** A liability is recognized for the operating lease in the business combination.
- ***Neither favorable nor unfavorable (at market):*** Neither an intangible asset nor a liability is recognized for the operating lease in the business combination.

The intangible asset or liability for the operating lease is measured at its fair value. Measuring the fair value of the intangible asset or liability recognized in conjunction with a favorable or unfavorable operating lease requires determining: (a) what a market participant would pay for a lease whose terms are favorable compared to the market terms for the same or similar lease or (b) what the buyer would have to pay a market participant to assume a lease whose terms are unfavorable compared to the market terms for the same or similar lease.

Beyond the asset or liability that may be recognized for an operating lease with favorable or unfavorable terms, respectively, the buyer must also consider whether the operating lease gives rise to an additional separately identifiable intangible asset. FASB ASC 805-20-25-13 provides the following examples in which the acquisition of a lease could give rise to the buyer recognizing an additional 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).

For a discussion of the classification of an acquired lease as an operating lease or a capital lease on the acquisition date, see Section 9.1.

10.11.2 Acquired operating leases in which target is lessee

No other assets or liabilities are recognized by the buyer for an operating lease acquired in a business combination in which the target is the lessee. In other words, an asset is not recognized for the lessee's (or target's) right to use the asset that is the subject of the operating lease nor is a liability recognized for the lessee's (or target's) obligation to make payments under the operating lease. This approach to accounting for operating leases acquired in a business combination in which the target is the lessee is consistent with the current approach used by lessees to account for operating leases outside of a business combination.

In effect, the buyer carries over the target's accounting for the lease. As such, it is important to understand the target's pre-acquisition accounting for the lease. If the target's financial statements were not audited, a high level of scrutiny should be placed on the target's pre-acquisition accounting for the lease.

10.11.3 Acquired operating leases in which target is lessor

If the target is the lessor, 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 terms of the lease contract being above market or below market. 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 earlier in Section 10.11.1.

Proposed ASU, "Real Estate – Investment Property Entities (Topic 973)," was issued in October 2011. This proposed ASU would define what an "investment property entity" is and provide accounting guidance for such entities.

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The proposed ASU would require an investment property entity that acquires an investment property in a business combination to include the expected cash flows under a lease contract in measuring the fair value of the investment property. In other words, a lease contract being above market or below market would affect the investment property entity's fair value measurement of the acquired investment property (i.e., the asset being leased). See the FASB's website for additional information on this proposed ASU.

10.11.4 Summary

The following table summarizes the guidance in Section 10.11:

	Accounting for the business combination, if the target is the…	
Acquired in the business combination	**Lessee**	**Lessor**
Operating lease that includes favorable terms compared to market	Recognize an asset for the favorable terms	Recognize an asset for the favorable terms
Operating lease that includes unfavorable terms compared to market	Recognize a liability for the unfavorable terms	Recognize a liability for the unfavorable terms
Operating lease that includes at market terms	Recognize neither an asset or liability related to the terms of the lease	Recognize neither an asset or liability related to the terms of the lease
Separate identifiable intangible asset associated with the operating lease	Recognize a separate intangible asset, as appropriate	Recognize a separate intangible asset, as appropriate
Right to use the asset that is the subject of the operating lease	Do not recognize an asset	N/A
Obligation to make operating lease payments to use the asset that is the subject of the operating lease	Do not recognize a liability	N/A
Asset that is the subject of the operating lease	N/A	Recognize the asset that is the subject of the operating lease at its fair value exclusive of the terms of the lease

10.12 Application of measurement guidance to capital lease in which target is the lessee

Other than the classification of an acquired lease as an operating lease or a capital lease on the acquisition date (see Section 9.1), Topic 805 does not explicitly discuss the accounting for capital leases. Presumably, application of the general measurement guidance in Topic 805 to a capital lease in which the target is the lessee would result in the buyer recognizing an asset ***and*** a liability related to the lease and measuring this asset and liability at fair value. The nature of the asset being recognized and measured at fair value depends on which of the lease classification criteria resulted in the lease being accounted for as a capital lease by the target. For example, if the target accounted for the lease as a capital lease because ownership of the asset automatically transferred to the target at the end of the lease term, then the nature of the asset being recognized and measured at fair value

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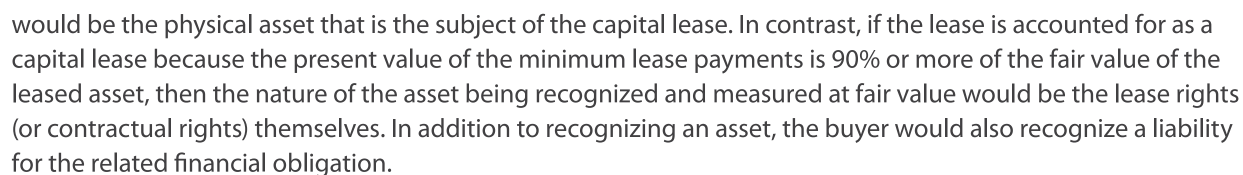

would be the physical asset that is the subject of the capital lease. In contrast, if the lease is accounted for as a capital lease because the present value of the minimum lease payments is 90% or more of the fair value of the leased asset, then the nature of the asset being recognized and measured at fair value would be the lease rights (or contractual rights) themselves. In addition to recognizing an asset, the buyer would also recognize a liability for the related financial obligation.

10.13 Guidance applicable to insurance and reinsurance contracts

Topic 944-805 covers the following subjects related to insurance and reinsurance contracts acquired in a business combination:

- Whether such contracts should be considered new contracts for measurement and accounting purposes;
- How such contracts should be classified for accounting purposes (the guidance on this subject is consistent with the discussion in Section 9.1);
- How such contracts should be recognized and measured in the accounting for the business combination;
- Which model should be used to account for other related contracts; and
- How the intangible asset (or liability) recognized as a result of applying this guidance should be subsequently measured.

Topic 944 provides subsequent accounting guidance in general for the insurance and reinsurance contracts acquired in a business combination.

10.14 Application of measurement guidance to working capital accounts (e.g., accounts receivable and accounts payable)

10.14.1 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 working capital accounts such as accounts receivable, accounts payable, and accrued liabilities. In other words, there is no exception that allows working capital accounts to be measured at an amount other than fair value (e.g., book value or carrying amount). In some cases, the buyer might assert that the fair value of the target's working capital accounts is the same as the target's book value for those accounts. 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 values and fair values are immaterial. The fair value of the asset or 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.

10.14.2 Additional considerations: Accounts or loans receivable

As discussed in Section 8.1.2, the FASB issued ASU 2011-04 in May 2011. This ASU amends the guidance in Topic 820 on the subjects of highest and best use of a financial asset and the valuation premises of in-use and in-exchange. Guidance on these subjects in the context of accounts receivable both before and after the effective date of ASU 2011-04 is discussed in this section. Refer to Section 8.1.2 for the effective date and transition guidance applicable to ASU 2011-04.

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Estimating fair value of accounts receivable before the effective date of ASU 2011-04

When estimating the fair value of accounts receivable, the buyer may use either an in-exchange or in-use premise for valuation purposes. In the context of accounts receivable, the in-exchange premise would base the fair value of the accounts receivable on the price that would be received if the accounts receivable were sold to market participants in the business of buying accounts receivable (e.g., factoring companies). As such, collection risk, payment timing, and the market participant's profit (if not already included in the discount rate used to address payment timing) would all be taken into consideration in the fair value estimate. The in-use premise in the context of accounts receivable would base the fair value of the accounts receivable on the market participant's collection of accounts receivable in the normal course of business. In essence, this view looks at the market participant as the buyer of the business as a whole and bases fair value on the market participant's ability to collect the accounts receivable in the normal course of operating the business. Instead of assuming that the highest and best use of the accounts receivable is selling them to a factoring company (as is the case with the in-exchange premise), the buyer assumes that the highest and best use of the accounts receivable is their collection in the normal course of business. Under this approach, the risk of the customer not paying (i.e., nonperformance risk) and payment timing would be taken into consideration in the fair value estimate.

Estimating fair value of accounts receivable after the effective date of ASU 2011-04

One of the changes made to Topic 820 by ASU 2011-04 is to indicate that the concept of highest and best use does not apply to financial assets because financial assets do not have alternative uses. In addition, ASU 2011-04 eliminates reference to the notions of in-use and in-exchange valuation premises. Instead, whether an asset should be valued on a standalone basis (previously thought of as in-exchange) or as part of a group of assets or a group of assets and liabilities (previously thought of as in-use) should be based on its unit of account. As a result, after the effective date of ASU 2011-04, the fair value of accounts receivable should be determined on a standalone basis. While ASU 2011-04 includes an exception in Topic 820 related to determining the fair value of financial assets on a standalone basis, this exception only applies to a group of financial assets and financial liabilities with offsetting positions in market risks or counterparty credit risks that are managed as part of a portfolio and that meet certain criteria. It is highly unlikely that this exception would ever enter into the valuation of the accounts receivable typically acquired in a business combination.

The practical effects of the changes to Topic 820 on measuring the fair value of accounts receivable acquired in a business combination is that, after the changes, fair value should be based on (a) the price that the buyer would receive if the accounts receivable were sold to market participants in the business of buying accounts receivable instead of (b) a market participant's ability to collect the accounts receivable in the normal course of operating the business. While both reflect the effects of collection risk and payment timing, only the former reflects the market participant's profit. When estimating the fair value of accounts receivable, whether the market participant's profit needs to be explicitly incorporated into the estimate depends on whether the discount rate used to address payment timing implicitly incorporates the market participant's profit.

No separate valuation allowance for receivables

As discussed in the previous subtopic, using fair value to measure accounts or loans receivable includes the potential of not collecting the contractual balances. In addition, the fair value of acquired loans that fall within the scope of Topic 310-30 is based on the present value of the amounts expected to be received as of the acquisition date. The amount expected to be received takes into consideration the potential of not collecting the contractual balances. Because the fair value of receivables and loans takes into consideration amounts not expected to be collected, it is not necessary (or permissible) to recognize separate valuation allowances for these receivables (e.g., allowance for doubtful accounts, allowance for loan losses, etc.) when they are acquired in a

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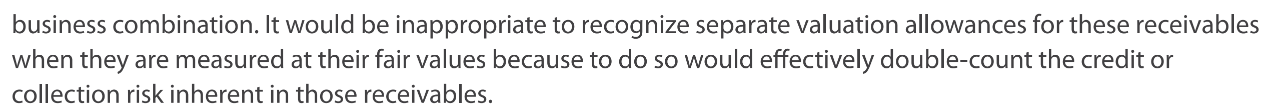

business combination. It would be inappropriate to recognize separate valuation allowances for these receivables when they are measured at their fair values because to do so would effectively double-count the credit or collection risk inherent in those receivables.

Effects of having mixed bases in loans receivable and accounts receivable

A financial institution may have both of the following in its loan portfolio: (a) loans originated by it and (b) loans it purchased in a business combination. The basis on which the loan loss is determined for loans originated by the financial institution is the original 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 the fair value of the loans on the related acquisition date. 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) Topic 805 requires the disclosure of certain information for acquired receivables that do not fall within the scope of Topic 310-30 (see Section 14.2.5) and (b) Topic 310-30 requires the disclosure of certain information for acquired receivables that fall within its scope.

10.14.3 Additional considerations: Accounts payable and accrued liabilities

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 would need to 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 would estimate the amount at which it would be able to transfer one of its liabilities has received a significant amount of attention 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 qualified valuation specialist for assistance.

10.15 Application of recognition guidance to deferred revenue

The target may have legal performance obligations to its customers and these obligations may or may not have been recognized as deferred revenue by the target prior to its acquisition by the buyer. Prior to accounting for the business combination, the buyer should take the following steps with respect to the legal performance obligations the target has to its customers:

a. Identify all of the legal performance obligations the target has with its customers;

b. Determine whether there are any valid outstanding accounts receivable balances related to the identified performance obligations; and

c. Estimate the fair value of the performance obligations and any related valid outstanding accounts receivable.

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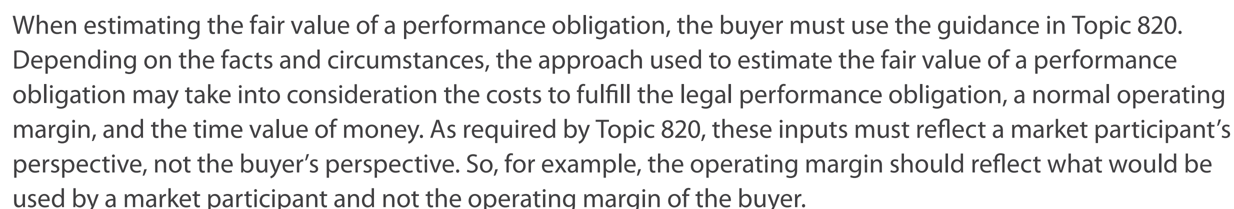

When estimating the fair value of a performance obligation, the buyer must use the guidance in Topic 820. Depending on the facts and circumstances, the approach used to estimate the fair value of a performance obligation may take into consideration the costs to fulfill the legal performance obligation, a normal operating margin, and the time value of money. As required by Topic 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.

Whether just a liability or both a liability and related asset are recognized related to the legal performance obligation in the accounting for the business combination depends on the status of billings to and payments from the customers:

- If the customer has already paid the amount due related to the legal performance obligation, then the buyer would recognize a liability for the fair value of the legal performance obligation in the accounting for the business combination.
- If there are valid outstanding accounts receivable balances due from the customer related to the legal performance obligation, then the buyer would recognize an asset for the fair value of the accounts receivable (see Section 10.14.1) and recognize a liability for the fair value of the legal performance obligation in the accounting for the business combination.
- If there is not a valid outstanding accounts receivable balance due from the customer related to the legal performance obligation and there is not a right to bill the customer (perhaps because no performance related to the unbilled amounts has occurred), then we believe the buyer should generally recognize a net contract asset or liability for the difference between: (a) the fair value of the unbilled receivable and (b) the fair value of the legal performance obligation.

In this last situation, an argument could be made to separately recognize: (a) an asset for the fair value of the unbilled receivable and (b) a liability for the fair value of the legal performance obligation. However, outside of a business combination: (a) deferred revenue would likely not have been recorded because cash was not received or the entity did not have the right to bill the customer and (b) unbilled receivables would likely not have been recognized because the entity did not have the right to bill the customer (i.e., the customer was not unconditionally obligated to pay the entity as no performance related to the unbilled amounts had occurred). To reflect an unbilled receivable and deferred revenue gross on the balance sheet in this situation may mislead users of the financial statements into thinking that the buyer has the right to bill for the unbilled receivable and (or) that cash has been received related to the deferred revenue. However, although not preferable, if the buyer were to include robust disclosures regarding the deferred revenue and unbilled receivables in this situation (including disclosures about its accounting policy) and apply the accounting policy on a consistent basis to all transactions, we believe it may be acceptable to record the amounts on a gross basis on the balance sheet.

In its accounting for the business combination, the buyer should not just carryover the amount of deferred revenue recognized by the target as of the acquisition date. There are some situations in which the buyer does not recognize any deferred revenue in the accounting for the business combination even though the target has recognized deferred revenue as of the acquisition date. For example, the target may have fulfilled its legal performance obligation with respect to a particular customer contract prior to the acquisition, but may have recognized deferred revenue at the acquisition date because of collectibility issues related to the customer. In this situation, even though the target has recognized deferred revenue as of the acquisition date, the buyer would not recognize a liability for a legal performance obligation in the accounting for the business combination because there is no legal performance obligation that must be satisfied by the buyer after the acquisition date. Furthermore, even if the target has unsatisfied legal performance obligations as of the acquisition date, it is

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highly unlikely that the amount of the legal performance obligation recognized by the buyer in the accounting for the business combination will be the same as the deferred revenue recognized by the target as of the acquisition date. In most cases, the amount of the legal performance obligation recognized by the buyer will be much less than the amount of deferred revenue recognized by the target prior to the acquisition. This situation is illustrated in Example 10-5.

Example 10-5: Software and PCS

Consider a situation in which the target entered into a contract with the customer on June 1, 20X1. Under the terms of the contract, the customer bought software and one year of PCS. Under the software revenue recognition guidance in the Codification, the target concludes that it cannot account for the software and PCS as separate units of account. Total arrangement consideration under the contract with the customer is $1,240,000 ($1,000,000 up-front for the software and $20,000 per month for the PCS). Amounts due for PCS are billed at the beginning of the month and paid by the 25th of the month. On July 31, 20X1, the target is acquired by the buyer. At this point in time, the customer has paid the target $1,040,000 ($1,000,000 up-front fee and two months of PCS at $20,000 per month). The amount yet to be billed to the customer for PCS (i.e., the unbilled receivable) is $200,000 (ten months at $20,000 per month). In this situation, the buyer would need to determine the fair value of the legal performance obligation it has to the customer under the remaining ten months of the contract. In addition, the buyer would need to determine the fair value of the unbilled receivable. Assume that the fair value of the legal performance obligation is $50,000 and the fair value of the unbilled receivable is $190,000. In this situation, the buyer would recognize a net contract asset of $140,000 (the difference between the fair value of the unbilled receivable and the fair value of the legal performance obligation). The subsequent accounting for the net contract asset would be based on its components. As such, the $190,000 debit representing the unbilled receivable would be reversed as it is billed. The difference between the amount to be billed to the customer over the remainder of the contract ($200,000) and the $190,000 would be recorded as interest income over the remaining term of the contract. In addition, the $50,000 credit representing the fair value of the legal performance obligation would be amortized into revenue over the remaining term of the contract. This subsequent accounting is illustrated by the following journal entries that would be recognized in August.

Billing the customer on August 1st for one month of PCS:

	Debit	Credit
Accounts receivable	$20,000	
Net contract asset		$20,000

Recognition of interest income for August:

	Debit	Credit
Net contract asset	$1,000	
Interest income		$1,000

Note: For ease of illustration, interest income was amortized on a straight-line basis over the remaining ten months of the contract. The effective interest rate method should be used to recognize interest income unless there is not a material difference between that method and the straight-line method.

Recognition of revenue related to the portion of the legal performance obligation satisfied in August:

	Debit	Credit
Net contract asset	$5,000	
Revenue		$5,000

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10.16 Application of recognition guidance to straight-line rent liability

Prior to the acquisition, the target may have recognized a liability related to recording rent expense under an operating lease on a straight-line basis. This straight-line rent liability should not be recognized by the buyer in the accounting for the business combination as it does not represent a legal obligation. Rather, that liability results from an accounting convention.

As discussed in Section 10.11.1, to the extent the terms of the operating lease are favorable or unfavorable compared to market terms for the same lease, an intangible asset or liability would be recognized by the buyer in the accounting for the business combination to reflect that favorability or unfavorability.

Example 10-6: Straight-line rent liability

Consider a situation in which the target enters into a three-year operating lease on January 1, 20X1. The amount of rent payable in each month and year of the lease is noted below:

	Monthly lease payment	Total annual payments
January 1, 20X1 to December 31, 20X1	$50,000	$600,000
January 1, 20X2 to December 31, 20X2	55,000	660,000
January 1, 20X3 to December 31, 20X3	60,000	720,000

The target must recognize rent expense related to this lease on a straight-line basis. As such, the amount of rent expense to be recognized on a monthly basis over the three-year term of the lease is $55,000 [($50,000 + $55,000 + $60,000)/3]. As such, at the end of 20X1, the target has recognized a liability in the amount of $60,000 (difference between rent expense in 20X1 [$55,000 * 12 = $660,000] and total lease payments in 20X1 [$50,000 * 12 = $600,000]). Now assume that on January 1, 20X2, the target is acquired by the buyer. The $60,000 liability recorded by the target to reflect rent expense on a straight-line basis will not be recognized by the buyer in the accounting for the business combination.

After the acquisition-date, the accounting for the lease is based on the terms applicable to the two years remaining on the lease. As such, the amount of rent expense to be recognized on a monthly basis over the remaining two-year term of the lease is $57,500 [($55,000 + $60,000)/2]. To the extent an intangible asset or liability is recognized in the accounting for the business combination to reflect the favorability or unfavorability of the lease compared to market terms for the same lease, the subsequent accounting for the operating lease would need to reflect the derecognition of that asset or liability over the lease term, which would affect rent expense.

Assuming the lease terms are at market as of the acquisition date and, as a result, no asset or liability is recognized in the accounting for the business combination because the lease is neither favorable nor unfavorable, the amount of rent expense recognized after the acquisition date will be $1,380,000 ($57,500 monthly rent expense * 24 months). This rent expense added to the rent expense recognized by the target prior to the acquisition date ($660,000) totals $2,040,000. This amount exceeds the total rent payments made over the entire term of the lease, which is $1,980,000 ($600,000 + $660,000 + $720,000). The difference between the two is $60,000, which is the same as the straight-line rent liability recognized by the target prior to the acquisition. However, as discussed earlier, this liability results from an accounting convention and does not warrant recognition in the accounting for the business combination.

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10.17 Subsequent accounting for acquired accounts or loans receivable with deteriorated credit quality

When the buyer in a business combination acquires loan receivables as part of the business combination, the buyer must consider whether those loans have experienced deterioration in their credit quality. To the extent they have, the buyer must determine whether those loans fall within the scope of Topic 310-30 (formerly known as AICPA SOP 03-3). If the loans fall within the scope of Topic 310-30, then the guidance in that topic should be used to subsequently account for the loans. If the loans do not fall within the scope of Topic 310-30, or the buyer is not able to make that determination on the acquisition date, the question arises as to how the buyer should account for those loans on "Day 2" (i.e., after the acquisition date). Consider the following situation:

- A loan receivable is acquired in a business combination.
- It is not probable as of the acquisition date that the buyer will be unable to collect the principal (or contractual) amount due under the loan. In other words: (a) it is still possible that the buyer will be unable to collect some of the principal (or contractual) amounts due under the loan and (b) the loan does not fall within the scope of Topic 310-30.
- The loan's fair value as of the acquisition date is less than the principal (or contractual) amount due under the loan.
- There is a discount attributable to the loan at the acquisition date that is at least partially due to a decline in the debtor's credit quality.
- The loan will not be subsequently accounted for at fair value.

The question that arises in this situation is how the buyer should accrete the discount related to the acquired loan. We understand that it would be acceptable to adopt an accounting policy based on either contractual cash flows or expected cash flows. Contractual cash flows are based on the cash flows provided for in the underlying contracts while expected cash flows are based on an acquisition-date estimate of the cash flows the buyer expects to collect. Expected cash flows would take into consideration amounts the buyer does not expect to collect due to credit deterioration in the loans while contractual cash flows would not take expected uncollectible amounts into consideration.

Contractual cash flows are used to apply the interest method when accounting for nonrefundable fees, origination costs, and acquisition costs related to lending activities and loan purchases, which is covered in Topic 310-20. An accounting policy to accrete the discount related to the acquired loan in the situation provided earlier that is based on the loan's contractual cash flows should be consistent with the model used in Topic 310-20. Expected cash flows are used in the initial and subsequent measurement of loans that fall within the scope of Topic 310-30. From a subsequent measurement perspective, expected cash flows are used to recognize income on a level-yield basis over the life of the loan. An accounting policy to accrete the discount related to the acquired loan in the situation provided earlier that is based on the loan's expected cash flows should be consistent with the model used in Topic 310-30.

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In comparing a contractual cash flows accounting policy to an expected cash flows accounting policy:

- A contractual cash flows accounting policy is easier to manage administratively than an expected cash flows accounting policy.
- A contractual cash flows accounting policy would result in a higher yield (i.e., higher interest income) than an expected cash flows accounting policy.
- An expected cash flows accounting policy would result in lower bad debt expense than a contractual cash flows accounting policy.

Under an expected cash flows accounting policy, if the amount ultimately collected is the amount that was initially expected to be collected, no bad debt expense would be recorded on the loan after its acquisition. The accounting policy elected by the buyer should be sufficiently disclosed and consistently applied.

Our understanding that it would be acceptable to adopt an accounting policy based on either contractual cash flows or expected cash flows for the situation provided earlier 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 December 2009.

10.18 Application of recognition and measurement guidance to 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 re-introduce its former competitor's brand name. The possibility of this happening does not disqualify the trade name from being considered a defensive intangible asset.
- 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 useful life of a defensive intangible asset is the period over which its value is expected to diminish.

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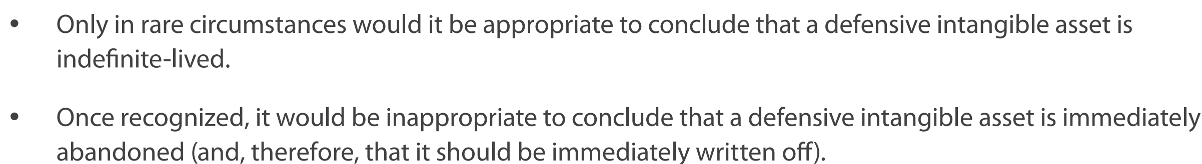

- Only in rare circumstances would it be appropriate to conclude that a defensive intangible asset is indefinite-lived.
- Once recognized, it would be inappropriate to conclude that a defensive intangible asset is immediately abandoned (and, therefore, that it should be immediately written off).

The guidance otherwise applicable to R&D intangible assets would be applied to R&D defensive intangible assets (see Section 10.7).

10.19 Application of recognition and measurement guidance to 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 asset retirement obligations in general is included in Topic 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 on the target's books prior to the acquisition.

10.20 Recognition and measurement of noncontrolling interest

10.20.1 General

Noncontrolling interest 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% noncontrolling interest in Company B in Company A's consolidated financial statements.

The FASB's guidance on accounting for business combinations and noncontrolling interests 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 Topic 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 noncontrolling interest. This approach results in the buyer recognizing both its and the noncontrolling interest's share of goodwill (i.e., the buyer recognizes 100% of goodwill).

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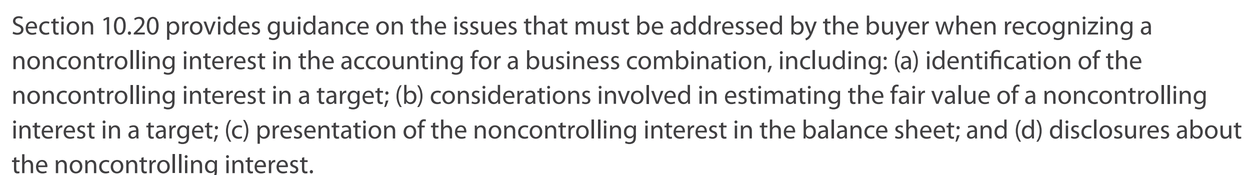

Section 10.20 provides guidance on the issues that must be addressed by the buyer when recognizing a noncontrolling interest in the accounting for a business combination, including: (a) identification of the noncontrolling interest in a target; (b) considerations involved in estimating the fair value of a noncontrolling interest in a target; (c) presentation of the noncontrolling interest in the balance sheet; and (d) disclosures about the noncontrolling interest.

10.20.2 Identification of the noncontrolling interest in a target

As mentioned previously, noncontrolling interest 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, FASB 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 noncontrolling interest 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?

In addition, FASB ASC 810-10-45-16A(b) also refers to the following financial instrument (or embedded feature) as a noncontrolling interest 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 noncontrolling interest holders to put their interests to the buyer (i.e., controlling interest holder), call options allowing the buyer to acquire the noncontrolling interest, or forward contracts requiring the buyer to acquire the noncontrolling interest at some later date. Whether these instruments should be included in the noncontrolling interest 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 would not be taken into consideration when identifying the noncontrolling interest 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 would not be considered when identifying the noncontrolling interest because those instruments would 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 noncontrolling interest.

Identifying the noncontrolling interest 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

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(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 Topic 805 and (b) the noncontrolling interest in Target is represented by a 30% interest in the common stock of Target. On the acquisition date, the noncontrolling interest in the consolidated financial statements would be measured based on the fair value of the 30% interest in the common stock of Target. Going forward, the noncontrolling interest in the consolidated financial statements would essentially reflect the equity attributable to that 30% noncontrolling interest.

In other situations, identifying the noncontrolling interest can be quite complex. The types of financial instruments (or embedded features) that might be considered a noncontrolling interest (depending on the facts and circumstances) are discussed earlier in this section (and in FASB 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 a noncontrolling interest (depending on the facts and circumstances). When determining whether these financial instruments (or embedded features) should be included in the noncontrolling interest, a number of decision points may need to be considered. Many of those decision points focus on whether the financial instrument (or embedded feature) should be classified as equity and are captured in Topic 480, Topic 815-10, Topic 815-15, and Topic 815-40. Only after considering the decision points relevant to a particular set of facts and circumstances would it be 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 noncontrolling interest.

10.20.3 Considerations involved in estimating the fair value of a noncontrolling interest

As discussed in Section 8.1.2, the FASB issued ASU 2011-04 in May 2011. This ASU amends the guidance in Topic 820 on the subject of including premiums and discounts in a fair value measurement. Guidance on how premiums and discounts should be taken into consideration in estimating the fair value of a noncontrolling interest is discussed in this section. Refer to Section 8.1.2 for the effective date and transition guidance applicable to ASU 2011-04.

Any noncontrolling interest 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 noncontrolling interest), then that active market price multiplied by the number of shares held by the noncontrolling interest represents the fair value of the noncontrolling interest. This is supported by the guidance in FASB ASC 820-10-35-41, which states the following:

Before ASU 2011-04	After ASU 2011-04
A quoted price in an active market provides the most reliable evidence of fair value and shall be used to measure fair value whenever available, except as discussed in paragraphs 820-10-35-16D, 820-10-35-42, and 820-10-35-43.*	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 references listed in the quote do not address measurement issues specific to a noncontrolling interest.

ASU 2011-04 clarified that, if available, a quoted price in an active market should be used "without adjustment" when measuring fair value. This is consistent with the practice that had developed with respect to measuring the fair value of the noncontrolling interest prior to the issuance of ASU 2011-04.

In some situations it may not be clear whether the market that produces a quoted price is an "active" market. FASB ASC 820-10-35-51A through 51D (before ASU 2011-04) and FASB ASC 820-10-35-54C through 54H (after ASU 2011-04) provide guidance on this subject.

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When there is not an active market price for the shares held by the noncontrolling interest, then the fair value of the noncontrolling interest could be estimated directly by using one or more valuation techniques (e.g., market and (or) income approaches). Alternatively, it may be appropriate to determine the fair value of the noncontrolling interest indirectly by taking the fair value of the target as a whole and subtracting the consideration transferred by the buyer for the controlling interest.

When there is not an active market price for the shares held by the noncontrolling interest and the fair value of the noncontrolling interest is estimated using another valuation technique, a question often arises as to whether the consideration transferred by the buyer for a controlling interest can be used to extrapolate the fair value of the noncontrolling interest. Generally, the answer to that question is "No" because the buyer would often be willing to pay more on a per-unit basis for a controlling ownership interest (more than 50%) in an entity than a noncontrolling ownership interest (50% or less) in that entity. The incremental amount that a buyer would be willing to pay on a per-unit basis to obtain a controlling interest in an entity (compared to a noncontrolling interest in an entity) is referred to as a control premium. Conversely, the discount an investor would require to obtain a noncontrolling interest in the same entity is referred to as a noncontrolling interest discount.

The existence of a control premium or a noncontrolling interest discount would make it inappropriate for the buyer to determine the fair value of the noncontrolling interest solely by extrapolating what it paid for the controlling interest. Consider a situation in which the buyer pays $8,000,000 for an 80% interest in the target. It would not be appropriate in this situation to assume that the fair value of the 20% noncontrolling interest is $2,000,000 (or that each individual percent ownership in the target is worth $100,000). The $8,000,000 paid for the 80% interest in the target generally reflects a control premium. The control premium included in the $8,000,000 paid for the 80% interest in the target should generally not be reflected in the valuation of the 20% noncontrolling interest.

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

Before ASU 2011-04	After ASU 2011-04
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 minority interest discount) in the per-share fair value of the noncontrolling interest.	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.

The language added to FASB ASC 805-20-30-8 by ASU 2011-04 makes it clear that including a noncontrolling interest discount in the per-share fair value of the noncontrolling interest is appropriate only if market participants would include such a discount when pricing the noncontrolling interest. When there is an active market price for the shares held by the noncontrolling interest, any noncontrolling interest discount is effectively presumed to be reflected in the active market price. As such, a separate adjustment to the active market price to reflect a noncontrolling interest discount is not necessary or appropriate. When there is not an active market price for the shares held by the noncontrolling interest and the fair value of the noncontrolling interest is

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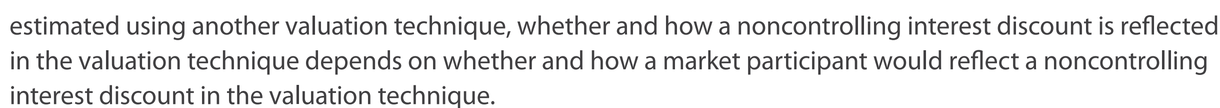

estimated using another valuation technique, whether and how a noncontrolling interest discount is reflected in the valuation technique depends on whether and how a market participant would reflect a noncontrolling interest discount in the valuation technique.

The payment of a control premium by the buyer is certainly expected to benefit the buyer as the buyer is obtaining control over the target's business. However, in limited situations, the noncontrolling interest may also benefit from the buyer's payment of a control premium. In other words, some of the incremental value received by the buyer as a result of the control premium may also benefit the noncontrolling interest. In a sense, any incremental benefit received by the noncontrolling interest would result in a lower noncontrolling interest discount. Consider a situation in which the payment of a control premium allows the buyer to benefit from economies of scale it can achieve by coordinating some of its existing operations with the target's operations. It is possible in this situation that the noncontrolling interest may also benefit from these economies of scale. But, how do the benefits to the noncontrolling interest get reflected in the valuation of the noncontrolling interest? When there is an active market price for the shares held by the noncontrolling interest, then it would be reasonable to expect that any benefit expected to be received by the noncontrolling interest from these economies of scale would be reflected in that active market price. When the fair value of the noncontrolling interest is estimated using another valuation technique (because there is not an active market price), the buyer should consider whether the valuation technique used appropriately reflects any of the benefits the noncontrolling interest would expect to receive from these economies of scale. In many cases, the valuation technique used would take those expected benefits into consideration and it would not be necessary to make an explicit adjustment to the output of the valuation technique for those expected benefits.

Given the complexities that may arise in determining the fair value of a noncontrolling interest, particularly when there is not an active market price for the shares held by the noncontrolling interest, it is often prudent to consult a valuation specialist when faced with the task of measuring the fair value of a noncontrolling interest.

In 2011, the AICPA issued a working draft of a practice aid entitled, "Valuation of Privately Held Company Equity Securities Issued as Compensation." While the scope of the working draft does not explicitly address estimating the fair value of a noncontrolling interest in a private entity, many of the general concepts discussed in the working draft are relevant in that situation. Additional information about the working draft and expected new edition of the practice aid (including their lack of authoritative standing) is provided in Section 12.3.3. Refer to the AICPA's website (www.aicpa.org) for information related to the working draft and the status of the expected new edition of the practice aid.

Example 10-7: Fair value of noncontrolling interest

Buyer acquires a 60% interest (120,000 shares) in Target for $7,200,000. 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 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 noncontrolling interest 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) is a control premium. The fair value of the noncontrolling interest would be $4,400,000 (80,000 shares * $55 per share) in this situation.

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10.20.4 Presentation of noncontrolling interest in the balance sheet

Within the consolidated balance sheet, the noncontrolling interest 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 ASR 268 and FASB 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). The financial instruments (or embedded features) that represent the noncontrolling interest in a target may include redemption features. This noncontrolling interest is referred to as redeemable noncontrolling interest. The public company redeemable securities guidance applies to a redeemable noncontrolling interest in a target unless the redemption feature is considered a freestanding option within the scope of Topic 480. Depending on the facts and circumstances, application of the public company redeemable securities guidance may result in classifying a redeemable noncontrolling interest outside of permanent equity in the consolidated financial statements. Sometimes this is referred to as mezzanine equity. Mezzanine equity is a caption that is presented on the balance sheet between liabilities and equity. Mezzanine equity is not shown as part of total liabilities or total equity.

Whether the public company redeemable security guidance is applicable to an instrument depends on a number of factors, including: (a) whether the instrument's redemption price and date are determinable and (b) 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 noncontrolling interest itself and the surrounding facts and circumstances. Analyzing the circumstances requires having a sound understanding of the terms of the redeemable noncontrolling interest as well as the public company redeemable securities guidance.

One question that often arises is whether private companies should follow the public company redeemable securities guidance. Given that the public company redeemable securities guidance was issued by the SEC and SEC staff, it is only technically applicable to public companies. However, depending on the facts and circumstances, and in the absence of guidance applicable to non-SEC registrants, it may be appropriate or preferred for a private company to follow that guidance.

10.20.5 Disclosures about the noncontrolling interest

Specific information about the noncontrolling interest, 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 noncontrolling interest.

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Exceptions to the General Recognition and (or) Measurement Guidance

11.1 Exceptions to overall recognition and measurement principles

Topic 805's overall recognition and measurement principles are discussed in Section 7.1 and Section 8.1. Topic 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
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
Assets held for sale		X	Section 11.8

11.2 Exception: Buyer's accounting for target's preacquisition contingencies

11.2.1 General

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

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 Topic 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

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be possible to determine the fair value of some preacquisition contingencies, an entity should often be able to determine the fair value of a warranty obligation. 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 Topic 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 Topic 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 Topic 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/loss contingency guidance in Topic 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 Topic 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.

11.2.5 Income tax effects

The income tax effects of contingencies are discussed in 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.

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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 31st of the following year. As of the acquisition date, Target has litigation outstanding against it. Buyer assumes this litigation in the acquisition. Target 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 Topic 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 $1,000,000 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 fair value estimate for this liability and concludes that a better fair value estimate for the liability as of the acquisition date is $1,100,000.

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.

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The acquisition date 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 would recognize a provisional liability of $750,000 in the accounting for the business combination.</td><td>Buyer would recognize a provisional liability of $1,000,000 in the accounting for the business combination.</td></tr>
<tr><td rowspan="2">Acquisition-date accounting reflected in the December 31, 20X1 amounts that are included for comparative purposes in the financial statements for the year ending December 31, 20X2 (which are given to the lender on March 31, 20X3)</td><td>Buyer would recognize 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 as of the acquisition date and either:</td><td>Buyer would recognize 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 $1,100,000 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 retroactively back to the acquisition date.</td></tr>
<tr><td>Accounting for the effects of the tentative settlement agreement</td><td colspan="2">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 and $700,000 in Scenario B) would be reflected in income.</td></tr>
</table>

11.3 Exception: Buyer's accounting for 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 in a business combination for this type of indemnification 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 would depend on the buyer's accounting for the litigation (i.e., the indemnified item) (see Section 11.2).

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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 recognized in the accounting for the business combination. If the indemnified item is not recognized in the accounting for the business combination, then the indemnification asset is also not recognized in the accounting for the business combination.

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 later 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 would 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 later 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 reflected in the appropriate line item on the income statement based on the applicable U.S. GAAP. In many cases, the change in the indemnified asset or liability and the change in the indemnification asset will offset each other in the same line item of the income statement (i.e., the changes would effectively be 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 Topic 740 and the corresponding change in the indemnification asset would be reported as an expense or gain based on other applicable U.S. GAAP.

Consider a situation in which the buyer recognizes both an indemnified liability and an indemnification asset for $1,000,000 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

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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. If the indemnification asset is measured using a basis other than fair value, then the buyer should ensure that the measurement basis 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 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 Exception: Buyer's accounting for income taxes

11.4.1 General

Topic 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 Topic 805:

- From a recognition perspective, deferred tax assets and liabilities are recognized in accordance with Topic 740 instead of being recognized based solely on whether those assets and liabilities meet the technical definitions of assets and liabilities included in CON 6 (which is the general recognition principle in Topic 805). While Topic 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 Topic 740 differ from those that would be recognized as a result of using the definitions in CON 6.
- From a measurement perspective, the amounts recognized for deferred tax assets and liabilities are determined in accordance with Topic 740, which use undiscounted amounts to measure deferred tax assets and liabilities and uncertain tax positions. In addition, Topic 740 measures tax positions that meet its more-likely-than-not threshold at the largest amount of tax benefit that is more than 50 percent likely of being realized upon ultimate settlement with a taxing authority. The measurement approaches used in Topic 740 are fundamentally different from the fair value measurement principle used in Topic 805.

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The following income-tax-related accounting topics are discussed in detail in Section 11.4:

- Acquired temporary differences and loss or credit carryforwards (acquisition-date accounting issue) (see Section 11.4.2);
- Change in buyer's pre-existing 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 acquisition 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); and
- Applicability of subsequent accounting guidance to changes in valuation allowances and income tax positions recognized in the accounting for business combinations that occurred prior to the effective date of Topic 805 (see Section 11.4.8).

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 Topic 805. These temporary differences arise if the recognized amounts under Topic 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, Topic 805-740 requires that deferred tax assets or liabilities be recognized as appropriate for these temporary differences as well as any loss or credit carryforwards of the target that exist at the acquisition date. Specialized guidance exists with respect to the accounting for the tax effects of: (a) the portion of goodwill for book purposes for which amortization is not deductible for tax purposes (which is addressed in Section 11.4.5), (b) leveraged leases acquired in a business combination, and (c) various taxable temporary differences covered by FASB ASC 740-10-25-3(a) (e.g., undistributed earnings of subsidiaries) that may be acquired in a business combination.

The guidance in Topic 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 would be reflected in the deferred tax assets and liabilities as well as the receivable from or payable to the taxing authorities that are recognized in the accounting for the business combination.

For income tax purposes, business combinations are generally identified as either a taxable or nontaxable transaction. 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. These transactions are often referred to as asset acquisitions. Nontaxable transactions are not taxable to the target either because it is a non-tax-paying entity or the ownership interests (i.e., "C" corporation shares) are sold to the buyer. These transactions are often referred to as stock acquisitions.

Taxable transactions will have few temporary differences as the book bases and tax bases of assets and liabilities will be the same amounts for most assets and liabilities. One of the few temporary differences that would 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

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effects of this temporary difference when settlement of the liability will result in an immediate tax deduction are illustrated later 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 later in Section 11.4.4 and Example 11-5.

Nontaxable transactions will often result in several temporary differences. 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 fair values on the date of the acquisition as required by Topic 805.

A stock acquisition (which is a nontaxable transaction) can be turned into a taxable "asset acquisition" transaction if the buyer and seller agree to treat the transaction as a taxable transaction. This falls under Section 338 of the U.S. Income Tax Code and is often referred to as a "338 Election."

Example 11-2: Accounting for an acquired temporary difference

To illustrate the accounting for a temporary difference arising in connection with a business combination, assume the following:

- In the accounting for a business combination, a liability (in the amount of $1,000,000) is recognized by the buyer for a preacquisition contingency of the target.
- For tax purposes, a liability will not be recognized at the acquisition date and, as such, 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, the buyer identifies a deductible temporary difference of $1,000,000, which is the difference between the book basis of the liability ($1,000,000) and the tax basis of the liability ($0). If a tax rate of 40% is assumed for the buyer, a deferred tax asset of $400,000 would be recognized by the 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 later in Example 11-6.

Example 11-3: Accounting for an acquired operating loss carryforward

To illustrate the accounting for an operating loss or tax credit carryforward acquired in a business combination, assume the target has $5,000,000 of operating loss carryforwards that are being acquired by the buyer in the business combination and that these operating loss carryforwards are not limited as to their use under the Internal Revenue Code. If a tax rate of 40% is assumed for the buyer, a deferred tax asset of $2,000,000 is recorded by the buyer in the accounting for the business combination.

When the buyer recognizes deferred tax assets for deductible temporary differences and (or) operating loss and tax credit carryforwards in the accounting for a business combination, the buyer must also determine whether a valuation allowance should be established for some or all of those deferred tax assets as part of the accounting for the business combination. FASB ASC 740-10-30-18 discusses the four sources of possible taxable income that should be taken into consideration in determining whether the gross amount of the deferred tax asset is realizable. One of these sources is future reversals of existing taxable temporary differences. As such, the deferred tax liabilities recognized in the accounting for the business combination should be taken into consideration

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when determining if there is sufficient taxable income to support the realizability of the deferred tax asset. However, the tax effects of amortizing indefinite-lived intangible assets and goodwill for tax purposes (for book purposes, such assets are not amortized) generally should not be taken into consideration when determining if there is sufficient taxable income to support the realizability of the deferred tax asset. An indefinite-lived intangible asset is not expected to be amortized within the period that temporary deductions are expected to be realized; therefore, the deferred tax liabilities related to indefinite-lived intangible assets should generally not be used to reduce net deferred tax assets to determine the amount of valuation allowance needed to reduce deferred tax assets to their estimated recoverable amount. An exception to this general principle is a deferred tax liability for an IPR&D asset that is considered to be indefinite-lived as of the acquisition date (see Section 10.7). An indefinite-lived IPR&D asset may be recovered or written off during the reversal period of other temporary differences that result in deferred tax assets. This is because the acquired IPR&D asset is only considered indefinite-lived to: (a) preclude amortization of the asset until the related R&D project is completed and (b) require recognition of an impairment of the IPR&D asset in accordance with other applicable literature. As such, it is possible that the IPR&D asset will be amortized or written off within the period that temporary deductions are expected to be realized. Therefore, it may be appropriate to consider the deferred tax liabilities related to the indefinite-lived IPR&D asset as reductions to net deferred tax assets in determining the amount of valuation allowance necessary.

Example 11-4: Recognizing a valuation allowance on deferred tax assets

Assume that the only two deferred tax assets recognized by the buyer in the business combination are the $400,000 deferred tax asset related to the accounting for a preacquisition contingency of the target and the $2,000,000 deferred tax asset related to the operating loss carryforwards of the target. The buyer must consider whether a valuation allowance should be recorded in the accounting for the business combination related to some or all of the gross deferred tax asset of $2,400,000. If the buyer determines that a valuation allowance of $1,500,000 should be recorded related to these deferred tax assets, then the net effect on the accounting for the business combination is $900,000. In other words, the buyer would recognize the following in the accounting for the business combination: (a) a deferred tax asset for $2,400,000 and (b) a valuation allowance on the deferred tax asset for $1,500,000.

11.4.3 Acquisition-date accounting: Change in buyer's pre-existing valuation allowance

The buyer's acquisition of a target may affect its assessment of the realizability of its own pre-existing 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 pre-existing 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 pre-existing 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 FASB 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 previously existing valuation allowances is required to be disclosed to give users the opportunity to understand the true nature and financial effects of a business combination (see Section 14.2.7).

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

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 would 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 as illustrated earlier in Example 11-2.

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

The following illustrates the calculation of the deferred tax asset and goodwill for book and tax purposes when there is contingent consideration in a taxable business combination:

Facts:	Buyer acquires Target in a taxable business combination and estimates the fair value of the contingent consideration to be $1,000,000 at the acquisition date. Goodwill for book purposes is $1,200,000, 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 40% and when the contingent consideration is settled, it will result in additional tax-deductible goodwill.
Question:	What are the deferred tax effects of the contingent consideration?
Answer:	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 ($1,200,000) is less than tax-deductible goodwill after including the acquisition-date fair value of the contingent consideration ($1,500,000 [$1,000,000 + $500,000]), a deferred tax asset of $200,000 would be recorded along with a reduction to goodwill for book purposes of $200,000 (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.

Subsequent accounting: Contingent consideration in a taxable transaction

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). To the extent that these income statement adjustments affect the amount of tax-deductible goodwill, the corresponding effect on the deferred tax provision would also be recognized in the same period. This is true even if the goodwill for book purposes exceeded tax-deductible goodwill at the acquisition date and, therefore, the buyer did not record related deferred taxes for that excess in the accounting for the business combination. Because subsequent adjustments to the fair value of contingent

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consideration are considered to be outside of (or separate from) the accounting for the business combination, the comparison of goodwill for book purposes to tax-deductible goodwill is not re-performed as a result of these adjustments.

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

To illustrate the accounting described in the previous paragraph, reconsider Example 11-5 and further assume:

- That 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).
- All changes in the fair value of the contingent consideration resulted in a reduction (Year 2) or increase (Year 3) of tax-deductible 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	$600,000	
Deferred tax expense (Note 1)	240,000	
Deferred tax asset (Note 2)		$200,000
Deferred tax liability (Note 3)		40,000
Other income/expense (Note 4)		600,000

Note 1: Calculated as follows: [$600,000 decrease in liability for contingent consideration * 40% tax rate].

Note 2: This represents the reversal of the deferred tax asset recognized in the accounting for the business combination (see Example 11-5).

Note 3: This represents the balance of the tax basis difference caused by the reduction in the liability for contingent consideration ($240,000 total deferred tax effects [see Note 1] less the $200,000 reversal of the previously recorded deferred tax asset [see Note 2]).

Note 4: Topic 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.

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

	Debit	Credit
Other income/expense (Note 1)	$200,000	
Deferred tax asset (Note 2)	40,000	
Deferred tax liability (Note 3)	40,000	
Liability for contingent consideration		$200,000
Deferred tax expense (Note 4)		80,000

Note 1: Topic 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 2: This represents the balance of the tax basis difference caused by the increase in the liability for contingent consideration ($80,000 total deferred tax effects [see Note 4] less the $40,000 reversal of the previously recorded deferred tax liability [see Note 3]).

Note 3: This represents the reversal of the deferred tax liability recorded in Year 2.

Note 4: Calculated as follows: [$200,000 increase in liability for contingent consideration * 40% 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

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.

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.

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

Generally, in a taxable transaction, the book basis and tax basis of goodwill will be the same amount. Note, however, that the tax basis of goodwill in a taxable transaction is deductible and, in future periods, a deferred tax liability will be recorded as the tax-deductible goodwill is amortized and the goodwill for book purposes is not amortized. Occasionally, an exception to this general condition occurs and 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.

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In a nontaxable transaction, the amount of goodwill for book purposes recorded in a business combination is not deductible for income tax purposes. However, in some nontaxable transactions, there may be tax basis for tax-deductible goodwill within the target related to a previous acquisition.

If tax-deductible goodwill is less than goodwill for book purposes, a taxable temporary difference exists. In theory, the difference between the goodwill for book purposes and tax-deductible goodwill is a temporary difference and deferred taxes should be recorded. However, the buyer is prohibited from recognizing a deferred tax liability when tax-deductible goodwill is less than goodwill for book purposes.

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 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 increase the temporary difference. As such, a simultaneous equation may be used to calculate the amount of the deferred tax asset and, ultimately the amount of goodwill for book purposes, to be recognized.

Example 11-7: Calculation of deferred tax asset when goodwill for book purposes is less than goodwill for tax purposes

The following illustrates the calculation of the deferred tax asset and goodwill for book purposes when there is an excess of tax-deductible goodwill over goodwill for book purposes:

Facts:	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 noncontrolling interest in Target, the amount of goodwill for book purposes is $1,200,000 while the amount of tax-deductible goodwill is $1,500,000 (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 40%.
Question:	What amount should be recognized for the deferred tax asset that arises from the excess of tax-deductible goodwill over goodwill for book purposes? In addition, what amount of goodwill for book purposes should ultimately be recognized by Buyer as a result of its acquisition of Target?
Answer:	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 [$1,500,000] over the initial amount of goodwill for book purposes [$1,200,000]). ***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)) x PDTD.*** In Buyer's fact pattern, the amount of the DTA to be recognized is $200,000 ((40% tax rate / [1 – 40% tax rate]) x $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 $1,000,000 ($1,200,000 of initial goodwill for book purposes – $200,000 DTA).

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	4. ***Check the calculations performed in Steps 1 through 3, using the following formula: (Tax-Deductible Goodwill – Goodwill for Book Purposes Recognized [as calculated in Step 3]) x Tax Rate = Recognized DTA (as calculated in Step 2).*** In Buyer's fact pattern, the product of the formula is $200,000 ([$1,500,000 of tax-deductible goodwill – $1,000,000 of recognized goodwill for book purposes] x 40% tax rate), which equals the recognized DTA calculated in Step 2.
Key Points:	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 may be used or repeated iterations applied until the deferred tax asset is determined to take 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 acquisition 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 and (or) equity issuance and registration, should be expensed when incurred and when the related services have been received by the buyer. These acquisition costs generally do not represent assets and they result from transactions that should be accounted for separate from the business combination.

Whether acquisition costs are deductible for tax purposes depends on the facts and circumstances of the business combination. Furthermore, if these costs are deductible, the timing of the deduction may vary. A temporary difference occurs if the acquisition costs are deductible for tax purposes but not deductible 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 acquisition costs are also not accounted for as part of the business combination. In other words, the acquisition costs that are included for tax purposes as a component of tax-deductible goodwill would not be considered in the comparison of tax-deductible goodwill to goodwill for book purposes or the simultaneous equation used in Example 11-7.

Example 11-8: Accounting for the tax effects of acquisition costs

Assume a buyer in a taxable business combination recorded $600,000 in goodwill for book purposes. Furthermore, assume the buyer incurred $300,000 of acquisition costs for services received, which resulted in $900,000 in tax-deductible goodwill. In this case, even though the tax-deductible goodwill was $900,000, only the portion of that tax-deductible goodwill that does not relate to acquisition costs would be considered 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 acquisition costs outside of a business combination, the tax effects of the acquisition costs ($120,000 [$300,000 of acquisition costs * 40% tax rate) should also be accounted for outside of the business combination. The following journal entry captures the accounting for the acquisition costs and the tax effects of the acquisition costs:

	Debit	Credit
Operating expense	$300,000	
Deferred tax asset	120,000	
Cash		$300,000
Deferred tax expense		120,000

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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

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 is recognized as a gain from a bargain purchase (see Section 12.2). Because this is a measurement period adjustment, it must be made retroactive to the acquisition date. This approach may require changing the amounts reflected in the financial statements of previous reporting periods (e.g., those that fell between the acquisition date and the "adjustment" date) (see Section 12.7.1).

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 FASB ASC 740-10-45-20.

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

To illustrate 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, reconsider Example 11-4 in which a valuation allowance of $1,500,000 was recorded on deferred tax assets of $2,400,000. Assume 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 $1,200,000. Further assume that the amount of goodwill recognized for book purposes for this business combination was in excess of $500,000. Consider the following two scenarios in this illustration:

1. The buyer determined ***during*** the measurement period that a reduction in the valuation allowance 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. The buyer determined ***after*** the measurement period that a reduction in the valuation allowance 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).

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The journal entry that would be recorded in each of these scenarios is as follows:

Account	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.

This guidance should be used in the accounting for post-acquisition-date changes in valuation allowances on deferred tax assets recorded in the accounting for a business combination regardless of when the business combination occurred (see Section 11.4.8).

Change in uncertain tax positions

The buyer in a business combination may recognize assets and (or) liabilities related to uncertain tax positions as a result of one or both of the following: (a) uncertain tax positions of the target and (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 Topic 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 amount(s) 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, or 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. In other words:

- If the buyer determines ***during*** the measurement period that it is necessary to change a tax-related amount(s) 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 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(s) 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.

This guidance should be used when accounting for post-acquisition-date changes in the tax-related assets and liabilities recognized for uncertain tax positions arising from or acquired in a business combination regardless of when the business combination occurred (see Section 11.4.8 for additional discussion).

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11.4.8 Applicability of subsequent accounting guidance to changes in valuation allowances and income tax positions recognized in the accounting for business combinations that occurred prior to the effective date of Topic 805

In general, the subsequent accounting for items involved in the accounting for a business combination whose acquisition date fell prior to the effective date of Topic 805 should follow the guidance in effect prior to the effective date of Topic 805. In other words, the subsequent accounting guidance in Topic 805 should generally not be applied to assets and liabilities recognized in the accounting for business combinations that occurred prior to its effective date. One exception relates to the accounting for changes to valuation allowances on deferred tax assets and changes to income tax positions acquired in a business combination that occurred prior to the effective date of Topic 805. After the effective date of Topic 805, changes to valuation allowances on deferred tax assets and changes to income tax positions acquired in a business combination that occurred prior to the effective date of Topic 805 should be accounted for using the guidance in effect after the effective date of Topic 805. As discussed earlier in Section 11.4.2, in the case of changes to valuation allowances on deferred tax assets recognized in the accounting for a business combination, this transition exception results in the effects of such changes being reflected in income tax expense (or in certain limited situations, as a direct adjustment to contributed capital as required by FASB ASC 740-10-45-20).

The following example illustrates the applicability of the subsequent accounting guidance to a change in a valuation allowance recognized in the accounting for a business combination that occurred prior to the effective date of Topic 805. Assume Buyer has a calendar year end and acquires Target in 2007, which is prior to the effective date of Topic 805. In the accounting for the business combination, Buyer recognizes acquired deferred tax assets of $1,000,000 and a valuation allowance on those deferred tax assets of $200,000. Buyer also recognizes $300,000 in goodwill for book purposes in the accounting for that business combination. During 2009, which is after the effective date of Topic 805, Buyer determines that it should reduce the valuation allowance on the deferred tax assets acquired from Target by $100,000. The guidance in effect after the effective date of Topic 805 results in Buyer debiting (reducing) the valuation allowance by $100,000 and crediting income tax expense by $100,000. If the guidance in effect prior to the effective date of Topic 805 had been applicable, then Buyer would have credited goodwill for book purposes in the amount of $100,000 instead of income tax expense.

11.5 Exception: Buyer's accounting for 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 Topic 715-30 and Topic 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

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measuring the asset or liability should be changed to reflect the buyer's expectations about relevant future events. In addition, Topics 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 Topic 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 FASB ASC 710-10-25 and 30;
- If the target provides compensated absences, the buyer should follow the relevant recognition and measurement guidance in FASB ASC 710-10-25;
- If the target provides nonretirement postemployment benefits, the buyer should follow the relevant recognition and measurement guidance in FASB ASC 712-10-25; and
- 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 FASB ASC 420-10-25 and 30 (see Section 10.8 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 Exception: Buyer's accounting for 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. Topic 805 provides accounting guidance for both the initial and subsequent accounting for these reacquired rights.

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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 pre-existing 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 Topic 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 Exception: Buyer's accounting for share-based payment awards

In a business combination, the buyer may replace share-based payment awards held by employees of the target with its own share-based payment awards. The measurement principle and related guidance in Topic 718 should be used when measuring these replacement awards. While Topic 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, Topic 718 permits use of either a calculated value method or intrinsic value method. Use of any of the measurement methods in Topic 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 Topic 805.

Topic 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 compensation costs (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 and (b) postcombination compensation costs:
  - Use of the calculated value or intrinsic value methods in Topic 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;

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- Other post-acquisition 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 service regardless of whether the target's awards had all vested by the acquisition date (see Section 13.4); and
- How to account for the income tax effects of replacement awards classified as equity.

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

11.8 Exception: Buyer's accounting for assets held for sale

To the extent the buyer in a business combination acquires a long-lived asset(s) 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 Section 9.1). In addition, the buyer may have plans at the acquisition date to sell a long-lived asset(s) 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 asset(s) or disposal group acquired in the business combination as held for sale if: (a) it will be sold, (b) the one-year requirement in FASB ASC 360-10-45-9 is met, and (c) the other requirements in FASB ASC 360-10-45-9 are probable of being met within a short period of time (usually no more than 3 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 Topic 805. Without this exception, a "Day 2" 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.

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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." 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 through 12.5 and 12.9);
2. The acquisition-date fair value of any noncontrolling interest in the target (if the buyer acquires less than 100% of the target) (see Section 10.20);
3. The acquisition-date fair value of the buyer's previously held equity interest in the target (if the business combination is a step acquisition) (see Section 12.6); and
4. Net assets acquired by the buyer (which is 100% of the target's net assets measured predominantly at fair value) (see Section 7.1 and Section 8.1).

The aggregate of Elements 1 through 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 would 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 through 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 of the 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 through 11 of this guide. In addition, disclosures that must be provided when goodwill results from the accounting for a business combination are discussed in Chapter 14.

Topic 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 Topic 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 noncontrolling interest (see Section 10.20). This approach results in the buyer recognizing both its and the noncontrolling interest's share of goodwill (i.e., the buyer recognizes 100% of goodwill).

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While the buyer recognizes 100% of the goodwill that arises in a business combination on its financial statements as goodwill, it may still be necessary to allocate the goodwill between itself and any noncontrolling interest 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 noncontrolling interest. To reiterate, the buyer still recognizes 100% of the goodwill on its financial statements as goodwill. The allocation of goodwill between the buyer and the noncontrolling interest is done purely as a "memorandum" entry to facilitate the accounting for any goodwill impairment charge recognized at a future date.

Example 12-1: Determination of goodwill

To illustrate the calculation of goodwill, assume the following facts for a business combination in which Buyer acquires 70% of Target:

- Buyer transfers cash consideration of $5,250,000 to Target's owners.
- Buyer previously owned 20% of Target and accounted for its investment in Target using the equity method.
- The carrying value of Buyer's previously held equity interest in Target on the acquisition-date is $900,000. The fair value of that investment on the acquisition date is $1,240,000.
- Buyer's 70% acquisition results in it owning 90% of Target.
- The fair value of the 10% noncontrolling interest that still exists after Buyer's acquisition of 70% of Target is $620,000.
- Target's net assets acquired by Buyer are $6,500,000, which consists of $10,000,000 of identifiable assets acquired and $3,500,000 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% noncontrolling interest	620,000
Element 3: Acquisition-date fair value of Buyer's 20% previously held equity interest in Target	1,240,000
Total	7,110,000
Element 4: Net assets acquired	6,500,000
Goodwill: Excess of Elements 1 through 3 over Element 4	$610,000

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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
Previously held equity interest in Target (Note)	$340,000	
Gain		$340,000
Identifiable assets	$10,000,000	
Goodwill	610,000	
Cash		$5,250,000
Liabilities		3,500,000
Noncontrolling interest		620,000
Previously held equity interest in Target		1,240,000

Note: 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 ($1,240,000) over the carrying value of the related investment on Buyer's books 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 through 3 of the goodwill calculation is less than Element 4 of that calculation. This result may occur when the owner(s) of the target is (are) forced or compelled to sell its (their) interest(s) 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 Topic 805. These exceptions are discussed in Chapter 11 of this guide.

Topic 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; and
- The appropriateness of: (a) the procedures used to measure the individual components within each of Elements 1 through 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;

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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; and

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 (or) 5 in the preceding list. In other words, correcting the initial accounting for those items would 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.

While a gain from a bargain purchase ***should not*** be reflected as an extraordinary gain, there is no prescriptive guidance in Topic 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.

FASB 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 noncontrolling interest. An example of attributing the entire gain from a bargain purchase to the buyer is included in FASB ASC 805-30-55-14 through 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 Topic 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 Topic 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 acknowledges in FASB ASC 805-30-25-2 that bargain purchases may occur occasionally for the reasons discussed in Section 12.2.1.

Given that Topic 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, due to the number of failing financial institutions in 2009 and 2010, the FDIC and the NCUA often offered substantial incentives to a healthy financial institution to assume the deposits and acquire selected assets of a failed financial institution. Sometimes this incentive came in the form of a loss sharing arrangement on the acquired loans. As a result of the substantial

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incentives being offered by regulators, bargain purchases have occurred more frequently than originally expected with respect to transactions in which one financial institution acquires another financial institution.

Even in situations in which regulatory assistance leads one financial institution to acquire another financial institution, the acquiring financial institution 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 acquiring financial institution would also be required to explain in its disclosures the factors that gave rise to the gain (e.g., explain the incentives offered by the regulators that resulted in the bargain purchase).

12.3 Consideration transferred

12.3.1 General

Normally, consideration is transferred to the seller(s) from the buyer upon executing a business combination (see Section 12.5). The nature of the consideration transferred in a business combination typically results in the buyer:

- Transferring cash or other assets on a contingent or noncontingent basis;
- Incurring liabilities payable to former owners of the target; and (or)
- Issuing its 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).

12.3.2 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 Topic 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 and compensation, see Section 13.4.

If the consideration transferred by the buyer has a carrying value 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 value immediately before the acquisition date (i.e., the buyer should not recognize a gain or loss prior to transferring the consideration).

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 Section 6.1). The fair value of the buyer's own equity securities should be measured in accordance with the principles in Topic 820.

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As discussed in Section 8.1.2, the FASB issued ASU 2011-04 in May 2011. This ASU adds guidance to Topic 820 on the subject of measuring the fair value of an entity's own equity securities. This subject is discussed in this section. Refer to Section 8.1.2 for the effective date and transition guidance applicable to ASU 2011-04.

Prior to the issuance of ASU 2011-04, Topic 820 did not include any specific guidance on how to apply its principles to measuring the fair value of an entity's own equity securities. The guidance added by ASU 2011-04 on this subject can be found in FASB ASC 820-10-35-16 through 18C. This guidance points 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. It is not expected that the specific guidance added by ASU 2011-04 will affect the practice that has developed with respect to measuring the fair value of the buyer's equity securities that are issued as consideration transferred in a business combination.

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 those securities would be the number of securities issued as consideration 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. FASB ASC 820-10-35-51A through 51D (before ASU 2011-04) and FASB ASC 820-10-35-54C through 54H (after ASU 2011-04) provide 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 and (or) income approaches). There is typically not an active market for the buyer's own equity securities when the buyer is a private entity. As such, a valuation technique 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 Topic 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.

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To the extent that a business combination is effected 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 2011, the AICPA issued a working draft of a practice aid entitled, "Valuation of Privately Held Company Equity Securities Issued as Compensation." This working draft is an update to the 2004 edition of the practice aid. The new edition of the practice aid is expected in 2012. While the working draft is not (and any new edition of the practice aid issued will not be) part of the authoritative accounting literature, it will still provide very useful and helpful guidance on how to estimate the fair value of privately held company equity securities. The SEC staff refers to the 2004 edition of the practice aid in comment letters and we would expect that the SEC staff would utilize the new edition of the practice aid in a similar fashion once it is issued. While the scope of the working draft is focused on the valuation of privately held company equity securities issued as compensation, many of the concepts discussed in the working draft are equally applicable to the valuation of privately held company equity securities issued as consideration transferred in a business combination. For example, the discussion in the working draft on valuation techniques and related best practices would likely prove to be very useful and helpful in estimating the fair value of privately held company equity securities issued as consideration transferred in a business combination. Refer to the AICPA's website (www.aicpa.org) for information related to the working draft and the status of the expected new edition of the practice aid.

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 Topic 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 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 Topic 805 and other topics of the Codification that apply to the accounting, classification, and disclosure of contingent consideration are discussed in Section 12.4.

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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 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 consideration transferred to the buyer if the level of assets being serviced declines below a certain dollar amount. 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 Topic 480 and Topic 815-40 as well as any other applicable U.S. GAAP.

Initial 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 other assets indicates that the contingent consideration should be classified as a liability. Additional decision points (including those in the bullet points that follow) must be considered if: (a) payment of the contingent consideration is based partially or wholly on changes in the fair value of the buyer's own shares or the shares of one of the buyer's consolidated subsidiaries or (b) payment of the contingent consideration could be made in the buyer's own shares or the shares of one of the buyer's consolidated subsidiaries.
- ***Is the contingent consideration one of the instruments covered by the guidance in FASB ASC 480-10-25?*** The instruments covered by the guidance in FASB ASC 480-10-25 include most mandatorily redeemable financial instruments; many obligations to repurchase the buyer's equity shares by transferring assets; and certain obligations to issue a variable number of shares. To the extent the contingent consideration is one of the instruments covered by the guidance in FASB ASC 480-10-25, then the contingent consideration should be classified as a liability.

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- ***Does the contingent consideration fall within the scope of Topic 815-40?*** Topic 815-40 addresses the classification of contracts that are indexed to, and potentially settled in, an entity's own equity. There are several factors that must be considered in determining whether contingent consideration falls within the scope of Topic 815-40. For example, one factor that must be considered is whether the contingent consideration is a freestanding financial instrument. Another factor that must be considered is whether the contingent consideration is potentially settled in the buyer's own stock.
- ***If the contingent consideration falls within the scope of Topic 815-40, does it meet the conditions to be considered indexed to the buyer's own stock?*** FASB ASC 815-40-15-5 through 8 provide guidance on whether an instrument is considered indexed to an entity's own stock. Two key aspects of the contingent consideration emphasized in this guidance are the nature of the contingent exercise provisions and the nature of the settlement provisions. In assessing the nature of these provisions, there are several factors that must be considered. For example, in assessing the nature of the settlement provisions, the buyer would need to consider whether variables other than those that would be used as inputs in the fair value of a fixed-for-fixed forward or option on equity shares affect the contingent consideration's settlement amount. If so, then the contingent consideration would not be considered indexed to the buyer's own stock and liability classification would be appropriate. This is but one of many factors that need to be considered in assessing whether the contingent consideration is indexed to the buyer's own stock.
- ***If the contingent consideration falls within the scope of Topic 815-40 and it is considered indexed to the buyer's own stock, does it meet the conditions for liability or equity classification in FASB ASC 815-40-25-1 through 38?*** There are several factors that must be considered in assessing whether the contingent consideration meets the conditions for liability or equity classification in FASB ASC 815-40-25-1 through 38. Some of the factors that must be considered include the following: (a) whether the contingent consideration requires or permits net cash settlement, physical settlement, or net share settlement; and (b) whether the buyer or seller has a choice of net cash settlement or settlement in shares. These are just a few of the many factors that need to be considered in assessing whether the contingent consideration meets the conditions for liability or equity classification in FASB ASC 815-40-25-1 through 38.

In Example 12-2, 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 the 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 were 10% or more for the nine-month period following the acquisition date, the analysis that would need to be performed to determine the appropriate classification of the contingent consideration would become 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 would need 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 FASB ASC 480-10-25; (b) does the contingent consideration fall within the scope of Topic 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 liability or equity classification in FASB ASC 815-40-25-1 through 38? All of the relevant decision points must

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be considered due to the many factors provided in the authoritative accounting literature that could trigger liability classification even in the most "plain-vanilla" of situations. Examples of factors that could trigger liability classification in the revised example include:

- 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.
- Buyer is required to post collateral.

Only after considering all of the decision points relevant to its situation in the revised example would Buyer be in a position to conclude on the appropriate classification of the contingent consideration.

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., Topic 815-10). Making that determination affects the subsequent accounting for the contingent consideration to the extent the contingent consideration qualifies as a designated hedging instrument (which is uncommon, as discussed later in Section 12.4.4) 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

To the extent the contingent consideration falls within the scope of Topic 815-40, the classification of the contingent consideration would need to 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. FASB ASC 815-40-35-8 through 13 provides guidance on how to record the reclassification.

12.4.4 Adjustments after initial accounting

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 would make an adjustment to the provisional amount of contingent consideration recorded in the initial accounting for the business combination, which would affect 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 would be used to determine if an adjustment to contingent consideration should be accounted for as a measurement period adjustment. In other situations, the buyer could be required to account for the adjustment using the subsequent accounting guidance applicable to contingent consideration, which would likely result in the recognition of income or expense instead of an adjustment to the accounting for the business combination.

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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 is not automatically accounted for using the subsequent accounting guidance applicable to contingent consideration. 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 need to apply the guidance in Topic 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 would not give rise to a measurement period adjustment include achieving an earnings target, a specified share price, or a pre-determined 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 would be used to account for that adjustment. 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/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 unless the contingent consideration qualifies as a designated hedging instrument for which FASB ASC 815-20-35 requires the change in fair value to be recognized in OCI.
  - Contingent consideration is not generally used as a hedging instrument. As such, it would be extremely unlikely to see a situation in which contingent consideration qualifies as a designated hedging instrument.
  - Whether the contingent consideration is a derivative only affects the subsequent accounting for the contingent consideration to the extent it qualifies as a designated hedging instrument for which FASB ASC 815-20-35 requires the change in fair value to be recognized in OCI. Otherwise, the accounting for contingent consideration that is a derivative or is not a derivative is essentially the same in that both are remeasured to their fair value at the end of each reporting period with the change in fair value reflected in income or expense. To the extent 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.

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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 FASB 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 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.

Removal of a contingent consideration liability from the buyer's books

A liability recognized for contingent consideration in the accounting for a business combination should only be removed from the buyer's books upon settlement or expiration of the contingency. Removing a contingent consideration liability from the books 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.

Equity that was recognized when accounting for the contingent consideration involved in a business combination is not removed from the buyer's books 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 classification of a cash payment for a contingent consideration obligation on the cash flow statement depends on how the recognition of the liability was treated from an accounting perspective. In other words, did recognizing some or all of the liability affect the accounting for the business combination or did recognizing some or all of the liability affect the income statement?

Consider a situation in which the buyer in a business combination recognizes a contingent consideration liability in the amount of $1,000,000 in its initial accounting for the business combination. The contingent consideration is identified as a provisional amount as the buyer is still waiting for the final valuation of the obligation from an external valuation specialist it hired. The final valuation indicates that a contingent consideration liability in the amount of $1,250,000 should have been recognized in the accounting for the business combination. As such, the 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). In a subsequent accounting period, there is a change in the facts and circumstances and the buyer determines that the fair value of the contingent consideration liability at the end of that subsequent accounting period is

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$1,750,000. As such, the buyer increases the contingent consideration liability through a subsequent accounting adjustment, which results in the buyer recognizing $500,000 of operating expenses in the income statement. When the buyer subsequently makes a cash payment of $1,750,000 to settle the contingent consideration liability, we believe that 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

Classification of the portion of the payment reflected in the accounting for the business combination as a cash outflow from financing activities is consistent with the guidance in FASB ASC 230-10-45-13(c), which indicates the following:

> Payments at the time of purchase or soon before or after purchase to acquire property, plant, and equipment and other productive assets, including interest capitalized as part of the cost of those assets *[are cash flows for investing activities]*. Generally, only advance payments, the down payment, or other amounts paid at the time of purchase or soon before or after purchase of property, plant, and equipment and other productive assets are investing cash outflows. However, incurring directly related debt to the seller is a financing transaction (see paragraphs 230-10-45-14 through 45-15, and subsequent payments of principal on that debt thus are financing cash outflows. *[Clarifying phrase added]*

Because contingent consideration reflected in the accounting for the business combination is more akin to the buyer incurring debt to acquire the business than it is to an amount that the buyer will pay soon after the acquisition date to acquire the business, the cash payment for the contingent consideration reflected in the accounting for the business combination should be reflected as a cash outflow from financing activities instead of a cash outflow from investing activities.

Consider another situation in which the buyer in a business combination recognizes a contingent consideration liability in the amount of $1,000,000 in its initial accounting for the business combination. The contingent consideration is identified as a provisional amount as the buyer is still waiting for the final valuation of the obligation from an external valuation specialist it hired. The final valuation indicates that a contingent consideration liability in the amount of $1,250,000 should have been recognized in the accounting for the business combination. As such, the 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 the buyer determines that the fair value of the contingent consideration liability at the end of that subsequent accounting period is $750,000. As such, the buyer decreases the contingent consideration liability through a subsequent accounting adjustment, which results in the buyer recognizing $500,000 of operating income in the income statement. When the buyer subsequently makes a cash payment of $750,000 to settle the contingent consideration liability, we believe 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.

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Example 12-2: 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 must provide its audited comparative financial statements to one of its lenders annually on February 28th. 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 expert to determine the fair value of this contingent consideration. The valuation expert 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 expert 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 12.7.2 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 as it is waiting for the valuation expert 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 expert:

      Buyer receives the fair value estimate from the valuation expert 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 expert's fair value estimate pertain to the facts and circumstances that existed as of the acquisition date?

      2. If the buyer had the valuation expert's fair value estimate 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?

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- ***Yes*** to both. The valuation expert 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 would record the following measurement period adjustment as of the acquisition date:

	Debit	Credit
Liability for contingent consideration	$50,000	
Goodwill		$50,000

Note: 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 expert ($400,000).

Buyer would 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 would 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 Topic 805 does not address the classification of this amount in the income statement, we believe that this expense should enter into the determination of operating income as 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 expert's fair value estimate of the liability) and the amount Buyer is obligated to pay Sellers upon it determining that Target achieved the necessary revenue growth ($600,000).

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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 twelve 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 $50,000,000 in revenue during the first twelve 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 $2,000,000.
- The fair value of the contingent consideration on the acquisition date is $1,000,000. As such, this is the amount that is recognized as a liability in the accounting for the business combination. For ease of illustration, the time value of money has been ignored in this situation.
- The fair value of the contingent consideration is $1,000,000 at the end of each reporting period that occurs in the first eleven months after the acquisition date. As such, no adjustments are made to the contingent consideration liability recognized in the accounting for the business combination.
- In the last month of the twelve month period, a major customer unexpectedly cancels a large order due to financial difficulties, which will result in the target only generating $48,000,000 in revenue during the first twelve 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 in this regard. The first critical question the buyer would consider in this regard 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 $1,000,000 when it removes the contingent consideration liability from its books. It may seem counterintuitive to recognize $1,000,000 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 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

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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 (i.e., its deconsolidation of a subsidiary). While the EITF discussed this issue, it could not reach a final consensus. In the minutes for the last meeting in which this issue was discussed, the FASB staff member that serves as the chairman of the EITF observed that support exists in the authoritative literature for a seller to either: (a) recognize contingent consideration at fair value upon selling the business (or deconsolidating the subsidiary) or (b) account for contingent consideration using the same authoritative literature that would be applied when accounting for any general gain contingency. The seller would need to select and apply an accounting policy. In doing so, the seller would need to ensure that the accounting policy is consistently applied and appropriately disclosed.

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. As such, 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.

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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; and
- 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 effected without the transfer of consideration.

An example of a transaction in which a buyer obtains control of the target through contract alone involves a situation in which a PPM entity obtains control of a physician practice solely through the execution of a management agreement with the physician practice. Additional information about these types of arrangements is provided in various sections of Topic 810-10.

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 in which consideration is transferred include the amount of:

1. Consideration transferred (measured predominantly at fair value);
2. The acquisition-date fair value of any noncontrolling interest in the target;
3. The acquisition-date fair value of the buyer's previously held equity interest in the target (if any); and
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 previously held equity interest and it does so without transferring consideration, we believe that the previously held equity interest (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 control premium would be included in the acquisition-date fair value of the buyer's previously held equity interest. As discussed in Section 12.6, any difference between the acquisition-date fair value and the carrying amount of the buyer's previously held equity interest should be recognized as a gain or loss in the income statement. While on the surface including the control premium in the acquisition-date fair value of the buyer's previously held equity interest seems 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 any control premium) 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 previously held equity interest in the target and obtains control of the target without transferring consideration, we believe the acquisition-date fair value of the buyer's previously held equity interest should include the control premium.

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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 noncontrolling interest in the target (see Section 10.20.3). In determining these fair values, the guidance in Topic 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 noncontrolling interest 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 12-3: Buyer obtains control as a result of target's acquisition of its own shares

Assume the following facts for a business combination in which 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.
- 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 value of Buyer's investment in Target prior to gaining control of Target was $6,500,000.
- 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 divided by 125,000 shares [150,000 of Target's outstanding shares before Target's acquisition of 25,000 of its own shares less the 25,000 shares acquired by Target]).
- The fair value of Buyer's interest in Target on the acquisition date after it gains control is $9,600,000.
- The acquisition-date fair value of the noncontrolling interest's 46% equity interest in Target is $6,900,000.
- Target's net assets acquired by Buyer are $15,200,000, which consists of $25,800,000 of identifiable assets acquired and $10,600,000 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 noncontrolling interest in Target	$6,900,000
Element 3: Acquisition-date fair value of Buyer's previously held equity interest	9,600,000
Total	16,500,000
Element 4: Net assets acquired	15,200,000
Goodwill: Excess of Elements 1 through 3 over Element 4	$1,300,000

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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
Previously held equity interest in Target (Note)	$3,100,000	
Gain		$3,100,000
Identifiable assets	$25,800,000	
Goodwill	1,300,000	
Liabilities		$10,600,000
Noncontrolling interest		6,900,000
Previously held equity interest in Target		9,600,000

Note: 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 previously held equity interest in Target over the carrying value of the related investment on Buyer's books.

Example 12-4: Buyer obtains control through contract alone

Assume the following facts for a business combination in which Buyer obtains control of Target through contract alone:

- Buyer transfers no consideration to Target or Target's owners.
- The contract between Buyer and Target's owners results in Buyer obtaining control.
- 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 noncontrolling interest's 100% equity interest in Target is $2,500,000.
- Target's net assets acquired by Buyer are $2,400,000, which consists of $5,200,000 of identifiable assets acquired and $2,800,000 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 noncontrolling interest's 100% interest in Target	$2,500,000
Element 3: Acquisition-date fair value of previously held equity interest in Target	-
Total	2,500,000
Element 4: Net assets acquired	2,400,000
Goodwill: Excess of Elements 1 through 3 over Element 4	$100,000

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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
Noncontrolling interest		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 pre-existing ownership interest in the target. In other words, the buyer may already own 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 previously held equity interest in the target and recognize either: (a) a gain for the excess of the acquisition-date fair value of its previously held equity interest in the target over its carrying value or (b) a loss for the excess of the carrying value of its previously held equity interest in the target over its acquisition-date fair value. The acquisition-date fair value of the buyer's previously held equity interest 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 noncontrolling interest in the target;
3. The acquisition-date fair value of the buyer's previously held equity interest in the target; and
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 through 3 and Element 4. If the total of Elements 1 through 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 previously held equity interest 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 value of the previously held equity interest 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 previously

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held equity interest 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 securities classified as available-for-sale, and foreign currency translation adjustments.

Recognition of the gain or loss on the buyer's previously held equity interest 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 previously held equity interest 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 noncontrolling interest'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 previously held equity interest in the target (see Section 14.2.9).

12.6.2 Determining fair value of buyer's previously held equity interest in target

As discussed in Section 8.1.2, the FASB issued ASU 2011-04 in May 2011. Many of the changes to Topic 820 clarify its requirements to make them consistent with the FASB's original intent with respect to those requirements. The effects of ASU 2011-04 on estimating the fair value of the buyer's previously held equity interest in the target is discussed in this section. Refer to Section 8.1.2 for the effective date and transition guidance applicable to ASU 2011-04.

The buyer's previously held equity interest 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 previously held equity interest would 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 FASB ASC 820-10-35-41, which states the following:

Before ASU 2011-04	After ASU 2011-04
A quoted price in an active market provides the most reliable evidence of fair value and shall be used to measure fair value whenever available, except as discussed in paragraphs 820-10-35-16D, 820-10-35-42, and 820-10-35-43.*	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 references listed in the quote do not address measurement issues specific to a buyer's previously held equity interest in the target.

ASU 2011-04 clarified that, if available, a quoted price in an active market should be used "without adjustment" when measuring fair value. This is consistent with the practice that had developed with respect to measuring the fair value of a buyer's previously held equity interest in the target prior to the issuance of ASU 2011-04.

In some situations it may not be clear whether the market that produces a quoted price is an "active" market. FASB ASC 820-10-35-51A through 51D (before ASU 2011-04) and FASB ASC 820-10-35-54C through 54H (after ASU 2011-04) provide guidance on this subject.

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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, then the fair value of the previously held equity interest would be estimated by using one or more valuation techniques (e.g., market and (or) income approaches), which are discussed in Topic 820.

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 and the fair value of the buyer's previously held equity interest is estimated using another valuation approach, a question often arises as to whether the amount paid by the buyer for a controlling interest can be used to extrapolate the fair value of the buyer's previously held equity interest. Generally, the answer to that question is "No" because the amount paid by the buyer for a controlling interest includes a control premium, which is the incremental amount that a buyer would be willing to pay on a per-unit basis to obtain a controlling interest in an entity (compared to a noncontrolling interest in an entity). Section 10.20.3 provides additional discussion on control premiums and noncontrolling interest discounts.

Consider a situation in which the buyer previously 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 $4,000,000. It would not be appropriate in this situation to assume that the fair value of the previously held equity interest is $2,000,000 (or that each individual percent ownership in the target is worth $100,000). The $4,000,000 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 previously held equity interest because that previously held equity interest should represent the fair value of the buyer's interest ***prior*** to it gaining control of the target. In addition, the purpose of estimating the fair value of the buyer's previously held equity interest 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 previously held equity interest 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 the carrying amount and the fair value of the buyer's previously held equity interest in the target.

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 20% previously held equity interest in the target represented 200,000 shares. Because the buyer paid $4,000,000 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) is a control premium. The fair value of the previously held equity interest would be $1,800,000 (200,000 shares multiplied by $9 per share).

Given the complexities that may arise in determining the fair value of a previously held equity interest, particularly 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, it is often prudent to consult a valuation specialist when faced with the task of measuring the fair value of a buyer's previously held equity interest.

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Example 12-5: Step acquisition

The example discussed earlier in Section 12.6.2 is elaborated upon to illustrate the accounting for a step acquisition. Following are the facts presented earlier as well as additional necessary facts related to Buyer's acquisition of Target:

- Buyer pays $4,000,000 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.
- The carrying value of Buyer's previously held equity interest on the acquisition date is $500,000.
- The fair value of Buyer's previously held equity interest on the acquisition date is $1,800,000.
- Buyer's 40% acquisition results in its owning 60% of Target.
- The fair value of the 40% noncontrolling interest that exists after Buyer's acquisition of 40% of Target is $3,600,000.
- Target's net assets acquired by Buyer are $8,775,000, which consists of $10,000,000 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% previously held equity interest in Target over its carrying value 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 value of Buyer's previously held equity interest in Target is equal to $1,800,000 (the acquisition-date fair value of Buyer's previously held equity interest). 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 would 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 noncontrolling interest	3,600,000
Element 3: Acquisition-date fair value of Buyer's 20% previously held equity interest in Target	1,800,000
Total	9,400,000
Element 4: Net assets acquired	8,775,000
Goodwill: Excess of Elements 1 through 3 over Element 4	$625,000

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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	$10,000,000	
Goodwill	625,000	
Cash		$4,000,000
Liabilities		1,225,000
Noncontrolling interest		3,600,000
Equity method investment in Target		1,800,000

12.7 Provisional amounts and measurement period adjustments

12.7.1 General

What are provisional amounts, the measurement period, and measurement period adjustments?

Through its measurement period guidance, Topic 805 implicitly acknowledges that identifying and measuring the various items involved in accounting for a business combination is often a complex and lengthy process. FASB 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 December 31, 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 likely that the buyer will need additional time to gather all information necessary to finalize its accounting for the business combination by March 15, 20X2, which is why Topic 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 Topic 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 to ensure that an appropriate level of rigor was exercised and that adequate supporting documentation exists 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.

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Recognizing a provisional amount is necessary when the buyer has to issue financial statements that include the acquired company 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 intangible asset as of December 31, 20X1 (i.e., the acquisition date) by the time it issues its financial statements on March 15, 20X2. In that situation, the buyer would recognize a provisional amount representing its best estimate for 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 recognize a measurement period adjustment prior to December 31, 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 December 31, 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 as of the acquisition date:

- Results from the buyer obtaining additional information about the facts and circumstances that existed ***as of*** the acquisition date; and
- 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 noncontrolling interest) ***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).

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, noncontrolling interest, and (or) items of consideration is the initial accounting incomplete?

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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 would 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 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.

What is the significance of recording a measurement period adjustment as of the acquisition date?

The practical implication of recording measurement period adjustments as of the acquisition date is that when the financial statements are prepared for any period that includes the initial accounting for the business combination, the initial accounting as of the acquisition date should be adjusted to reflect the measurement period adjustment. Continuing with the previous example, assume the buyer makes the appropriate disclosures in its December 31, 20X1 financial statements related to the provisional amount it recognized for the acquired intangible asset in the accounting for the business combination. 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 makes this adjustment as of December 31, 20X1 (i.e., the acquisition date). As such, when it includes its financial information for the year-ended December 31, 20X1 in its December 31, 20X2 financial statements for comparative purposes, the measurement period adjustment will be reflected in the December 31, 20X1 financial statements.

The buyer should also consider whether a measurement period adjustment affects the intervening period from the acquisition date to the end of the prior reporting period. For example, the buyer acquires the target on June 30, 20X1 and issues its financial statements for its fiscal year end December 31, 20X1 on February 28, 20X2. If the buyer makes a measurement period adjustment on March 31, 20X2 (which is recorded retrospectively back to June 30, 20X1), the buyer must determine whether the period from June 30, 20X1 to December 31, 20X1 (i.e., the intervening period) is affected by that measurement period adjustment. For example, if the measurement period adjustment affected the amount recorded for a finite-lived intangible asset as of the acquisition date, the amortization expense related to that asset for the period June 30, 20X1 to December 31, 20X1 would need to change as a result of that measurement period adjustment. Example 12-6 illustrates how the intervening period can be affected by a measurement period adjustment.

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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 noncontrolling interest in the target;
- Consideration transferred;
- Buyer's previously held equity interest in the target (only in connection with a step acquisition [see Section 12.6]); and
- Goodwill or a gain from a bargain purchase.

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 would be accounted for in accordance with the subsequent accounting guidance in Topic 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:
        1. Does the information giving rise to the adjustment pertain to the facts and circumstances that existed as of the acquisition date?

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2. 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 affects 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 Topic 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 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 to an amount recorded in the accounting for a business combination is necessary subsequent to the end of the measurement period, consideration should be given to what gave rise to the revision. If the 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 Topic 250. If, however, the revision is discovered after the end of the measurement period, but results from a change in estimate, its accounting effects (if any) would be reflected outside of the accounting for the business combination in the current period financial statements. For example, assume that after the measurement period ends, the buyer determines a significant fact was not taken into consideration when determining the acquisition-date fair value of an acquired asset. In this situation, adjusting the acquisition-date carrying value of the acquired asset after the end of the measurement period to reflect the revised estimate would be treated as an error. However, if a different estimate of the asset's acquisition-date fair value is arrived at after the measurement period ends because a different approach or method was used to estimate the fair value, further analysis would need to be performed to assess the accounting effects of that different estimate. Such an analysis may show that the only accounting effect of the revised fair value estimate is triggering the need for a post-acquisition-date impairment analysis of the asset.

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Both a measurement period adjustment and the correction of an error are reflected in the financial statements retroactive to the acquisition date. The practical effects of accounting for an adjustment as a measurement period adjustment vs. the correction of an error revolve around how the adjustment is described and presented in the financial statements. In the case of restating for the correction of an error, the following must take place:

- Complying with the requirements of the error-correction guidance in Topic 250, which includes disclosing the fact that the financial statements have been restated and the nature of the error giving rise to the restatement along with other information pertinent to the restatement;
- If the buyer is a public company, filing the restated financial statements with the SEC; and
- If the buyer is a private company, potentially re-issuing the financial statements, as restated, to the appropriate parties (e.g., lenders).

Example 12-6: 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 31st. 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 expert to perform an appraisal of the manufacturing facility as of the acquisition date. The valuation expert 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 $12,900,000, 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 $700,000. The appraisal received from the valuation expert on April 30, 20X2 indicated the fair value of the manufacturing facility as of the acquisition date is $11,700,000.

The analysis of this fact pattern in the context of the measurement period adjustment thought process 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 expert to finish its appraisal of the facility. As such, Buyer records a provisional amount ($12,900,000) 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 expert:

      When Buyer receives the appraisal from the valuation expert (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:

      1. Does the valuation expert's appraisal pertain to the facts and circumstances that existed as of the acquisition date?
      2. If the buyer had the valuation expert'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?

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- ***Yes*** to both. The valuation expert 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. As such, Buyer would record the following measurement period adjustment ***as of*** the acquisition date:

	Debit	Credit
Goodwill	$1,200,000	
Property, plant and equipment – Manufacturing facility		$1,200,000

Note: 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 ($12,900,000) and the fair value estimated by the valuation expert ($11,700,000).

Buyer would also record the following adjustment for the effects of the measurement period adjustment on the depreciation expense recognized related to the manufacturing facility for November and December of 20X1:

	Debit	Credit
Accumulated depreciation – Manufacturing facility	$10,000	
Depreciation expense		$10,000

Note: 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 $12,900,000 in the December 31, 20X1 financial statements and the depreciation expense that would have been recorded if a cost basis of $11,700,000 had been used [($12,900,000 divided by 20 years (estimated useful life) multiplied by two-twelfths (portion of year Buyer owned and depreciated manufacturing facility)) less ($11,700,000 divided by 20 years multiplied by two-twelfths)].

Buyer would also disclose the nature and amount of the measurement period adjustment in the financial statements for the period(s) in which it is included.

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The following table illustrates the effects of recording the measurement period adjustment as of the acquisition date:

	Amounts reflected in financial statements given to lender on March 31, 20X2 for year ended December 31, 20X1	Amounts reflected in financial statements given to lender on March 31, 20X3 for year ended December 31, 20X1
Property, plant and equipment – manufacturing facility, net (Note 1)	$12,792,500 (Note 2)	$11,602,500 (Note 3)
Goodwill (Note 4)	700,000	1,900,000
Depreciation expense (Note 5)	107,500	97,500

Note 1: The adjustment to property, plant and equipment – manufacturing facility, net reflects the reduction in the basis of the manufacturing facility from $12,900,000 to $11,700,000 (decrease of $1,200,000) and the reduction to accumulated depreciation that results from using a basis of $11,700,000 when depreciating the manufacturing facility instead of a basis of $12,900,000 (increase of $10,000) (see also Notes 2, 3 and 5).

Note 2: Calculated as follows: [$12,900,000 – $107,500 ($12,900,000/20 * 2/12)].

Note 3: Calculated as follows: [$11,700,000 – $97,500 ($11,700,000/20 * 2/12)].

Note 4: The increase to goodwill results from the measurement period adjustment to reduce the recorded amount of the manufacturing facility from $12,900,000 to $11,700,000. Buyer would need to consider the effects this increase in goodwill would have on testing for goodwill impairment in the December 31, 20X1 financial statements (both as issued on March 31, 20X2 and 20X3).

Note 5: The decrease to depreciation expense results from using a basis of $11,700,000 ($11,700,000/20 * 2/12) when depreciating the manufacturing facility instead of a basis of $12,900,000 ($12,900,000/20 * 2/12).

12.7.4 Additional examples

Additional examples of the accounting for adjustments made during the measurement period can be found in Example 11-1 in Section 11.2 (litigation contingency) and Example 12-2 in Section 12.4 (contingent consideration).

12.8 Assigning goodwill to reporting units

The goodwill impairment topics within FASB ASC 350-20-35 describe the model that must be used to recognize and measure a goodwill impairment loss. 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. The "Master Glossary" of the Codification defines the term reporting unit as "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 FASB ASC 280-10-50-1. In describing what would constitute one level below an operating segment, FASB 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 4.1.1).

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. Examples of such factors include the method used to determine the fair value of the target 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.

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12.9 Working capital adjustments

12.9.1 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 $10,000,000 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 $10,000,000 purchase price) was $2,500,000 and the buyer issued its financial statements on February 28, 20X2, which reflected consideration transferred of $10,000,000 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 $3,000,000. 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 pre-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.

12.9.2 Accounting guidance

The buyer in a business combination must determine whether a working capital adjustment represents a measurement period adjustment (which would be retroactively reflected in the accounting for the business combination [see Section 12.7.1]). Continuing with the example introduced earlier in Section 12.9.1, 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 straight-forward 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 would 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; and
- The working capital adjustment was finalized before the close of the measurement period.

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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 would need to 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 $1,400,000 (which was included in the initial estimate of working capital of $2,500,000) and the final amount of accounts receivable was $1,900,000 (which was included in the final amount of working capital of $3,000,000). 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 12.9.1 and 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. These situations require a complete understanding and analysis of all of the facts and circumstances. One factor the buyer would consider in this regard is whether an arbitrator was involved in determining the working capital adjustment. If an arbitrator was involved, the buyer would need to 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 would 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 were 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."

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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 would 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 the subject of a measurement period adjustment (as discussed earlier in this section).
- The effects of the working capital adjustment upon the buyer's and seller's compromise would 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 would 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.

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Determining What Is Part of the Business Combination

13.1 Determining what is or is not part of the business combination

The guidance in Topic 805 addresses the accounting for business combinations, not other transactions and relationships between the buyer and the target and (or) the sellers. The buyer and the target and (or) the sellers in an impending business combination essentially become related parties and they may be influenced by this relationship in their other dealings. As such, to the extent another transaction or relationship occurs or exists 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 and (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 and (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 treated separately from the business combination for accounting purposes.

When there are other transactions and relationships between the buyer and the target and (or) the sellers, the buyer must first identify any and all of these other transactions and relationships. While this sounds like a straight-forward 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 and (or) the sellers have been identified can be a rather complex exercise. The buyer will need to ensure it has processes and procedures in place to identify all of the other transactions and relationships between the buyer and the target and (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 and (or) sellers should be accounted for separate from the business combination include the following:

- ***Why did the buyer, target, sellers, and (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(ies) to the business combination that receives the primary benefit of the relationship or transaction should be identified. If the party(ies) that receives the primary benefit is the buyer and (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(ies) that receives the primary benefit of the relationship or transaction. And, as discussed in the previous bullet point, if the party(ies) that receives the primary benefit is the buyer and (or) the combined entity, then it is most likely that the relationship or transaction should be accounted for separate from the business combination.

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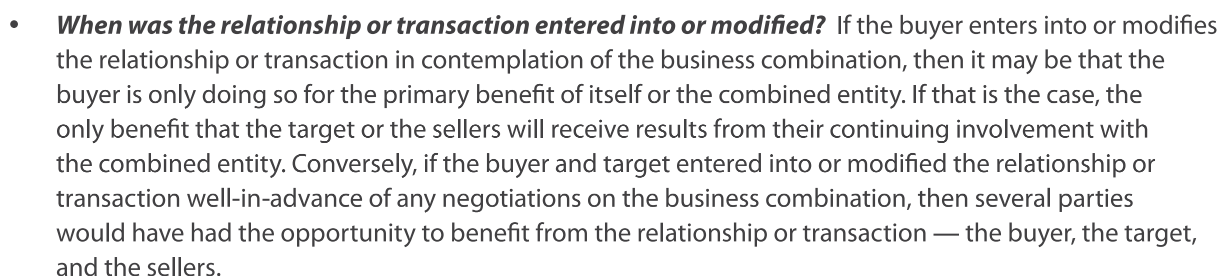

- ***When was the relationship or transaction entered into or modified?*** If the buyer enters into or modifies the relationship or transaction in contemplation of the business combination, then it may be that the buyer is only doing so for the primary benefit of itself or the combined entity. If that 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(ies) 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 and (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 pre-existing relationship should be accounted for separate from the business combination. For additional discussion on the settlement of a pre-existing relationship between the buyer and the target and (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 and (or) the sellers during the negotiations of, or concurrent with, a business combination include:

- The buyer may request that the target pay the acquisition-related costs associated with the business combination in return for the transfer of additional consideration. In this situation, the buyer's reimbursement of 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 acquisition 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 compensation for future services to be provided by employees and (or) sellers of the target. This compensation could be embedded in what, at first glance, appears to be contingent consideration. If the transaction represents compensation, then the buyer should account for the compensation separate from the business combination. For additional discussion related to identifying whether a transaction represents compensation, 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 10.8 and Section 13.6.

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The ultimate end goal in analyzing the other transactions and relationships between the buyer and the target and (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 and (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 pre-existing relationship between buyer and target and (or) sellers

As discussed in Section 13.1, the buyer and the target may have a relationship that pre-dates 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 would 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 would 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 pre-existing 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 would be contractual. Other pre-existing 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 pre-existing relationship between the buyer and the target depends, at least in part, on whether the nature of the relationship was contractual or noncontractual.

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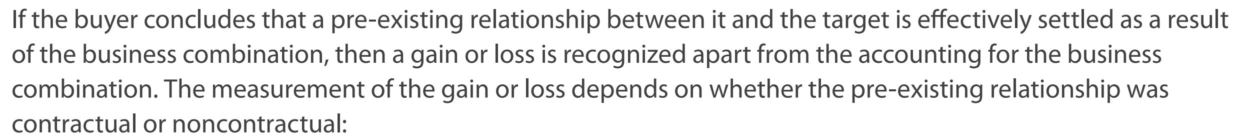

If the buyer concludes that a pre-existing relationship between it and the target is effectively settled as a result of the business combination, then a gain or loss is recognized apart from the accounting for the business combination. The measurement of the gain or loss depends on whether the pre-existing 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 pre-existing 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 later in this section); (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 pre-existing relationship between it 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 pre-existing 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 pre-existing 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 $10,000,000. In return, Buyer receives net assets of $8,000,000, which consists of $12,000,000 of identifiable assets acquired and $4,000,000 of liabilities assumed. Buyer and Target have a relationship that pre-dates 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 Topic 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.

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Buyer has a pre-existing relationship with Target that is effectively being settled by the business combination. As such, a loss related to the settlement of that pre-existing 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 accounting for the business combination on 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 pre-existing 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 Topic 450.

Buyer has a pre-existing 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 pre-existing 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 ($400,000). A summary journal entry representing the recognition of the incremental loss and the accounting for the business combination on 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 pre-existing 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 $15,000,000. In return, Buyer receives net assets of $13,000,000, which consists of $18,000,000 of identifiable assets acquired and $5,000,000 of liabilities assumed. Buyer and Target have a relationship that pre-dates the business combination.

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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 pre-existing 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 pre-existing 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 pre-existing 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 pre-existing 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 pre-existing 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.

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13.3 Arrangements with employees and sellers of target

13.3.1 General

As discussed in Section 13.1, the buyer may enter into or modify an arrangement with employees and (or) sellers of the target concurrent with the negotiations for a business combination. There may also be pre-existing 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 pre-existing contractual and noncontractual relationships, see Section 13.2;
- Acquisition costs, see Section 13.5; and
- Restructuring activities, see Section 13.6.

Guidance on other types of arrangements entered into by the buyer and employees and (or) sellers of the target is provided in this section.

In determining whether arrangements that will or may result in payments to employees should be accounted for within or separate from the business combination, the buyer should first consider whether the payments to the employees are forfeited upon termination of employment (i.e., whether the payments are contingent upon employment). If the payments are forfeited upon termination of employment, then they should be accounted for separate from the business combination as compensation. 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 factors (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 and (or) the combined entity receives the primary benefit from the arrangement. If it is the buyer and (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 seller(s) enter into or modify another arrangement, such as a lease or 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

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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 (or) the other arrangement. For example, if the other arrangement requires the buyer to pay the seller(s) less in the future for a leased asset, 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 lease payments or 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 and (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...
Duration of continuing employment	***Accounted for separate from the business combination (e.g., as compensation),*** if the contingent payment period and the required employment period coincide with one another or if the required employment period is longer than the contingent payment period.
Level of compensation	***Accounted for within the business combination (e.g., as consideration),*** if the other amounts being paid to the employee (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, the contingent payments may essentially represent profit-sharing payments. ***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. ***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.

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Factor	The factor indicates the contingent payment *may* need to be...
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). ***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 regarding 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 and (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

Base facts: 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 $500,000,000 to the sellers.

Scenario A: 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 $2,000,000 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).

Analysis and additional facts: If CEO is employed by Target upon the acquisition closing, CEO is entitled to the $2,000,000 payment. In other words, the $2,000,000 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 factors:

- ***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.

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- ***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, 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.

Because the arrangement between Target and CEO primarily benefits Target and its owners, the $2,000,000 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 FASB ASC 805-10-55-34 through 35.

Scenario B: 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 $2,000,000 at that point in time.

Analysis: 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 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. This is the case even if there are other indicators that the payment represents compensation for precombination services.

Example 13-6: Supply agreement with sellers

Facts: Buyer acquires 100% of Target on December 31, 20X4 from Sellers. The business acquisition agreement requires Buyer to pay Sellers $100,000,000 for Target. The net assets acquired by Buyer (measured in accordance with Topic 805) amount to $65,000,000. 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 the Sellers' other subsidiaries. If Sellers were to buy this manufacturing compound from other suppliers, Sellers would have to pay $700 per kilogram.

Analysis: 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 $3,000,000 (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 $3,000,000 (from $100,000,000 to $97,000,000), which reduces goodwill by $3,000,000 (from $35,000,000 to $32,000,000). In addition, a separate asset in the amount of $3,000,000 should be recorded for the favorable supply agreement outside of the accounting for the business combination.

The same accounting should result if the supply terms were included in the business acquisition agreement instead of being executed as a separate agreement.

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13.3.2 Disclosures

Specific information about arrangements between the buyer and employees and (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 compensation and consideration

As discussed in Section 11.7, the buyer in a business combination may issue replacement share-based payment awards to employees of the target. Also as discussed in Section 11.7, the buyer should use Topic 718 to measure these awards. Some or all of the amount measured for these awards under Topic 718 (the Topic 718 value) is treated as part of the consideration transferred in the business combination (see Section 12.3).

The steps that must be taken to determine the portion of the replacement awards that should be treated as consideration transferred or compensation are as follows:

1. Measure both the replacement awards and the awards being replaced (i.e., the target's awards) in accordance with Topic 718 as of the acquisition date using assumptions that reflect the conditions (e.g., volatility, expected terminations) at the acquisition date, not the conditions at the date the original award was granted;
2. Determine which of the following service periods is longer: (a) the total service period (the sum of the requisite service period for the target's awards completed prior to the acquisition date and the requisite service period (if any) for the replacement awards to be completed after the acquisition date) or (b) the service period of the target's award;
3. Determine the ratio of the precombination service period (the portion of the target's awards' requisite service period completed prior to the acquisition date) to the longer of the service periods identified in (2);
4. Multiply the Topic 718 value of the target's awards by the ratio determined in (3) to identify the portion of the replacement awards' Topic 718 value attributable to precombination service;
5. Calculate the excess of the replacement awards' Topic 718 value over the amount calculated in (4) to identify the portion of the replacement awards' Topic 718 value attributable to postcombination service; and
6. Treat the amount determined in (4) as part of the consideration transferred in the business combination and the amount determined in (5) as post-acquisition-date compensation.

Additional guidance to keep in mind when applying these steps includes:

- Requisite service period in the context of these steps has the same meaning as it does in the context of Topic 718.
- When apportioning the replacement awards' Topic 718 value between consideration transferred and compensation, the buyer should take into consideration its expectations about the number of awards for which the requisite service will be rendered (i.e., its expectations about vesting).
- The steps are the same regardless of whether the replacement award would be classified as a liability or equity based on the provisions in Topic 718. For those awards classified as a liability, any post-acquisition-date changes in their value, and the related income tax effects, are recognized by the buyer in its post-

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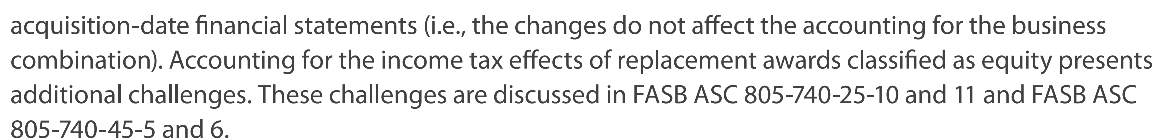

acquisition-date financial statements (i.e., the changes do not affect the accounting for the business combination). Accounting for the income tax effects of replacement awards classified as equity presents additional challenges. These challenges are discussed in FASB ASC 805-740-25-10 and 11 and FASB ASC 805-740-45-5 and 6.

- To the extent all requisite service related to the target's awards has been rendered by the acquisition date and the replacement awards do not include a requisite service period, the buyer may ultimately recognize compensation expense immediately after the acquisition occurs if the Topic 718 value of the replacement awards exceeds the portion of that amount attributed to precombination services (the amount determined in the fourth step) (see Cases 1 and 4 later in Example 13-7).

- 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 would be accounted for separate from the business combination and the Topic 718 value of those awards would be attributed to the postcombination financial statements.

- If the replacement award has a graded vesting schedule, the buyer must take into consideration its policy election for other awards with graded vesting. FASB ASC 718-10-35-8 discusses this policy election.

- After the acquisition date, the amount of the replacement awards' Topic 718 value attributed to post combination service is accounted for under the provisions of Topic 718.

Example 13-7: Various replacement awards

FASB ASC 805-30-55-17 through 24 provide four cases focused on determining the portion of the replacement awards' Topic 718 value attributable to: (a) precombination service (and, therefore, included in consideration transferred for purposes of accounting for the business combination) and (b) postcombination service (and, therefore, accounted for as compensation after the acquisition date and not reflected in the accounting for the business combination). The key facts from those cases and the conclusions are summarized in the following table to provide insight on the way in which the accounting for replacement awards varies based on changes in certain facts.

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		Case 1	Case 2	Case 3	Case 4
		(dollar amounts in 000s)			
Step 1:					
• Topic 718 value of buyer's replacement awards at acquisition date	A	$110	$100	$100	$100
• Topic 718 value of target's awards at acquisition date	B	$100	$100	$100	$100
Step 2:					
• Precombination service period (i.e., the portion of the target's awards' requisite service period completed prior to the acquisition date)	C	All (Note 1)	4 yrs	2 yrs	2 yrs
• Length of the replacement awards' requisite service period	D	None (Note 1)	1 yr	1 yr	None
• Total service period (C + D)	E	Note 1	5 yrs	3 yrs	2 yrs
• Target's awards' service period	F	Note 1	4 yrs	4 yrs	4 yrs
• Longer of total service period and the target's awards' service period (if E > F, use E; if F > E, use F)	G	Note 1	5 yrs	4 yrs	4 yrs
Step 3:					
• Ratio of the precombination service period to the longer of the total service period and the target's awards' 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 service and included in consideration transferred (H x B)	J	$100 (Note 1)	$80 ($100 x 80%)	$50 ($100 x 50%)	$50 ($100 x 50%)
Steps 5 and 6:					
• Amount attributable to postcombination service and treated as compensation (A – J)		$10 (Note 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 service period had been completed prior to the acquisition date and that there was no requisite service period for the replacement awards. Based on these facts: (a) 100% of the target's awards' Topic 718 value would be attributable to precombination service and included in consideration transferred and (b) the difference between the replacement awards' Topic 718 value and the target's awards' Topic 718 value would be attributable to postcombination service and treated as compensation.

Note 2: Because no postcombination service is required of the employees in this case, the amount attributable to postcombination service would be recognized as compensation expense immediately after the acquisition takes effect.

Note 3: After the acquisition date, these amounts would be accounted for in accordance with Topic 718.

For additional information on and discussion of this example, refer to the examples in FASB ASC 805-30-55-17 through 24.

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13.5 Acquisition 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; and
- 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 acquisition costs generally do not represent assets and they result from transactions that should be accounted for separate from the business combination. Acquisition costs should be reflected as an operating expense on the income statement. Recognizing these costs in earnings may create volatility in the buyer's pre-acquisition-date earnings. Cash payments for acquisition 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 acquisition costs within operating expenses on the income statement.

Acquisition costs incurred in connection with acquisitions that are not accounted for as business combinations in accordance with Topic 805 are treated as part of the purchase price (see Section 15.1).

Debt and (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 and (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.
- For equity securities, the costs are included in the appropriate paid-in capital account.

Specific information about acquisition costs must be disclosed by the buyer in its financial statements (see Section 14.2.8).

13.5.2 Acquisition costs paid by seller

As indicated previously, acquisition 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 acquisition costs does not change the substance of those costs or how they should be accounted for. In other words, those costs are still acquisition costs that should be expensed by the buyer separate from the business combination. Furthermore, the reimbursement to the sellers for the acquisition costs should not be treated as additional consideration for purposes of accounting for the business combination. To do so would effectively circumvent the requirement to account for the costs separate from the business combination as it would result in an increase to the goodwill (or a decrease to 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.

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13.5.3 Acquisition costs paid by related party

In general, acquisition costs paid by related parties (e.g., the buyer's shareholder) should be evaluated to ensure that the expense is reflected on the buyer's books. Consider a situation in which a PEG pays the acquisition costs related to the acquisition of an operating company by one of the PEG-created acquisition entities (NEWCO). Those acquisition costs should be reflected as an expense on the NEWCO's books 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).

Example 13-8: Acquisition costs paid by buyer and acquisition costs paid by seller

Buyer entered into a business combination to acquire Target. Buyer transferred $15,000,000 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 Topic 805, amounted to $13,800,000, which consisted of $20,000,000 of identifiable assets acquired and $6,200,000 of liabilities assumed. Under Scenario 1, assume that in connection with the acquisition, Buyer incurred $500,000 of acquisition 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 acquisition 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 acquisition costs should be handled was accounted for in accordance with its substance rather than its form.

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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) acquisition 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 and amortized. Allocating the service provider's total fees among the different services provided is consistent with the discussion in SAB Topic 2A6 (which is included in FASB 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 would be another category of legal services the buyer would need to 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 would 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 would be 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 would include interest and the allocated debt issuance costs) is reasonable when compared to what the effective debt service cost has been for similar debt issuances.

Example 13-9: 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 $50,000,000 in equity to the sellers in connection with its purchase of Target; and (c) Buyer's borrowing of $100,000,000 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.

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Buyer also hired Investment Banking Firm (IBF) to provide services in connection with its purchase of Target and its borrowing of $100,000,000 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	1,000,000	
Acquisition expenses	500,000	
Payable to Law Firm		$650,000
Payable to Investment Banking Firm		900,000

In considering whether the breakdowns provided by Law Firm and IBF represent the relative fair values of the services provided (or if Buyer did not receive any breakdowns from Law Firm or IBF), Buyer would need to determine the fair values of the different services provided by Law Firm and IBF. With respect to the services provided by Law Firm, Buyer would need to consider the following questions:

- What would another law firm charge to provide legal advice and 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 $50,000,000 in equity to the sellers in connection with its purchase of Target?
- What would another law firm charge to provide legal advice and assistance in drafting documents solely related to Buyer's borrowing of $100,000,000 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 $100,000,000 borrowing (which would include interest and the allocated debt issuance costs) is reasonable when compared to the effective debt service cost for similar debt issuances.

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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 transaction(s) between it and the related party is (are) occurring on an arm's length basis. In other words, are the related party's charges to the buyer for services provided reasonable and customary for the 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.

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.

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 pre-acquisition-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 and (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 FASB ASC 420-10-30.

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Example 13-10: 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?		
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 would not be recognized within or separate from the business combination on the acquisition date because the criteria in the Codification 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 10.8 for additional information.

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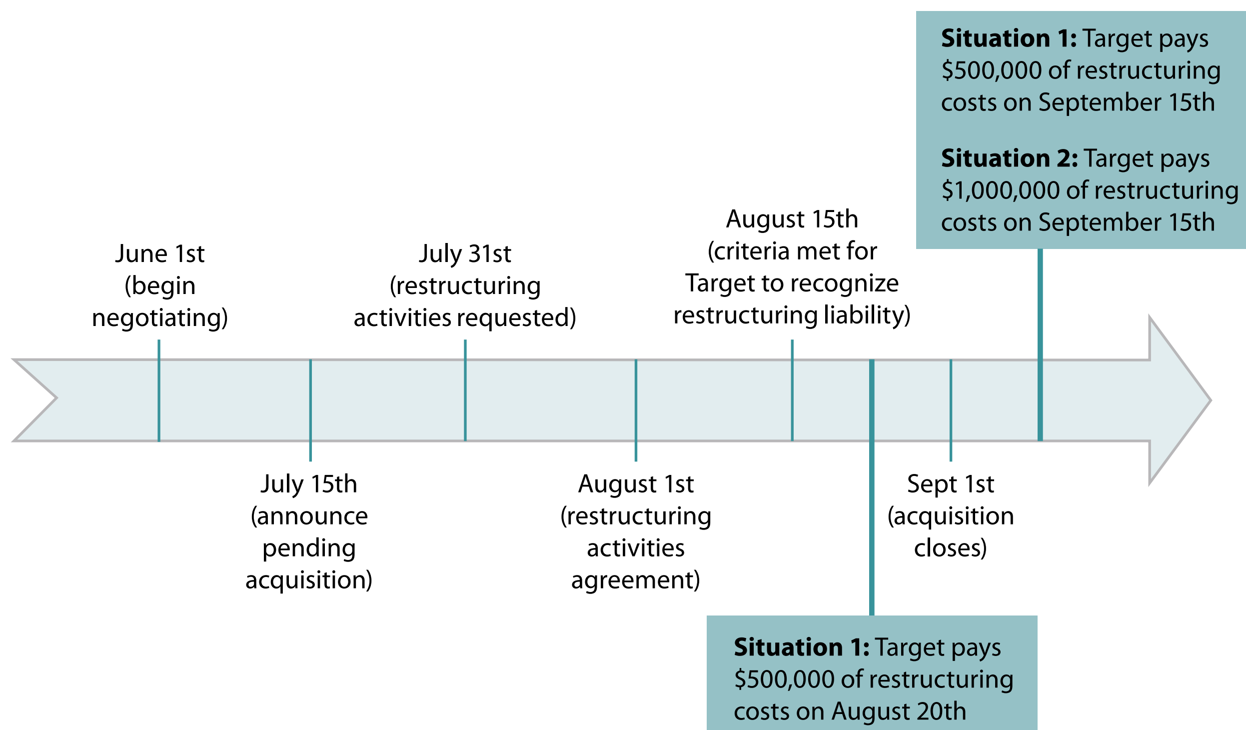
Depending on the facts and circumstances, the accounting for Scenario A can be complex. Consider these additional facts related to Scenario A:

- The amount of the liability recognized by Target on August 15, 20X2 is $1,000,000.
- On September 1, 20X2, the business combination closes and Target becomes a wholly-owned subsidiary of Buyer.
- The amount Buyer agrees to pay is $20,000,000 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 Topic 805, is $18,000,000. (**NOTE:** This amount does not include a liability for the restructuring activities undertaken at Buyer's request.)
- Buyer did not have a previously held equity interest 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 $1,000,000 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).

Presented below 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:



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Buyer's journal entries under Scenario A

August 15th

	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 on the Buyer's books. 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 1st

	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 1st, the net assets acquired would have amounted to $17,000,000 and the amount of goodwill recognized would have amounted to $3,000,000. In addition, Buyer would not have previously recognized a restructuring charge or liability in its financial statements for $1,000,000.

September 15th

	Situation 1		Situation 2	
	Debit	Credit	Debit	Credit
Liability to Target	$500,000		$1,000,000	
Cash		$500,000		$1,000,000

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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 financial reporting period and (b) those that occur after the end of the current reporting period, but before the buyer issues its financial statements for that period (or before the buyer's financial statements for that 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.

Topic 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 I 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 period, but before the financial statements for the current period are issued or available to be issued; and
- Section 14.4, which focuses on specific information the buyer must disclose in its financial statements about adjustments made in the current period that relate to a business combination that occurred in the current or a prior 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 Topic 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 post-retirement benefits. If the buyer acquires the obligation to provide these benefits 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

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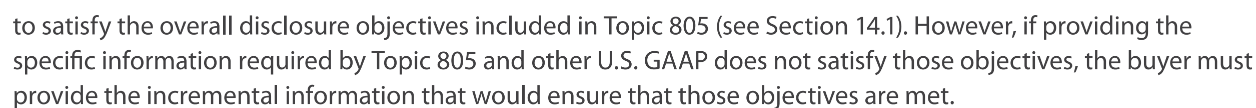

to satisfy the overall disclosure objectives included in Topic 805 (see Section 14.1). However, if providing the specific information required by Topic 805 and other U.S. GAAP does not satisfy those objectives, the buyer must provide the incremental information that would ensure that those objectives 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 noncontrolling interest 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 pre-existing 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); and
- Incremental information required to be provided by a buyer that is a public company(*) (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 Section 6.1);
- The portion of the target's voting equity interests acquired by the buyer;
- The buyer's reasons for entering into the business combination; and
- How the buyer obtained control of the target.

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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 what 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 piece of information should be disclosed and discussed by the buyer.

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 would suggest 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 would 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; and
- 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 would be part of the class of consideration that includes other tangible or intangible assets.

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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(s) why; and
- If there is no upper limit on the range of estimated outcomes (i.e., an unlimited maximum payment), that fact.

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 noncontrolling interest

Topic 805 requires the buyer to disclose details about specific assets acquired, liabilities assumed, and any noncontrolling interest recognized in connection with a business combination. In addition, FASB ASC 350-30-50-1 through 5 require the disclosure of specific information about intangible assets acquired in a business combination. The assets, liabilities, and noncontrolling interest for which additional information must be disclosed along with the additional information to be provided are listed in the following table:

Asset, liability, or noncontrolling interest	Additional discussion	Required disclosures
Indemnification assets	Section 11.3	• The amount recognized by the buyer as of the acquisition date; • A description of the indemnification; • The manner in which the indemnified amount is determined; • If determinable, a range of estimated outcomes (undiscounted); • If a range of estimated outcomes is not determinable, that fact and the reason(s) why; and • If there is no upper limit on the range of estimated outcomes (i.e., an unlimited maximum indemnification), that fact.
Accounts receivable (excluding those that fall within the scope of Topic 310-30)	Section 10.14	• For each major class of receivable: – Fair value of amounts receivable; – Gross contractual amounts receivable; and – Acquisition-date best estimate of the contractual cash flows that are believed to be uncollectible.

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Asset, liability, or noncontrolling interest	Additional discussion	Required disclosures
Each major class of assets acquired and liabilities assumed	Chapters 7, 10 and 11	• Amounts recognized as of the acquisition date.
Intangible assets	Sections 10.2, 10.3, 10.6, 10.7, 10.10, 10.11 and 10.18	• For amortizable intangible assets, in period of acquisition (Note 1): – Total amount; – Amount by major class; – Total residual value; – Residual value by major class; – Weighted average amortization period in total; and – Weighted average amortization period by major class. • For amortizable intangible assets, for each period for which a balance sheet is presented: – Total gross carrying amount; – Carrying amount by major class; – Total accumulated amortization; – Accumulated amortization by major class; – Aggregate amortization expense for the period; and – Aggregate amortization expense estimated for the next five fiscal years. • For nonamortizable intangible assets, in period of acquisition (Note 1): – Total amount; and – Amount by major class. • For nonamortizable intangible assets, for each period for which a balance sheet is presented: – Total carrying amount; – Carrying amount by major class. • For intangible assets that meet certain criteria, in the period of acquisition and for each period for which a balance sheet is presented, information about the intangible asset's estimated useful life.

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Asset, liability, or noncontrolling interest	Additional discussion	Required disclosures
		• Specific information regarding intangible assets for which there are renewal or extension provisions. • 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: – The nature of the contingencies giving rise to the assets and liabilities; – The amounts recognized at the acquisition date; and – How the amount recognized was determined (i.e., fair value or reasonably estimable amount). • 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 Topic 450 to be disclosed for other unrecognized contingencies to the extent the conditions requiring disclosure exist. (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.)
Noncontrolling interest	Section 10.20	• Acquisition-date fair value of the noncontrolling interest; • Valuation technique(s) used to estimate the fair value of the noncontrolling interest; and • Significant inputs used in estimating the noncontrolling interest'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.

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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, 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 pre-existing deferred tax asset valuation allowance

Disclosure of the effects a business combination has on the buyer's pre-existing deferred tax asset valuation allowances must be provided. More specifically, FASB 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 and (or) the sellers separate from the business combination. One example involves the effective settlement of a pre-existing relationship between the buyer and the target and (or) the sellers as a result of the business combination.

The following information must be provided 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; and
- 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 accounted for separately was the effective settlement of a pre-existing relationship, then the method used to determine the settlement amount must also be disclosed.

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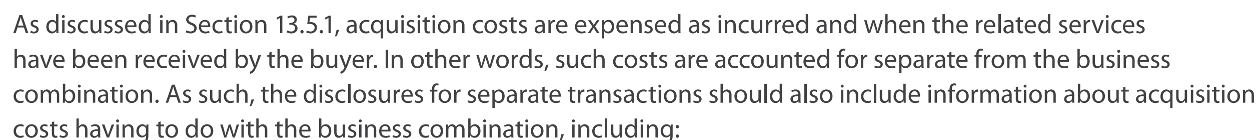

As discussed in Section 13.5.1, acquisition costs are expensed as incurred and when the related services have been received by the buyer. In other words, such costs are accounted for separate from the business combination. As such, the disclosures for separate transactions should also include information about acquisition costs having to do with the business combination, including:

- The amount of such costs;
- The amount of such costs recognized as an expense; and
- The line item(s) 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 such costs were treated from an accounting perspective 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 previously held equity interest in the target immediately before the acquisition and (a) the valuation technique used in the fair value measurement process and (b) information about the inputs used in the fair value measurement process;
- The gain or loss recognized in connection with adjusting the carrying amount of the buyer's previously held equity interest 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 business entity" as defined in the "Master Glossary" of the Codification, then the post-acquisition-date revenue and net income included in the consolidated financial statements that is 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.

Topic 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 FASB ASC 250-10-45-9 is used for this purpose.

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14.3 Disclosures when a business combination occurs after the end of the reporting period, but before issuance of financial statements

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 period, but before the financial statements for the current period are issued or available to be issued (as discussed in Section 14.1, the current 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 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 period that relates to a business combination that occurred in the current or a prior 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 Topic 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 Topic 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 in the current period. As discussed in Section 12.7, a measurement period adjustment is retrospectively applied as of the acquisition date. As such, prior period amounts would likely change as a result of recording a measurement period adjustment.

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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, 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; and
- 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 Topic 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

FASB ASC 350-20-50-1 requires a rollforward of goodwill from the beginning of the period to the end of the period. FASB 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 FASB ASC 805-740-25-2 through 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;

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- Changes in the net amount of any foreign currency exchange differences;
- Recognition of any other changes;
- Ending balances of:
  - The gross amount of goodwill; and
  - 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 allocated to reportable segments must also be part of the disclosure. If the goodwill has not yet been allocated to reportable units at the reporting date, then the amount not yet allocated must be disclosed along with the reasons why the allocation has not yet occurred.

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.

14.5 Disclosure illustrations

FASB ASC 805-10-55-37 through 49 provides an illustration of the requirements included in Topic 805. Note that this illustration is not comprehensive. In other words, it does not illustrate all of the disclosure requirements included in Topic 805. Nonetheless, it is useful to see one approach used to satisfy many of the disclosure requirements in Topic 805. The illustration in the Codification is included in Appendix B and cross-referenced to the disclosure checklist also included in that appendix.

In addition, FASB ASC 350-20-55-24 provides an illustration of the disclosure that must be provided for goodwill.

14.6 Disclosures upon initial consolidation of 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 3.1.3 and Section 5.1.

14.7 Fair value disclosures

Given that Topic 805 requires the vast majority of assets and liabilities to be measured at fair value in the accounting for a business combination, the disclosure requirements of Topic 820 must also be taken into consideration when preparing financial statements that include a business combination (see Section 8.1).

The nature and extent of the disclosures required by Topic 820 vary depending on whether the fair value measurement is considered recurring or nonrecurring. More extensive disclosures are required for recurring fair value measurements.

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

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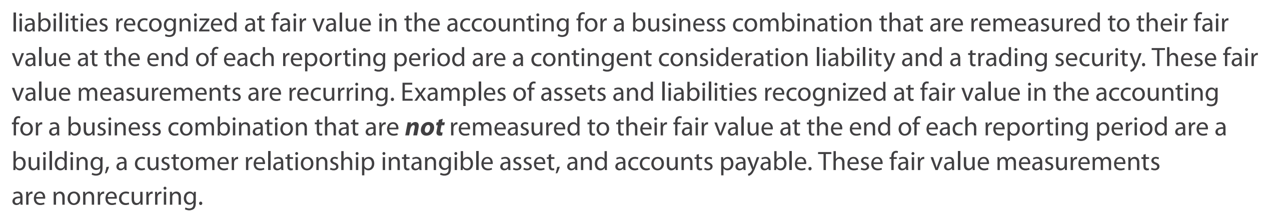

liabilities recognized at fair value in the accounting for a business combination that are remeasured to their fair value at the end of each reporting period are a contingent consideration liability and a trading security. These fair value measurements are recurring. Examples of assets and liabilities 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 building, a customer relationship intangible asset, and accounts payable. These fair value measurements are nonrecurring.

Except as described below, the disclosure requirements in Topic 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 1st and the buyer is analyzing whether the disclosures in Topic 820 are required in its December 31st year-end financial statements for a trading security and a building that were acquired in the business combination:

- ***Trading security:*** A trading security 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 trading 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 the trading security in the December 31st financial statements. Because the fair value reflected in the December 31st financial statements would be the fair value of the trading security on December 31st, 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 31st financial statements is based on the change between December 1st and December 31st, information about the fair value on December 1st 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.

- ***Building:*** A building is initially recognized at fair value in the accounting for a business combination and is subsequently depreciated and reviewed for impairment. In other words, the building 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 building is measured at fair value on a nonrecurring basis. Are the nonrecurring fair value measurement disclosures in Topic 820 applicable to the fair value of the building on the acquisition date? No. The nonrecurring fair value measurement disclosures are not required for the building in the December 31st 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 building 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 building was not written down to its fair value in connection with an impairment charge between the acquisition date [December 1st] and the balance-sheet date [December 31st]). While the nonrecurring fair value measurement disclosures are not required for the building in this situation, consideration should be given to voluntarily disclosing information about the fair value of the building. The needs of the financial statement users should be considered in this regard.

As it relates to the building, assume instead that it was acquired in a business combination that occurred on June 1st and that it was impaired and written down to its fair value on December 1st. In this situation, the nonrecurring fair value measurement disclosures should be provided for the building in the December 31st 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 building was written down to its fair value through an impairment charge in the December 31st year end. The disclosures provided are based on

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the fair value of the building at December 1st (the date the fair value was measured for purposes of determining the impairment charge) and not the fair value of the building at June 1st (the date of its initial acquisition in the business combination) or December 31st (the balance-sheet date).

Some question why the disclosure requirements in Topic 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 Topic 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 Topic 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 building 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 Topic 820's disclosures is to provide the user with information about significant judgments that affect an entity's results of operations, Topic 820's nonrecurring fair value measurement disclosures were not required with respect to the building 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 future reporting period, that change in fair value generally does affect the buyer's results of operations. In the example discussed earlier, the change in the fair value of the trading security did affect the buyer's results of operations. As a result, given that one of the primary purposes of Topic 820's disclosures is to provide the user with information about significant judgments that affect an entity's results of operations, Topic 820's recurring fair value measurement disclosures were required with respect to the trading security and its estimated fair value.

As discussed in Section 8.1.2, the FASB issued ASU 2011-04 in May 2011. This ASU amends the disclosure requirements in Topic 820. While significant new disclosure requirements were added by ASU 2011-04, a significant number of changes were also made to the disclosure requirements to provide clarification and to conform the grammar, style, and organization of the requirements with the corresponding requirements in IFRS. The preceding discussion is pertinent both before and after the effective date of ASU 2011-04.

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Other Topics

15.1 Asset acquisitions

As discussed in Section 3.1.1, purchases of assets (or assets and liabilities [net assets]) that do not constitute a business are not accounted for as business combinations using the acquisition method captured in Topic 805. As discussed in Section 4.2, 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 (which are discussed in detail later in this section). In addition, 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 and (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. Section 4.2 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.

While purchases of assets (or assets and liabilities [net assets]) that do not constitute a business are not accounted for using the acquisition method captured in Topic 805, authoritative guidance applicable to asset acquisitions is included in Topic 805-50. If an entity buys assets (or assets and liabilities [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. The key activities involved in accounting for an asset acquisition as of the acquisition date include:

- Recognize and measure assets (or net assets) acquired:
  - If the consideration surrendered is cash, then measure the cost of the acquired assets (or net assets) using the amount of cash surrendered, which generally should include cash paid for acquisition costs;
  - If consideration surrendered is made up of noncash assets, liabilities, and (or) equity, then measure the cost of the acquired assets (or net assets) using the more clearly evident and more reliably measurable of: (a) the fair value of the consideration given (unless certain conditions applicable to nonmonetary transactions are met [refer to FASB ASC 845-10-30-3]) or (b) the fair value of the assets (or net assets) acquired; and
  - Allocate the cost of the assets (or net assets) acquired to the individual assets (or assets and liabilities) acquired using the relative fair values of these assets (or assets and liabilities) (including those assets that the acquirer does not intend to use or intends to use to a lesser degree than their highest and best use).
- Derecognize assets surrendered in the acquisition:
  - Recognize a gain or loss (unless certain conditions applicable to nonmonetary transactions are met [refer to FASB ASC 845-10-30-3]) if the fair value of noncash assets surrendered exceeds or is less than the carrying value of those assets.
- Recognize liabilities incurred or equity issued in the acquisition.

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Other applicable U.S. GAAP or accounting policies are used to subsequently account for the assets (or assets and liabilities) recognized in an asset acquisition.

Some of the more notable differences between this accounting and the accounting for a business combination include the following:

- ***Acquisition costs:*** Acquisition costs are generally included in the cost of the assets (or net assets) acquired in an asset acquisition. However, such costs are not included in the accounting for a business combination. In other words, such costs are generally expensed separate from the accounting for the business combination (see Section 13.5.1).

- ***Goodwill:*** No goodwill or gain from a bargain purchase results from the accounting for an asset acquisition. However, either goodwill or a gain from a bargain purchase will almost always result from the accounting for a business combination (see Section 12.1).

- ***Assembled workforce:*** It may be appropriate in an asset acquisition to recognize an intangible asset for an assembled workforce. It is inappropriate to recognize such an intangible asset when accounting for a business combination (see Section 10.5).

- ***IPR&D:*** An asset for IPR&D is only recognized in an asset acquisition if it has an alternative future use. However, an asset for IPR&D must be recognized at its fair value in the accounting for a business combination regardless of whether it has an alternative future use (see Section 10.7.1).

If there appears to be goodwill in an asset acquisition because the fair value of the assets (or net assets) is less than their purchase price, there is a presumption that a business was acquired instead of a group of assets (or net assets) unless there is contrary evidence (see Section 4.1). Also, if the fair value of the assets (or net assets) is greater than their purchase price, that excess is effectively allocated among the individual assets (or assets and liabilities) acquired. This results in the individual assets being recorded at an amount in excess of their fair value. The buyer should consider whether an impairment may exist in this situation under the provisions of FASB ASC 360-10-35.

16.1 Interaction of business combination accounting and the equity method of accounting

16.1.1 General

FASB ASC 323-10-35-13 states the following: "A difference between the cost of an investment and the amount of underlying equity in net assets of an investee shall be accounted for as if the investee were a consolidated subsidiary." Because of the one-line consolidation concept embedded in the equity method of accounting for investments, there may be an expectation that the guidance used to account for certain aspects of a business combination or a consolidated subsidiary should be consistent with the guidance used to account for the same or similar aspects of an equity method investment. Section 16.1 addresses the consistency (or lack thereof) that exists between the aforementioned guidance on the following topics: (a) how the initial cost of an equity method investment is determined (e.g., are acquisition costs and contingent consideration reflected in that initial cost); (b) whether the investor is required to test the equity method investee's underlying assets for impairment; (c) how the issuance of shares by the equity method investee should be reflected by the investor; and (d) what are the accounting implications when changing from the equity method to the cost method.

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16.1.2 Initial cost

The initial cost of an equity method investment should be determined in the same manner as the cost of an asset acquisition (see Section 15.1). The implications of applying this guidance when determining the initial cost of an equity method investment include the following:

- Acquisition costs incurred to acquire an equity method investment are included in the initial cost of that investment (whereas, acquisition costs incurred in a business combination are expensed as incurred and when the related services have been received by the buyer [see Section 13.5.1]); and
- Contingent consideration involved in the acquisition of an equity method investment is only recognized in the initial cost of the equity method investment if authoritative literature other than that applicable to contingent consideration in a business combination (see Section 12.4) requires its recognition (whereas, contingent consideration is measured at fair value and included in the acquisition-date accounting for the business combination).

With respect to contingent consideration involved in the acquisition of an equity method investment, an additional step is required when the fair value of the investor's share of the equity method investee's net assets is greater than the investor's initial cost. This additional step compares the maximum amount of contingent consideration not otherwise recognized to the excess of the investor's share of the investee's net assets over the initial cost measurement (including contingent consideration otherwise recognized). The lesser of these two amounts is recognized as a liability. Subsequent accounting guidance for a liability recognized in this circumstance is included in FASB ASC 323-10-35-14A.

16.1.3 Testing underlying assets for impairment

The investor in an equity method investment should not perform separate asset impairment tests on the underlying assets of the equity method investee. For example, an investor is not required to independently perform annual impairment tests of an equity method investee's goodwill and indefinite-lived intangible assets. However, to the extent the equity method investee recognizes an impairment charge on one (or more) of its assets, the investor would recognize its share of that impairment charge through its usual equity method accounting procedures. In addition, to the extent the investor has a basis difference in one of the assets on which the equity method investee recognized an impairment charge, the investor should consider whether the impairment charge recognized by the equity method investee on that asset suggests that it may be necessary for the investor to recognize an impairment on the related basis difference. This basis difference arises upon the acquisition of an equity method investee when the cost of the equity method investment is greater than the investor's proportionate interest in the net assets of the equity method investee, in which case the basis difference is allocated to the underlying assets and liabilities of the investee.

16.1.4 Equity method investee's issuance of shares

When an equity method investee issues shares and the equity method investor's proportionate interest in that investee decreases as a result, the investor's accounting for that issuance of shares should be the same as its accounting would have been if it had actually sold some of its investment in that investee. Any resulting gain or loss would be reflected in the investor's earnings. This guidance is similar to the accounting treatment for deconsolidating a subsidiary (see Section 17.1).

16.1.5 Change from equity method to cost method

If an investor loses significant influence over an equity method investee, the investor stops accounting for the investment using the equity method and starts accounting for the investment using other applicable U.S. GAAP

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(such as that applicable to accounting for certain investments in debt and equity securities or the cost method of accounting). It would not be appropriate for the investor to remeasure its equity method investment at fair value when it loses significant influence and recognize a gain or loss on the retained interest. This guidance is inconsistent with that found on the subject of deconsolidating a subsidiary, which results in the recognition of a gain or loss. The inconsistency can be attributed to the accounting significance placed on gaining control and losing control by the FASB, which is discussed in Section 17.1.

17.1 Changes in buyer's ownership interest in target after 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. In general, the accounting for these changes is addressed in Topic 810-10. Three types of changes that may occur with respect to the buyer's ownership interest in the target are listed in the following table along with the accounting for that type of change under Topic 810-10. For purposes of the table, 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.

Nature of the change	Under Topic 810
Increases in the parent's ownership interest in its subsidiary (e.g., purchase of additional ownership interests by the parent; reacquisition of its own shares by the subsidiary)	Account for as an equity transaction as follows: (a) adjust the noncontrolling interest to reflect the change in the corresponding ownership interest and (b) adjust the parent's additional paid-in capital to reflect the difference between (a) and the consideration paid (if any)
Decreases in the parent's ownership interest in its subsidiary that do not result in deconsolidation (e.g., sale of ownership interests by the parent; sale of new ownership interests by the subsidiary) (Note 1)	Account for as an equity transaction as follows: (a) adjust the noncontrolling interest to reflect the change in the corresponding ownership interest and (b) adjust the parent's additional paid-in-capital to reflect the difference between (a) and the consideration received (if any)
Decreases in the parent's ownership interest in its subsidiary (due to something other than a nonreciprocal transfer to owners) that results in deconsolidation (i.e., loss of control) (Notes 1 and 2)	Use the fair value of the former parent's noncontrolling equity investment in the calculation of any gain or loss on deconsolidation [Note: If the parent's loss of control is expected to be accounted for as a discontinued operation, the appropriate impairment testing should be applied prior to the loss of control.]

Note 1: This guidance applies if: (a) the subsidiary is a business or a nonprofit activity and the decreases in the parent's ownership interest are not the sale of in-substance real estate or the conveyance of oil and gas mineral rights or (b) the subsidiary is not a business or a nonprofit activity and the decreases in the parent's ownership interest are not addressed by other guidance in the Codification (e.g., guidance on revenue recognition, exchanges of nonmonetary assets, transferring and servicing financial assets, conveyances of mineral rights and related transactions, and sales of in-substance real estate). Sales of in-substance real estate are discussed in Topic 360-20 and Topic 976-605, while conveyances of oil and gas mineral rights and related transactions are discussed in Topic 932-360.

Note 2: The FASB issued ASU 2011-10 in December 2011. This ASU results in a parent that "ceases to have a controlling financial interest (as described in Subtopic 810-10) in a subsidiary that is in substance real estate as a result of default on the subsidiary's nonrecourse debt" applying the real estate sales guidance in Topic 360-20 upon losing control instead of the deconsolidation guidance in Topic 810-10. For public companies, this guidance is effective for fiscal years, and interim periods within those years, beginning on or after June 15, 2012. For nonpublic companies, the effective date is deferred to fiscal years ending after December 15, 2013. The guidance should be applied on a prospective basis. See the FASB's website for additional information on this ASU.

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As discussed in Section 2.1, the acquisition method is only required to be used when the buyer gains control of the target. Topic 805 does not prescribe the use of the acquisition method in any other circumstances. Topic 805 places significant accounting importance on gaining control and Topic 810-10 places significant accounting importance on losing control. As discussed in the preceding table, upon loss of control, the parent (or investor) must recognize a gain or loss. The 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.

By the same token, the accounting repercussions of a parent decreasing its ownership interest while still maintaining control or of a parent increasing its ownership interest can be tied to the fact that 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.

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Appendix A: Application Checklist for Topic 805

Introduction

This appendix includes a checklist that will assist in the application of Topic 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 Topic 805. These questions are divided into the following categories:

- Preparation for the application of Topic 805 that should ideally take place in advance of entering into a business combination;
- Determination of whether the business combination is within the scope of Topic 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:
  - Determining the consideration transferred in the business combination;
  - Accounting for any noncontrolling interest that exists after the business combination;
  - Accounting for the buyer's previously held equity interest in the target;
  - Determining 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 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; and
- Considerations related to the post-acquisition-date accounting for amounts recognized in the accounting for a business combination.

To determine the answers to the questions posed in the checklist and to understand the accounting implications of those answers, it will be necessary for you 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.

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1. Questions to consider in advance of entering into 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 Sections 3.1.2 and 12.5)?	
1.2	Are adequate procedures in place to accumulate the information needed to account for and disclose information about the business combination in accordance with Topic 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 Topic 805? If so: (a) have the specialists been identified on a timely basis; (b) are appropriate procedures in place to review the qualifications 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 contents 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 Topic 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 (or) coordinating the accounting for the target's activities with the accounting processes and systems that already exist within the buyer's operations?	
1.6	Has an understanding of the tax effects of the business combination been obtained (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 4.2)?	

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2. Questions to consider when determining whether the business combination is within the scope of Topic 805:

		Relevant guide 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 Topic 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 Topic 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 Topic 805?	2.1	
	2.1.3 Is the target a development stage enterprise that satisfies the definition of a business?	4.1.2	
	2.1.4 Does the transaction involve one joint venturer acquiring the other joint venturer's interest in the joint venture?	3.4	
	2.1.5 If the target is a VIE, is the VIE a business and are the PB and the VIE ***not*** under common control?	3.1.3	
	2.1.6 Is the combination between mutual entities?	3.1.1	
	2.1.7 Is the transaction a leveraged buyout?	3.1.1	
	2.1.8 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 Topic 805?	2.1, 3.1, 4.1	
	2.2.1 Is the transaction an asset acquisition instead of a business combination?	4.1, 15.1	
	2.2.2 Does the transaction represent a combination between entities under common control?	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?	3.1.3	
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?	3.1.3	

If a business combination within the scope of Topic 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).

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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 sections	Comments
General		
3.1 Which of the entities involved in the business combination is the buyer (i.e., which of the entities involved in the business combination 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	
3.2 What is the acquisition date (i.e., what date did the buyer obtain control over the target)?	6.1	
What is or is not part of the business combination?		
3.3 Have all other transactions and (or) relationships between the buyer and any of the following parties been identified: (a) the target, (b) employees of the target, and (or) (c) the sellers?	7.1.3, 13.1	
3.4 Should any of the other transactions and (or) relationships identified in Question 3.3 be accounted for separate from (or outside of) the business combination?	7.1.3, 13.1	
3.4.1 Has the effective settlement of a pre-existing relationship between the buyer and the target and (or) sellers (e.g., litigation or 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 replacement share-based payment awards been apportioned, as appropriate, between compensation and consideration, with that portion representing compensation being accounted for separate from the business combination?	13.1, 13.4	
3.4.3 Have arrangements with the employees and (or) sellers of the target been analyzed to determine whether they should be included within the accounting for the business combination (e.g., as a liability assumed or contingent consideration) or treated separate from the accounting for the business combination (e.g., as compensation)?	13.1, 13.3	
3.4.4 Do any of the ongoing arrangements between the buyer and the sellers of the target (e.g., supply contracts or lease agreements) include above-market or below-market terms?	13.3	

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		Relevant guide sections	Comments
3.5	Have debt financing costs and fees and the costs of raising equity in connection with 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 acquisition 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 acquisition costs been paid by the target or the seller?	13.5.2	
	3.6.2 Have the buyer's acquisition 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 or an investment banking firm) provided multiple services to the buyer in connection with the acquisition of the target (e.g., a law firm 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)?	13.5.4	
	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 Have cash payments for acquisition costs been classified within operating activities on the cash flow statement?	13.5.1	
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)?	10.8, 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	

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The next five sets of questions (sets 4 through 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 noncontrolling interest in the target
Element 3	Acquisition-date fair value of the buyer's previously held equity interest 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 through 3 over Element 4
Gain from a bargain purchase	Excess of Element 4 over Elements 1 through 3

4. Questions to consider in determining the consideration transferred (i.e., Element 1) in the business combination:

		Relevant guide 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 value 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 replacement share-based payment awards been apportioned between compensation for future services and consideration transferred?	11.7, 13.4	
4.1.3	Has all contingent consideration been identified?	12.3, 12.4, 13.3	
4.1.4	Has consideration transferred subject to a working capital adjustment been identified?	12.9	
4.2	Has all consideration transferred, except for 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?	12.3.3	

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		Relevant guide sections	Comments
4.3	Have replacement share-based payment awards (or the portion thereof) that represent consideration transferred been measured using the guidance in Topic 718?	11.7, 13.4	
4.4	Was contingent consideration properly classified as an asset, liability or equity using the guidance in FASB ASC 480-10-25, 815-40-15, 815-40-25 and other applicable guidance?	12.4.2	

5. Questions to consider in accounting for any noncontrolling interest that exists after the business combination (i.e., Element 2):

		Relevant guide sections	Comments
5.1	Does a noncontrolling interest in the target remain after the acquisition? [**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.]	10.20, 12.1	
5.2	Have the financial instruments (or embedded features) that make up the noncontrolling interest been properly identified using the guidance in FASB ASC 810-10-45-16A, 480-10-25, 815-40-15, 815-40-25 and other applicable guidance?	10.20.2	
5.3	Has the noncontrolling interest been measured at its acquisition-date fair value?	10.20.3, 12.1	
	5.3.1 If there is an active market price for the shares held by the noncontrolling interest, was the fair value of the noncontrolling interest measured by taking that active market price and multiplying it by the number of shares held by the noncontrolling interest?	10.20.3	
	5.3.2 If there is not an active market price for the shares held by the noncontrolling interest, has a noncontrolling interest discount only been reflected in the fair value of the noncontrolling interest to the extent such a discount would be reflected in the fair value by a market participant?	10.20.3	
5.4	Within the consolidated balance sheet, has the noncontrolling interest been clearly identified and labeled and presented separately within equity (unless the public company redeemable securities guidance requires presentation of the noncontrolling interest as mezzanine equity)?	10.20.4	

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6. Questions to consider in accounting for the buyer's previously held equity interest in the target (i.e., Element 3):

		Relevant guide sections	Comments
6.1	Did the buyer previously hold an equity interest in the target? [**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 previously held equity interest 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, was the fair value of the buyer's previously held equity interest measured by taking that active market price and multiplying it by the number of shares held by the buyer prior to obtaining control?	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 previously held equity interest based on the fair value of the buyer's interest prior to it gaining control of the target (i.e., was any control premium not reflected in the fair value of the buyer's previously held equity interest)?	12.6.2	
	6.2.3 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 not transferred in the business combination, was the fair value of the buyer's previously held equity interest based on the fair value of the buyer's interest after it gained control of the target (i.e., was any control premium reflected in the fair value of the buyer's previously held equity interest)?	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 previously held equity interest in the target?	12.1, 12.5, 12.6.1	

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7. Questions to consider in determining the net assets acquired (i.e., Element 4) in the business combination:

	Relevant guide sections	Comments
Recognition		
7.1 Have all the identifiable assets acquired and liabilities assumed that meet the definitions of assets and liabilities in CON 6 been recognized?	7.1, 10.1	
7.1.1 Do all intangible assets recognized satisfy the separability and (or) contractual-legal criterion? Have all identifiable intangible assets that satisfy the separability and (or) contractual-legal criterion been identified?	10.2, 10.3	
7.1.2 Has the buyer's intended use (or non-use) of an acquired asset been ignored for purposes of determining whether an asset should be recognized?	10.2, 10.4, 10.18	
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 6 and (or) the separability and (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 Sections 10.2 and 10.3.]	7.1, 10.1, 10.2	
(a) Customer lists?	10.2	
(b) Customer contracts?	10.6	
(c) Customer relationships?	10.6, 10.11	
(d) Order or production backlog (e.g., backlog of purchase and sale orders)?	10.6	
(e) R&D activities?	10.3, 10.7	
(f) Servicing rights that are contractually separate from the financial assets to which they relate?	10.9	
(g) Construction contracts within the scope of Topic 605-35?	10.10	
(h) Operating leases in which the target is the lessee or the lessor?	10.11	
(i) Capital leases in which the target is the lessee?	10.12	

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			Relevant guide sections	Comments
	(j)	Legal performance obligations to the target's customers (i.e., deferred revenue)?	10.15	
	(k)	Defensive intangible assets?	10.18	
	(l)	Asset retirement obligations?	10.19	
	(m)	Reacquired rights (i.e., rights previously licensed by the buyer to the target)?	11.6	
	(n)	Contingent consideration liabilities related to business combinations in which the target was the acquirer?	12.4.9	
	(o)	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?		10.7	
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	10.5	
	(b)	A liability for any anticipated restructuring activities expected to be undertaken by the buyer with respect to the target's operations	10.8, 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 liability for the target's pre-existing straight-line rent liability	10.16	
	(e)	A customer relationship intangible asset for the relationship that existed between the buyer (as the target's customer) and the target prior to the business combination	10.6.6	
	(f)	Servicing rights that are ***not*** contractually separate from the financial assets to which they relate	10.9	

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			Relevant guide sections	Comments
	(g)	If the target is the lessee in an operating lease: (a) an asset for the right to use the asset that is the subject of the operating lease or (b) a liability for the obligation to make operating lease payments to use the asset that is the subject of the operating lease	10.10	
	(h)	A valuation allowance on accounts receivable (i.e., an allowance for doubtful accounts)	10.14.2	
	(i)	A deferred tax liability for the excess of goodwill for book purposes over tax-deductible goodwill	11.4.5	
7.2	Have the following been recognized even if they do not meet the definitions of assets and liabilities in CON 6? [**Note:** Topic 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 Topic 805 (e.g., litigation contingencies and warranty obligations) 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 using the guidance in Topic 805-740 and Topic 740?	11.4	
	7.2.4	Employee benefit-related assets and liabilities using the applicable guidance in the Codification (e.g., Topics 715-30 and 715-60)?	11.5	
	7.2.5	Share-based payment awards using the guidance in Topic 718?	11.7, 13.4	
	7.2.6	Insurance and reinsurance contracts using the guidance in Topic 944?	10.13	
7.3	Have all assets and liabilities been identified and recognized based on the facts and circumstances that existed as of the acquisition date?		6.1	
7.4	If the buyer reduces its pre-existing 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 FASB ASC 740-10-45-20?		11.4.3	

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		Relevant guide sections	Comments
Classification and designation			
7.5	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 FASB ASC 360-10-45?	9.1, 11.8	
7.6	Were the target's leases classified by the buyer as operating or capital based on the terms, conditions, and other relevant facts in existence at the inception of the lease 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 lease was modified?	9.1, 10.11	
7.7	If the target is an entity that falls within the scope of Topic 944, were the contracts written by it classified 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?	9.1, 10.13	
7.8	Have acquired transactions, instruments, or agreements other than those covered by Questions 7.5 through 7.7 been redesignated or reclassified by the buyer on the acquisition date, as appropriate? [**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.]	9.1	
	7.8.1 Should an acquired instrument previously designated as a hedging instrument in accordance with Topic 815 continue to be designated as a hedging instrument?	9.1	
	7.8.2 Should any acquired embedded derivatives within the scope of Topic 815 be separated from the host contract?	9.1	
	7.8.3 Do any acquired derivatives within the scope of Topic 815 that previously qualified for the normal purchases and normal sales exception continue to qualify for that exception?	9.1	
	7.8.4 Is it appropriate to continue to use the shortcut method in Topic 815 to account for an acquired hedging instrument that is a fair value hedge of a fixed-rate asset or liability?	9.1	

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	Relevant guide sections	Comments
7.8.5 Should acquired investments that fall within the scope of Topic 320 be reclassified between trading, available-for-sale, and (or) held-to-maturity?	9.1	
7.8.6 Should the election be made to account for any of the instruments acquired that fall within the scope of Topic 825-10 using the fair value option provided for in that topic?	9.1	
7.8.7 Should the multiple deliverables within a multiple-element arrangement be bundled together or separated for accounting purposes based on the guidance in Topic 605-25 or Topic 985-605?	9.1	
Measurement		
7.9 Have all of the assets acquired and liabilities assumed, except those in the list that follows, been measured at 100% of their fair value? [**Note:** Topic 805 provides different measurement attributes for the acquired assets and assumed liabilities listed below.]	8.1, 11.1	
7.9.1 Have contingent assets and liabilities not specifically addressed in Topic 805 (e.g., litigation contingencies and warranty obligations) been measured either at fair value or their reasonably estimable amount?	11.2	
7.9.2 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	
7.9.3 Have all income tax-related assets and liabilities been measured using the guidance in Topic 805-740 and Topic 740?	11.4	
7.9.4 Have employee benefit-related assets and liabilities been measured using the applicable guidance in the Codification (e.g., Topics 715-30 and 715-60)?	11.5	
7.9.5 Did the approach taken to measure the fair value of reacquired rights ***not*** take renewals into consideration?	11.6	
7.9.6 Have share-based payment awards been measured using the guidance in Topic 718?	11.7, 13.4	
7.9.7 Have assets that meet the held for sale criteria in FASB ASC 360-10-45 been measured using fair value less costs to sell?	11.8	

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		Relevant guide sections	Comments
	7.9.8 Have insurance and reinsurance contracts been measured using the guidance in Topic 944?	10.13	
7.10	Have all amounts been measured based on the facts and circumstances that existed as of the acquisition date?	6.1	
7.11	Have the fair value measurements for all nonfinancial assets been based on their highest and best use from a market participant's perspective?	10.4, 10.18	
7.12	If the buyer believes that the target's carryover bases in accounts receivable, 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 estimate for each of those accounts?	10.14	
7.13	Is the fair value measurement for deferred revenue based on the fair value of the remaining legal performance obligations to the target's customers (which is likely much less than the deferred revenue recognized by the target prior to the business combination)?	10.15	
7.14	Was the fair value of a tangible long-lived asset with a related ARO measured exclusive of the effects of the ARO?	10.19	

8. Questions to consider with respect to recognizing and measuring goodwill or a gain from a bargain purchase:

		Relevant guide sections	Comments
8.1	Have valuation and (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 noncontrolling interest in the target, and (or) (d) any previously held equity interest in the target?	7.1, 8.1, 12.1	
8.2	Has the amount of goodwill or gain from a bargain purchase been calculated in accordance with Topic 805?	12.1 through 12.9	
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 affects the accounting for the business combination been double-checked?	12.2	

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	Relevant guide sections	Comments
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 noncontrolling interest)?	12.2	
8.4 If applicable, have the acquired assets, assumed liabilities and goodwill been allocated to reporting units using a reasonable and supportable methodology?	12.8	
8.4.1 Has adequate documentation supporting the basis for the methodology and the methodology itself been prepared?	12.8	
8.5 If applicable, has goodwill been allocated to the controlling and noncontrolling interest?	12.1	

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 sections	Comments
9.1 Which aspects, if any, of the initial accounting for the business combination are incomplete?	12.7	
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 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 Topic 805 been included in the financial statements?	14.1, 14.2	
9.4 Have the additional disclosures for intangible assets required by FASB ASC 350-30-50-1 through 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	
9.6 Have the additional disclosures required upon the initial consolidation of a VIE been included in the financial statements?	14.6	
9.7 Have the additional fair value disclosures required by Topic 820 been included in the financial statements?	14.7	

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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 sections	Comments
10.1	Have the appropriate disclosures been made? [**Note:** If the buyer's initial accounting for the business combination is complete when the financial statements are issued or available to be issued, Topic 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 post-acquisition-date accounting for amounts recognized in the accounting for a business combination:

			Relevant guide 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? [**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	
	11.2.1	Did the adjustment occur during the measurement period?	12.7	
	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 that would have affected the accounting for the business combination ***as of*** the acquisition date if it had been known?	12.7	
11.3	Has any working capital adjustment been analyzed to determine whether it should be accounted for as a measurement period adjustment?		12.9	

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	Relevant guide sections	Comments
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 recorded retrospectively as of the acquisition date?	12.7	
11.4.2 Have the appropriate adjustments to previously reported amounts been reflected in those amounts when they are included in subsequently issued financial statements?	12.7	
11.4.3 Have any other post-acquisition effects of the measurement period adjustment been reflected in the buyer's balance sheet and (or) income statement (e.g., if the measurement period adjustment affects the fair value estimate for a piece of equipment, has depreciation expense recorded on that equipment since its acquisition by the buyer and the accumulated depreciation on that equipment been adjusted to take into consideration the adjusted book basis for the equipment)?	12.7	
11.4.4 Have the appropriate disclosures been made about the measurement period adjustment and the effects it has on goodwill?	12.7, 14.4.2	
Subsequent accounting adjustments		
11.5 Should the adjustment be accounted for using the subsequent accounting guidance in Topic 805 or other guidance in the Codification applicable to assets and liabilities recognized in the accounting for the business combination? [**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).]	8.2, 12.7	
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 with the change in fair value reflected in the income statement (unless the contingent consideration qualifies as a designated hedging instrument)?	12.4.4	
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	

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		Relevant guide 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 with the change in fair value reflected in the income statement (unless the contingent consideration qualifies as a designated hedging instrument)?	12.4.9	
11.8	If contingent consideration falls within the scope of Topic 815-40, has the classification of the contingent consideration as a liability or equity been reassessed at each balance-sheet date?	12.4.3	
11.9	Has a contingent consideration liability only been derecognized upon settlement or expiration of the contingency?	12.4.4	
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 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	
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 receivables with deteriorated credit quality			
11.13	Has the appropriate subsequent accounting guidance been applied to acquired accounts or loan receivables with deteriorated credit quality?	10.17	
Customer relationship intangible assets			
11.14	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?	10.6.5	
Defensive intangible assets			
11.15	Has the appropriate useful life for a defensive intangible asset been determined?	10.18	
Contingent assets and liabilities			
11.16	Is the buyer's subsequent accounting policy for contingent assets and contingent liabilities not specifically addressed by Topic 805 (e.g., litigation contingencies and warranty obligations) systematic and rational?	11.2.4	

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	Relevant guide sections	Comments
Indemnification assets		
11.17 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	
11.18 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		
11.19 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		
11.20 Have any R&D activities acquired in a business combination 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 indefinite-lived R&D intangible asset recognized in the accounting for the business combination?	10.7.2	
Income-tax related		
11.21 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 FASB ASC 740-10-45-20)?	11.4.7	
11.22 Have changes in uncertain tax positions that affect income tax-related amount(s) recognized in the accounting for the business combination (e.g., deferred tax assets or liabilities, payables to or receivables from taxing authorities, or a liability for unrecognized tax benefits) 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	
Buyer's ownership interest		
11.23 Have changes in the buyer's ownership interest after the acquisition date been accounted for appropriately?	17.1	
Disclosures		
11.24 Have the disclosures in Topic 805 about the subsequent accounting for certain amounts recorded in the accounting for the business combination been provided in the financial statements?	14.4	

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Appendix B: Topic 805 Disclosure Checklists and Illustration

Introduction

This appendix consists of the following three sections:

- ***Section I: Disclosures required by Topic 805*** includes a checklist that will assist in determining whether the disclosures required by FASB 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 II: Disclosures for combinations between entities under common control*** lists the disclosures required by FASB ASC 805-50-50 for combinations between entities under common control. Section 3.2 includes discussion on the accounting for combinations between entities under common control.
- ***Section III: Illustration of Topic 805 disclosure requirements*** includes the disclosure illustration presented in FASB ASC 805-10-55-37 through 50. As appropriate, each disclosure requirement listed in Section I is cross-referenced to where that disclosure is illustrated in Section III. Likewise, each paragraph of the disclosure illustration in Section III is cross-referenced to the corresponding disclosure requirement in Section I.

Topics in the Codification other than Topic 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 would need to consider the disclosure requirements in:

- FASB ASC 350-20-50 and 350-30-50 (disclosures related to goodwill and intangible assets);
- FASB ASC 740-10-50 (disclosures related to income taxes);
- FASB ASC 810-10-50-2A through 19 (disclosures related to VIEs [see Section 14.6]); and
- FASB 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 the financial statements of businesses acquired or to be acquired to be disclosed.

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Section I: Disclosures required by Topic 805

The following table lists the disclosures required by FASB 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 provides discussion of the disclosures that must be provided in conjunction with a business combination.

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.

Section III paragraph identifier	FASB ASC 805-	Disclosure requirement	Yes/ No	Remarks
	10-50-2 20-50-1 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.		
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 determining the fair value of those instruments or interests.		

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Section III paragraph identifier	FASB ASC 805-	Disclosure requirement	Yes/ No	Remarks
7, 14	20-50-1(a) 30-50-1(c)	g. For contingent consideration arrangements and indemnification assets:		
7, 14	20-50-1(a)(1) 30-50-1(c)(1)	(1) Amount recognized as of the acquisition date.		
14	20-50-1(a)(2) 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) 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) 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 Topic 310-30:		
15	20-50-1(b)(1)	(1) The fair value of the receivables.		
15	20-50-1(b)(2)	(2) The gross contractual amounts receivable.		
15	20-50-1(b)(3)	(3) 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 provided for each major class of receivables. Examples include: (a) loans, (b) direct financing leases in accordance with Topic 840-30, and (c) other classes 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 Topic 450.		
Note 1	20-50-1(d)(2)	(2) For contingencies that are not recognized at the acquisition date, the disclosures required by Topic 450 if the criteria for disclosures in that topic are met.		

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Section III paragraph identifier	FASB ASC 805-	Disclosure requirement	Yes/ No	Remarks
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 Topic 280-10:		
2	30-50-1(e)	(1) The amount of goodwill by reportable segment unless the assignment of goodwill to reporting units required by FASB ASC 350-20-35-41 through 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 is not complete 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.		

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Section III paragraph identifier	FASB ASC 805-	Disclosure requirement	Yes/ No	Remarks
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 acquisition-related 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:		
Note 1	30-50-1(f)(1)	(1) The amount of any gain recognized in accordance with FASB 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% of the equity interests in the target at the acquisition date:		
12	20-50-1(e)(1)	(1) The fair value of the noncontrolling interest in the target at the acquisition date.		
18	20-50-1(e)(2)	(2) The valuation technique(s) and significant inputs used to measure the fair value of the noncontrolling interest.		
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		

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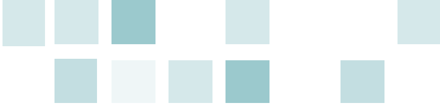

Section III paragraph identifier	FASB ASC 805-	Disclosure requirement	Yes/No	Remarks
		business combination and the line item in the income statement in which that gain or loss is recognized.		
Note 1	10-50-2(g)(3)	(3) The valuation technique(s) used to measure the acquisition-date fair value of the 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 target's financial statements to assess the inputs used to develop the fair value measurement of the equity interest in the target held by the buyer immediately before the business combination.		
20	10-50-2(h)	r. If the buyer is a public business enterprise, 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(s) that occurred during the current year had occurred as of the beginning of the comparable prior annual reporting period (supplemental pro forma information).		

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Section III paragraph identifier	FASB ASC 805-	Disclosure requirement	Yes/ No	Remarks
25	10-50-2(h)(4)	(4) The nature and amount of any material, nonrecurring pro forma adjustments directly attributable to the business combination(s) included in the reported pro forma revenue and earnings (supplemental pro forma information).		
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 these disclosures is impracticable.		
Note 1	10-50-3 20-50-2 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) through 1(s) of this section in the aggregate.		
Note 1	10-50-4 20-50-3 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 20-50-3 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 20-50-3 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	10-50-6 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:		

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Section III paragraph identifier	FASB ASC 805-	Disclosure requirement	Yes/No	Remarks
16	10-50-6	a. If the initial accounting for a business combination is incomplete for particular assets, liabilities, noncontrolling interests, or items of consideration and the amounts recognized in the financial statements for the business combination thus have been determined only provisionally:		
16	10-50-6(a)	(1) The reasons why the initial accounting is incomplete.		
16	10-50-6(b)	(2) The assets, liabilities, equity interests, or items of consideration for which the initial accounting is incomplete.		
Note 1	10-50-6(c)	(3) The nature and amount of any measurement period adjustments recognized during the reporting period in accordance with FASB ASC 805-10-25-17.		
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 cancelled 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 FASB 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 FASB ASC 350-20-50-1.		
Note 1	10-50-1 10-50-7	5. If the information provided in conjunction with items 1 through 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 end of the		

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Section III paragraph identifier	FASB ASC 805-	Disclosure requirement	Yes/ No	Remarks
		current reporting period but before the financial statements for that period 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.		
Note 1	10-50-5 10-50-7	6. If the information provided in conjunction with item 4 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	7. 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 FASB ASC 805-10-55-37 through 50 and Section III of this appendix.

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Section II: Disclosures for combinations between entities under common control

The following table lists the disclosures required by FASB ASC 805-50-50 for combinations between entities under common control (see Section 3.2).

Disclosure requirement	Yes/No	Remarks
1. For transfers of assets and liabilities 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.		
c. Any additional disclosures required by FASB ASC 850-10-50.		

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Section III: Illustration of Topic 805 disclosure requirements

The footnote illustration in the table that follows was taken from FASB ASC 805-10-55-37 through 50. The illustration is based on a hypothetical transaction in which Acquirer (a public entity) acquires Target (a private entity). While the majority of the disclosures included in Section I are illustrated in this footnote, a limited number are not. As such, the disclosure requirements in Section I of this appendix should be referred to for a complete list of all of the disclosures required by FASB 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 FASB ASC 805-10-55-37 through 50. The two columns that precede the illustration are meant to facilitate the simultaneous use of the disclosure checklist in Section I and the footnote illustration included in this section. The first column lists the item from Section I 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 I.

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 I reference	Paragraph identifier (used as reference in Section I)	Illustration from FASB ASC 805-10-55-37 through 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 $2,500 arising from the acquisition consists largely of the synergies and economies of scale expected from combining the operations of Acquirer and Target. All of the goodwill was assigned to Acquirer's network segment.	
1(k)	3	None of the goodwill recognized is expected to be deductible for income tax purposes.	
		The following table summarizes the consideration paid for Target and the amounts of the assets acquired and liabilities assumed recognized at the acquisition date, as well as the fair value at the acquisition date of the noncontrolling interest in Target.	
		At June 30, 20X2	
1(f)	4	**Consideration**	**$**
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

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Section I reference	Paragraph identifier (used as reference in Section I)	Illustration from FASB ASC 805-10-55-37 through 50	
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**	
		Financial assets	3,500
		Inventory	1,000
		Property, plant, and equipment	10,000
		Identifiable intangible assets	3,300
		Financial liabilities	(4,000)
		Liability arising from a contingency	(1,000)
		Total identifiable net assets	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 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 capital 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.	

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Section I reference	Paragraph identifier (used as reference in Section I)	Illustration from FASB ASC 805-10-55-37 through 50		
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 estimating 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
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.		

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Appendix C: Push-Down Accounting

Introduction

The guidance on the accounting for business combinations contained in Topic 805 only addresses the accounting by the buyer and not that of the target. As a result, certain issues continue to exist regarding the accounting by the target subsequent to an acquisition if separate standalone financial statements of the target are issued. This often occurs in situations in which the buyer is a financial buyer, such as a PEG, and the target remains a standalone operating company separate from the financial buyer's other investee companies.

Push-down accounting refers to establishing a new accounting basis for a target in its separate standalone financial statements based on an acquisition that results in the target's outstanding voting stock becoming substantially wholly owned. For example, assume Company A buys 100% of the voting stock of Company B from an unrelated third party for consideration of $300 million. Company A applies the acquisition method under Topic 805 when accounting for this business combination in its consolidated financial statements. Furthermore, assume Company B's net book value was $40 million immediately prior to the acquisition and that it will continue to issue its own separate standalone financial statements after the acquisition. If the push-down accounting approach is applied, Company B would establish a new basis for its net assets equal to $300 million (assuming the transaction is not a bargain purchase) in its own separate standalone financial statements. Establishing this new basis is appropriate because Company B became substantially wholly owned by Company A. The primary question in push-down accounting is under which circumstances is it appropriate for the buyer's accounting basis in the target (i.e., the amounts recorded by the buyer for the target's assets and liabilities when it applied the acquisition method) to be pushed down to the standalone financial statements of the target? This question is explored in more detail in this appendix along with other questions such as the following:

- What guidance exists on the subject of push-down accounting and to whom is this guidance applicable? Are there situations when non-SEC registrants may or must apply push-down accounting?
- Under what conditions is push-down accounting prohibited, permitted or required? Which securities of the target should be taken into consideration when analyzing these conditions?
- How is push-down accounting applied? What basis should be pushed down to the target if the buyer applies the acquisition method before the target is eligible to apply push-down accounting?
- How might the target's financial statements be affected by its acquisition even when push-down accounting is not applied? Are there situations when acquisition debt must be pushed down to the target even if the target does not apply push-down accounting?

In addition, a flowchart is provided that captures the basic concepts involved in determining whether push-down accounting is prohibited, permitted or required along with an example that illustrates how push-down accounting is applied to the balance sheet of a target.

Push-down accounting guidance and its applicability

The primary existing authoritative guidance on the subject of push-down accounting is provided by the SEC staff. This guidance was originally issued as SEC SAB 54 and 73, which are now included in SAB Topic 5J. This guidance was supplemented and amended over time by SAB 112 and an announcement made by the SEC staff observer at an EITF meeting. All of the SEC staff's guidance on push-down accounting is now codified in FASB ASC 805-50-

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S99-1 and 2. While included in the Codification, maintaining this guidance is still the responsibility of the SEC staff. SEC registrants are required to follow the SEC staff's guidance on push-down accounting.

Applicability to non-SEC registrants

Entities that are not SEC registrants are not required to follow the SEC staff's push-down accounting guidance. Therefore, a non-SEC registrant, which would include a subsidiary of an SEC registrant that does not file separate standalone financial statements with the SEC either on its own or as part of the parent's filing, would not be required to apply push-down accounting. While there is no authoritative guidance on push-down accounting for non-SEC registrants, we believe it is acceptable for a non-SEC registrant to analogize to the SEC staff's guidance on push-down accounting. In other words, a non-SEC registrant could choose to apply push-down accounting if the related requirements are met. However, a non-SEC registrant that met the related requirements to apply push-down accounting but elected not to apply push-down accounting would be required to do so (on a retroactive basis) if it becomes an SEC registrant at some later date. Whether non-SEC registrants should push down acquisition debt is discussed later in this appendix.

Conditions for push-down accounting

Transactions that result in a target becoming substantially wholly owned as a result of a single transaction or a series of related and anticipated transactions (such that the buyer has the ability to control the form of ownership of the target after the transaction[s]) establish a new basis of accounting in the target's standalone financial statements for its assets and liabilities. This is the overarching principle used to determine whether push-down accounting is appropriate. Controlling the form of ownership of a target may be evidenced by, among other things, the legal and operational rights of a buyer to merge the target upstream or to merge the target with another company controlled by the buyer.

As discussed in FASB ASC 805-50-S99-2, a company must distinguish between transactions resulting in only a significant change in (recapitalization of) its ownership (e.g., as the result of a diverse group of investors acquiring a company in an initial public offering for which push-down accounting should not be applied) and transactions in which it becomes substantially wholly owned and for which push-down accounting is required.

Push-down accounting should only be applied to the extent the target has become substantially wholly owned by the buyer and to the extent the buyer has the ability to control the form of ownership of the target after the transaction. The SEC staff has established the following guidelines as a practical expedient for determining whether push-down accounting is prohibited, permitted or required:

If the buyer's cumulative voting ownership interest in the target as a result of the most recent transaction is…	Then push-down accounting is…
Less than 80%	Prohibited
80% or more, but less than 95%	Permitted
95% or more	Required (Note)

Note: If the target has outstanding public debt or preferred stock that impacts the buyer's ability to control the form of ownership of the target, the target may not be required to apply push-down accounting even if the buyer owns 95% or more of the target's voting ownership interests. Refer to the additional discussion on this limited exception later in this appendix.

The guidelines for determining the appropriateness of the application of push-down accounting are not based on the guidance in Topic 805. In other words, even though Topic 805 requires a buyer to record 100% of the amounts measured in accordance with Topic 805 for a target's assets and liabilities when control is obtained (regardless of whether 100% or 51% of the target's voting ownership interests are acquired), push-down

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accounting still may not be applied until at least 80% of a target's voting ownership interests have been acquired. The threshold differences between when a buyer gains control and applies the acquisition method (i.e., records the target's assets and liabilities predominantly at their fair values) and when a target is permitted or required to apply push-down accounting creates a question with respect to the basis that should be pushed down when the buyer obtains control prior to the target being eligible for push-down accounting. This question is discussed later in this appendix.

When determining whether a target has become substantially wholly owned, the percentage of a target that has been acquired generally should be determined based on the target's outstanding voting securities. This is consistent with SEC Regulation S-X, Rule 1-02(aa), which states: "The term 'wholly owned subsidiary' means a subsidiary substantially all of whose outstanding voting shares are owned by its parents and/or the parent's other wholly owned subsidiaries." With that said, based on informal discussions with the SEC staff, we understand this rule may not always be applied literally by simply evaluating the outstanding voting shares and ignoring all other securities. In certain situations, it may be appropriate for a buyer to consider other securities it owns that are convertible into voting securities of the target (e.g., warrants, options, convertible debt) when determining the percentage owned by the buyer (i.e., on an "if-converted" basis).

The SEC staff has no bright lines when determining whether securities other-than-voting securities should be considered in the evaluation of whether a buyer substantially wholly owns and can control the form of ownership of a target. However, if the buyer's cumulative voting ownership interest in the target is 80% or more as a result of the most recent transaction, other-than-voting securities do not need to be considered when evaluating whether push-down accounting is permitted because the buyer is presumed to control the form of ownership of the target. If the buyer's cumulative voting ownership interest in the target is less than 80% after the most recent transaction, some of the factors that would be considered in determining whether other-than-voting securities should be considered in the calculation of the buyer's percentage ownership would be whether:

- The buyer (regardless of its holdings in securities other-than-voting securities) has sufficient representatives to control the board of directors;
- The buyer's representatives on the board are at least commensurate with its percentage ownership of voting securities and are not expected to be reduced in the near term as a result of board rotation requirements or elections;
- The other-than-voting securities are significantly "in-the-money" (e.g., the exercise price of a share warrant is significantly below the fair value of the share) and exercisable in the near term;
- The holder of the other-than-voting securities is provided voting rights on an as-converted/exercised basis; and
- The buyer, as a holder of the other-than-voting securities, intends to convert these securities to voting securities of the target.

If one or more of these factors exist, it may be appropriate for the buyer to include the other-than-voting securities in the buyer's percentage ownership. If doing so results in the buyer's percentage ownership being 80% or more, then that is a quantitative ***indicator*** that the buyer controls the form of ownership of the target. In other words, reaching an 80% or more ownership interest in the target as a result of including other-than-voting securities is not conclusive evidence in-and-of-itself that the buyer controls the form of ownership of the target. In this situation, the buyer must determine whether that quantitative indicator together with other qualitative indicators provides sufficient evidence that the buyer controls the form of ownership of the target. Examples of

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qualitative factors that would be considered by the SEC staff in this regard include whether the buyer has legal and operational rights to merge the target upstream or to merge the target with another company controlled by the buyer.

Outstanding public debt, preferred stock, and significant noncontrolling interest

As noted in FASB ASC 805-50-S99-1: "The [SEC] staff recognizes that the existence of outstanding public debt, preferred stock or a significant non-controlling interest in a subsidiary might impact the parent's ability to control the form of ownership. Although encouraging its use, the staff generally does not insist on the application of push down accounting in these circumstances." While not an explicit requirement of FASB ASC 805-50-S99-1, based on an SEC staff speech, an evaluation of the significance of the public debt (including mandatorily redeemable securities) or preferred stock outstanding should be performed to determine whether the buyer's ability to control the form of ownership of the target is affected. Quantitative and qualitative factors to consider when determining whether the buyer's ability to control the form of the target's ownership has been affected by outstanding public debt or preferred stock would include:

- Percentage of public debt in relation to the target's net book value and fair value;
- Percentage of common stock ownership that convertible public debt or preferred stock would equate to on an "if-converted" basis;
- Whether one or more put rights are contained in public debt or preferred stock agreements;
- Consent rights provided within public debt (e.g., debt holders must consent before certain capital transactions may occur);
- Level of substantive participating or protective rights held by the debt holders; and
- Number of debt holders or preferred stockholders currently represented on the target's board of directors and expected future representatives in the near term as a result of board rotation requirements or elections.

Flowchart

The following flowchart captures the basic concepts involved in determining whether push-down accounting is prohibited, permitted or required as discussed previously in this appendix.

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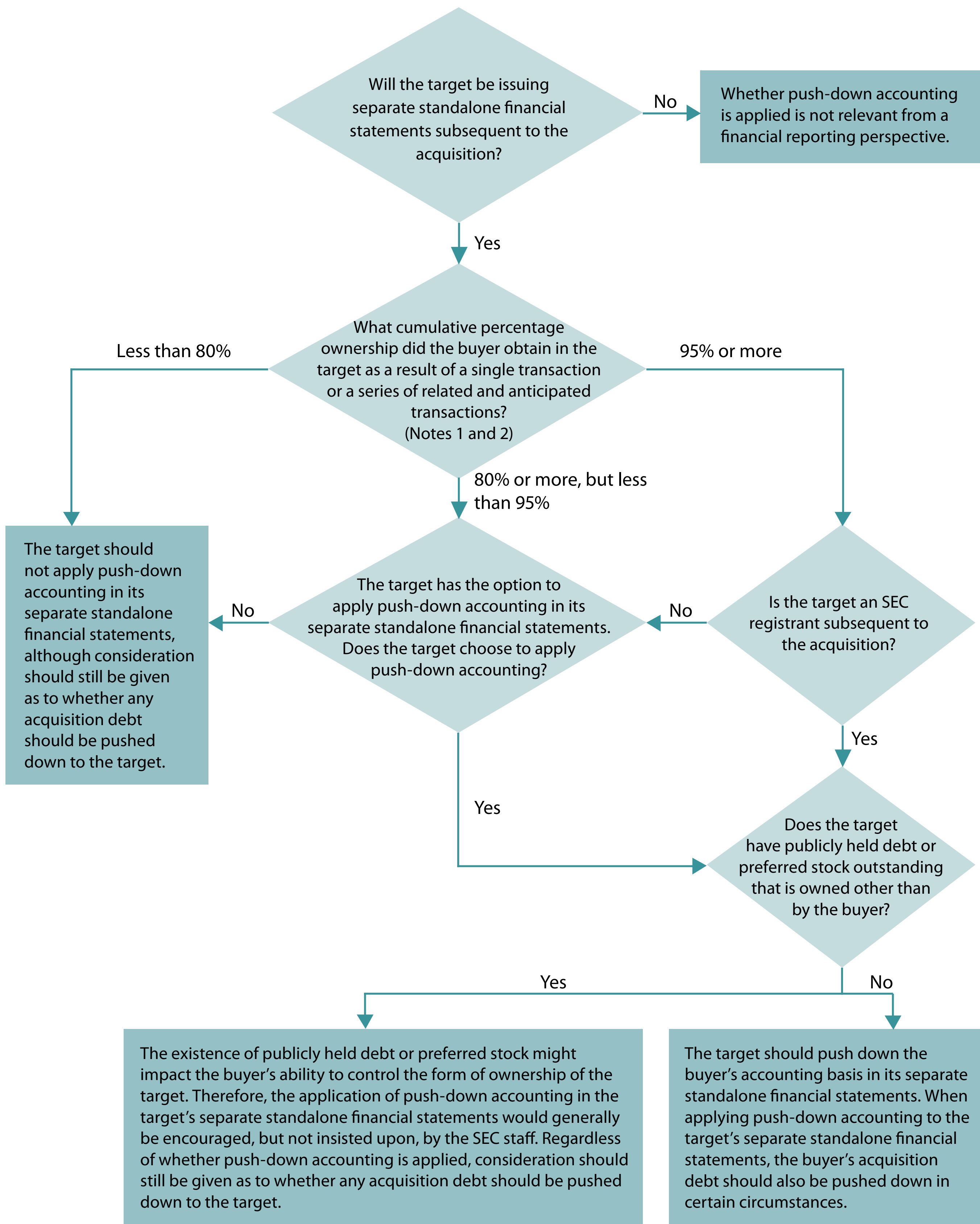

Note 1: In general, the securities that are included in determining the buyer's percentage ownership are limited to the target's voting securities. However, we understand that under certain circumstances, it may be appropriate for a buyer to consider securities it owns that are convertible into voting securities of the target (e.g., warrants, options, convertible debt). These circumstances are discussed earlier in this appendix.

Note 2: It is not necessary for the buyer to be a legal organization for the push-down accounting guidance to apply to the target. Under certain circumstances it may be appropriate to treat a collaborative group as the buyer. These circumstances are discussed later in this appendix.

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Reversal of push-down election

Once a target elects to apply push-down accounting, this election cannot be reversed in the future.

Collaborative group

It is not necessary for a new owner (i.e., the buyer) to be a legal organization for the push-down accounting guidance to apply to the target. For example, if the target is acquired by a group of individuals that are considered a "collaborative group," then the target must consider whether it is substantially wholly owned by the collaborative group and whether the collaborative group controls the form of ownership of the target. If the target is substantially wholly owned by the collaborative group and the collaborative group controls the form of ownership of the target, then, depending on the percentage of the target owned by the collaborative group, the target would push down, or have the option to push down, the basis the collaborative group would have recorded had the individuals in the collaborative group collectively been a legal organization.

As discussed in FASB ASC 805-50-S99-2, the SEC staff believes that a collaborative group is those investors who both "mutually promote" the acquisition and "collaborate" on the subsequent control of the target such that they effectively act as one investor. FASB ASC 805-50-S99-2 provides the following additional guidance on determining whether a collaborative group exists:

> The SEC staff believes that under a "mutual promotion and subsequent collaboration" model, a member of a collaborative group would be any investor[FN1] that helps to consummate the acquisition and works or cooperates with the subsequent control of the acquired company. For purposes of assessing whether an investor is part of a collaborative group, the SEC staff believes that a rebuttable presumption exists that any investor investing at the same time as or in reasonable proximity to the time others invest in the investee is part of the collaborative group with the other investor(s). Determination of whether such a presumption is rebutted necessarily will involve the consideration of all pertinent facts and circumstances. Among the factors considered by the SEC staff[FN2] that would be indicative of an investor not being part of a collaborative group include:
>
> [FN1] Pre-existing, or rollover, investors should be evaluated for inclusion in the collaborative group on the same basis as new investors.
>
> [FN2] In an assessment of whether the presumption is overcome, any single factor should not be considered in isolation.
>
> I. Independence
>
> - The investor is substantive. For example, the investor is an entity with substantial capital (that is, comparable to that expected for a substantive business with similar risks and rewards) and other operations. In contrast, an investor that is a special-purpose entity whose only substantive assets or operations are its investment in the investee generally would not be considered substantive.
> - The investor is independent of and unaffiliated with all other investors.
> - The investor's investment in the investee is not contingent upon any other investor making investments in the investee.
> - The investor does not have other relationships with any other investor that are material to either investor.
>
> II. Risk of Ownership
>
> - The investor is investing at fair value.
> - The investor invests funds from its own resources.

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- The investor fully shares with all other investors in the risks and rewards of ownership in the investee in proportion to its class and amount of investment. That is, the investor's downside risk or upside reward are not limited, and the investor does not receive any other direct or indirect benefits from any other investor as a result of investing in the investee.[FN3]

  [FN3] Put options, call options, tag-along rights, and drag-along rights should be carefully evaluated. They may act to limit an investor's risk and rewards of ownership, effective voting rights, or ability to sell its investee shares. A tag-along right grants a shareholder the option to participate in a sale of shares by the controlling shareholder or collaborative group, generally under the same terms and in the same proportion. A drag-along right grants the controlling shareholder or collaborative group the option to compel shareholders subject to the drag-along provision to sell their shares in a transaction in which the controlling shareholder or collaborative group transfers control of the company, generally under the same terms and in the same proportion.

- The funds invested by the investor are not directly or indirectly provided or guaranteed by any other investor.
- The investor is at risk only for its own investment in the investee and not another's investment in the investee. That is, the investor is not providing or guaranteeing any part of another investor's investment in the investee.[FN4]

  [FN4] See footnote 3.

III. Promotion

- The investor did not solicit other parties to invest in the investee.

IV. Subsequent Collaboration

- The investor is free to exercise its voting rights in any and all shareholder votes.
- The investor does not have disproportionate or special rights that other investors do not have, such as a guaranteed seat(s) on the investee's board, required supermajority voting rights for major or significant corporate decisions, guaranteed consent rights over corporate actions, guaranteed or specified returns, and so forth.
- The investor's ability to sell its investee shares is not restricted, except as provided by the securities laws or by what is reasonable and customary in individually negotiated investment transactions for closely held companies (for example, a right of first refusal held by the investee on the investor's shares in the event of a bona fide offer from a third party).

The SEC staff has considered the applicability of push-down accounting in transactions in which financial investors, acting together effectively as one investor (that is, as a collaborative group), acquire ownership interests in a company. The investee company experiences a significant change in ownership, but no single financial investor obtains substantially all of the ownership interest in the company. Consider the following example:

> Investor C formulates a plan to acquire and consolidate companies in a highly fragmented industry in order to achieve economies of scale. Investor C approaches Investors A and B with the plan, and they agree to invest with Investor C in the acquisition and consolidation plan. Investors A, B, and C (the Investors) are each substantive entities, with no overlap of employees but with a number of prior joint investments and other business relationships that are individually material to the Investors. Furthermore, upon completion of the current plan, the resulting entity is expected to be material to each individual investor.
>
> Shortly thereafter, Company D is identified as an acquisition candidate in the industry. The Investors negotiate a legally binding agreement with Company D to acquire 100 percent of the outstanding common stock of Company D (to be held 40 percent, 40 percent, and 20 percent by Investors A, B, and C, respectively) for cash. In connection with the change in ownership, Company D's bylaws are amended to provide that the Investors each have the right to elect an equal number of members of Company D's

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board of directors. Company D's board of directors also is to include Company D's chief executive officer and two independent directors. In addition, the bylaws are amended to provide that no action requiring board of directors' approval may be approved without consent of a majority of the board as well as a majority of the Investor A directors, the Investor B directors, and the Investor C directors, each voting as a separate class. Effectively, any significant corporate action by Company D would require the approval of each investor.

Stock held by the Investors is to be restricted as to transfer for five years, after which each of the Investors has a right of first refusal and tag-along rights if some part of the group of Investors decides to sell its interests.

The funds invested by each investor come from the respective investor's resources; however, Investors A and B provide Investor C certain limited first-loss guarantees of its investment.

In the context of this example, the SEC staff concluded that Investors A, B, and C did not overcome the presumption that they were members of a collaborative group of investors. Furthermore, since the collaborative group of Investors acquired 100 percent of the outstanding common stock of Company D, the SEC staff concluded that push-down accounting was required to be applied in Company D's financial statements. The factors the SEC staff considered in reaching its conclusion that the presumption was not rebutted included, among others, the following:

- Investors A, B, and C acted in concert to negotiate their concurrent investments in Company D, which were made pursuant to the same contract.
- The investments by Investors A, B, and C were being made in connection with a broader strategic initiative the three investors were pursuing together.
- There were a number of prior business relationships between the Investors that were material to the Investors.
- Investor C does not share fully in the risks and rewards of ownership due to the limited first-loss guarantees provided by Investors A and B.
- No single Investor controlled the board of directors, and due to the amendments to the bylaws regarding board representation and voting, any of the three Investors could unilaterally block any board action. In other words, Investors A, B, and C were compelled to collaborate on the subsequent control of Company D.
- There are restrictions on each Investor's ability to transfer its shares.

The SEC staff provided additional insights on whether a collaborative group exists in a speech given by SEC staff member Pamela R. Schlosser at the 2005 AICPA National Conference on Current SEC and PCAOB Developments. In that speech, Ms. Schlosser indicated that the following questions should also be considered when assessing whether a collaborative group exists:

- "How did the various investors come together to make this investment?
- Hypothetically, if one of the investors would have backed out of the deal, would the deal still have been done?
- How are board seats determined and can the number of seats change over time?
- What is the nature of decisions that require unanimous or majority approval of the investors?
- And lastly, what evidence supports that sale restrictions are considered reasonable and customary?"

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Application of push-down accounting

Basic application guidance

When applying push-down accounting, the target's accounting should be substantially similar to that appropriate for a new entity. Therefore, retained earnings must be reset to zero. If there has been no change in the legal entity, the retained earnings should be dated as of the date push-down accounting was applied to indicate the date from which the earnings have been accumulated. If a new legal entity has been formed in the transaction, it would not be appropriate to date the retained earnings.

When applying push-down 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. The target's additional paid-in capital account would represent the difference between its net assets recorded and the sum of the par value of its issued shares and the amount of any preferred stock outstanding.

As the application of push-down accounting effectively results in the creation of a new accounting entity, the target's operating results prior to push-down accounting should not be combined with those subsequent to push-down accounting. Therefore, if a full year of operations is shown in the statements of income, comprehensive income, cash flows, and changes in shareholders' equity, the periods prior to the application of push-down accounting would be separated from the periods after the application of push-down accounting by a vertical black line and clearly labeled "Predecessor" (for operations prior to push-down accounting) and "Successor" (for operations subsequent to push-down accounting). The relevant footnote disclosures also should be presented separately for the predecessor and successor accounting periods. Furthermore, the statement of cash flows for the successor period in the year in which push-down accounting is applied should include the application of push-down accounting just as it would be done for a new entity with no prior operations (e.g., report the noncurrent assets acquired and liabilities assumed).

Acquisition costs incurred by the buyer should be expensed when incurred and when the related services have been received and not pushed down to the target's standalone financial statements. In addition, any gain from a bargain purchase recorded by the buyer when applying the acquisition method is not pushed down to the target's standalone financial statements.

Basis to push down when control is obtained prior to being eligible for push-down accounting

In certain cases, a buyer obtains control of the target (i.e., over 50% ownership) prior to when the application of push-down accounting is permitted (i.e., 80% or more ownership). Through subsequent investments in the target, the buyer may subsequently meet the criteria to push down its basis in the target's assets and liabilities to the target's standalone financial statements. In this situation, based on informal discussions with the SEC staff, we believe the basis in the target's assets and liabilities that should be pushed down to the target's standalone financial statements is the basis recorded by the buyer on the date the buyer obtained control rolled forward for the target's activities between that date and the date push-down accounting is applied. This basis would generally be equal to the amounts reported in the buyer's consolidated financial statements for the target's underlying assets and liabilities. The basis pushed down should not be based on the fair values of the target's assets and liabilities on the date push-down accounting is applied. Pushing down the basis from the date the buyer obtained control applies equally to both a voting interest entity and a variable interest entity.

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For example, assume that Company A acquires the voting securities of Company B in four tranches as follows:

Date acquired	Percentage of voting securities acquired
April 30, 20X0	75
June 2, 20X1	10
August 7, 20X2	5
December 19, 20X3	5

Further assume that there is no public debt, preferred stock or significant noncontrolling interest outstanding, and there are no other facts that would indicate Company A's level of control of the form of ownership of Company B is inconsistent with these percentages.

In this example, push-down accounting would not be permitted with the April 30, 20X0 acquisition because Company A only acquired 75% of Company B's voting securities. Push-down accounting would be permitted with either the June 2, 20X1 or August 7, 20X2 acquisitions because Company A's cumulative percentage of Company B's voting securities acquired on those dates exceeded 80%, but were less than 95% (i.e., 85% in 20X1 and 90% in 20X2). Push-down accounting would be required for SEC registrants commencing with the December 19, 20X3 acquisition because Company A's cumulative percentage of Company B's voting securities acquired was 95%. When the voting securities are acquired in a series of transactions as in this example, the buyer would apply the acquisition method in accordance with Topic 805 on the date it obtained control of the target, which in this example is April 30, 20X0. This would result in the buyer recording on that date the assets acquired and liabilities assumed of the target at 100% of the amounts measured in accordance with Topic 805. All subsequent purchases of voting securities by the buyer after the date it obtains control (i.e., June 2, 20X1, August 7, 20X2 and December 19, 20X3) would be accounted for as equity transactions in accordance with Topic 810-10.

If the buyer contemplates a series of transactions that will ultimately result in it owning 95% or more of the target's voting securities, then the buyer should apply push-down accounting upon the occurrence of the transaction within the series that results in it owning 80% or more of the target's voting securities. Continuing with the previous example, if the series of transactions was contemplated by Company A when it acquired 75% of the voting securities of Company B, push-down accounting should be applied the first time the 80% threshold was achieved (i.e., June 2, 20X1). Alternatively, if the December 19, 20X3 transaction was only contemplated at the time the August 7, 20X2 transaction occurred, then push-down accounting should be applied by Company B on August 7, 20X2.

To illustrate the concept of rolling forward the buyer's basis on the date it gained control for the target's activities between that date and the date push-down accounting is applied, assume in the preceding example that push-down accounting was applied on June 2, 20X1. In this case, the basis to be pushed down to Company B's standalone financial statements starts with 100% of the amounts measured in accordance with Topic 805 for Company B's assets and liabilities that were recorded by Company A on April 30, 20X0. This basis would then need to be adjusted for Company B's operating activities between April 30, 20X0 and June 2, 20X1. Because retained earnings is reset to zero on the date push-down accounting is applied (see "Basic Application Guidance" earlier in this appendix), the income statement effects of rolling Company A's basis forward for Company B's operating activities from April 30, 20X0 to June 2, 20X1 would be subsumed into additional paid-in capital, which is the account in push-down accounting that represents the difference between net assets recorded by Company B and the sum of the par value of Company B's issued shares and the amount of any preferred stock outstanding.

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To simplify illustrating the effects of rolling forward Company B's basis for operating activities from April 30, 20X0 to June 2, 20X1, assume that Company B's only activity during this period was the depreciation of fixed assets. The basis pushed down to Company B for the fixed assets would be the fair value of those assets on April 30, 20X0 reduced by the related depreciation for the period through June 2, 20X1, which would be calculated using the fair value of those assets on April 30, 20X0. In this simplified example where there is no operating activity other than depreciation of fixed assets, the basis pushed down to Company B for its other assets and liabilities would be 100% of the amounts determined in accordance with Topic 805 on April 30, 20X0. In other words, the assets and liabilities of Company B should not be adjusted to their fair values at June 2, 20X1 (the date push-down accounting was applied) as that is not reflective of Company A's basis in the assets and liabilities of Company B. In addition, Company B's standalone financial statements would be reflected from the date push-down accounting was applied, June 2, 20X1, forward, with retained earnings reset to zero as of June 2, 20X1.

Application of push-down accounting to levels below the target

As discussed previously, a target has the option of applying push-down accounting when the percentage of its voting ownership interests acquired is 80% or more, but less than 95%. Questions may arise as to whether the application of push-down accounting is optional at any level within the ownership structure. To illustrate, assume a 90% acquisition of the voting ownership interests in a holding company where the holding company's principal asset is 100% of the stock of a subsidiary. In this situation, push-down accounting may be applied at the holding company level, but is not required to be pushed further down to the holding company's subsidiary if it separately issues its financial statements. Of course, if the percentage of the holding company acquired is 95% or more of the voting ownership interests and both entities are SEC registrants, the application of push-down accounting should be reflected in the financial statements of the holding company and the separately issued financial statements of the subsidiary.

Example of push-down accounting

On December 19, 20X2, a small group of investors pays $2,500,000 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 $8,000,000 and acquires all the outstanding common stock of Company B (an operating company) for $10,500,000. The term note is collateralized by the stock of Company A. Company B will continue to prepare and issue its separate 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 Topic 805 were the same as their carrying values, except for property and equipment. The fair value of the property and equipment of Company B was determined, by appraisal, to be $15,000,000. Also for simplicity purposes, the income tax effects of the acquisition have been ignored.

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The following table illustrates the application of push-down accounting to Company B and the amounts that would be reflected in Company B's standalone financial statements after push-down accounting is applied:

	Company B (000s omitted)			
	Company A	Before and after purchase at historical cost	Push-down entries	Presentation on push-down 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 (Note 2)	$8,000	4,800	-	4,800
Common stock	2,500	1,000	-	1,000
Additional paid-in capital (Note 2)	-	-	$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 $10,500,000 and the net assets acquired (measured in accordance with Topic 805) of $10,300,000 (which consists of current assets of $6,800,000; property and equipment of $15,000,000; current liabilities of $6,700,000; and long-term debt of $4,800,000).

Note 2: If, in this illustration, Company A's bank term note had been collateralized by the assets of Company B, the $8,000,000 note would have been pushed down to Company B, which would have then resulted in long-term debt of $12,800,000 and additional paid-in capital of $1,500,000.

Other effects of acquisition on target's financial statements

Deferred tax balances

Even when a target decides not to apply push-down accounting in its separate standalone financial statements, the target's deferred tax balances may still be affected by the acquisition if the target's tax basis in an asset or liability changes as a result of the acquisition. In that situation, the temporary difference related to the asset or liability would change as would the related deferred tax asset or liability. The tax effects of these changes in tax bases (along with any change in the valuation allowance as of the acquisition date) would have to be included in equity because the acquisition transaction was among shareholders of the company (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 FASB 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 push-down accounting is not applied. As a result of this

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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 must also be adjusted accordingly with a corresponding adjustment to additional paid-in capital. If a valuation allowance was required for certain deferred tax assets in this scenario, the effect of this valuation allowance would also be included in equity. Changes in the valuation allowance in subsequent periods would be included in the income statement.

Push down of acquisition debt

Regardless of whether push-down accounting is being applied by the target, a determination needs to be made regarding whether acquisition debt (i.e., debt incurred by the buyer to finance the acquisition) should be pushed down to the target. The initial consequences of pushing down acquisition debt are typically a reduction of additional paid-in capital.

Similar to the guidelines used to determine whether push-down accounting is prohibited, permitted or required, the conditions used to determine whether acquisition debt should be pushed down also come from the SEC staff. If any of the following conditions exist, the SEC staff believes the push down of acquisition debt is required:

- The target either assumes the debt or plans to assume the debt in an anticipated transaction;
- The proceeds of a debt or equity offering (either public or private, as in the case of a bank loan obtained by the target) of the target will be used to retire all or a portion of the buyer's debt;
- The target guarantees the debt; or
- The target pledges its assets as collateral for the debt.

If the buyer finances the acquisition of the acquired company through the issuance of mandatorily redeemable preferred stock, that stock should be treated similar to acquisition debt.

If acquisition debt is required to be pushed down, debt issue costs should also be pushed down. Furthermore, amortization of debt issue costs and interest on the debt that has been pushed down would be recognized in the target's income statement.

Other relationships may exist between the buyer and the target, such as the pledge of the target's stock as collateral for the acquisition debt. In these situations, absent any of the other aforementioned conditions requiring the debt to be pushed down, the SEC staff does not insist on the target's financial statements recognizing the push-down of the acquisition debt even if it is clear that the target's cash flows will service all or part of the acquisition debt. When the acquisition debt is not pushed down in these circumstances, there must be full and prominent disclosure in the target's financial statements of the relationship between the companies (which should be disclosed in the equity section of the target's balance sheet) and the actual or potential cash flow commitment of the target. Additionally, clear disclosure should be made of: (a) the target's intent to pay dividends or other amounts to satisfy its parent's debt service requirements and (b) any restrictions on the target's payment of dividends.

Disclosures provided in the target's financial statements when acquisition debt is pushed down or when the circumstances discussed in the preceding paragraph exist (regardless of whether the acquisition debt is pushed down) should describe:

- The nature of the relationship between the target and the buyer;
- The arrangements involving the target that provide security for the buyer's debt, including any arrangements in which the target provides a guarantee or pledges its assets or stock (if a pledge of assets is material to the target, such pledge should be disclosed on the face of its balance sheet);

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- The degree to which the buyer must rely on the target's cash flows to make the principal and interest payments under the debt (both the aggregate amount of the target's cash flows that will be used for these purposes as well as the amounts that will be used for these purposes in the five years following the most recent balance sheet presented) and the method by which the target's cash flows will be used to make these payments (e.g., the target will make the payments directly or the target will pay dividends to the buyer that will be used to make the payments); and
- How the target's ability to pay dividends or other amounts to holders of its securities will be affected by the use of some of its cash flows to make the principal and interest payments required under the acquisition debt.

In addition, the target should consider whether it is necessary to provide the disclosures required by FASB ASC 460-10-50.

While the conditions for determining whether acquisition debt should be pushed down come from the SEC staff, we believe they should also enter the evaluation as to whether non-SEC registrants should push down acquisition debt. More specifically, when the buyer has no substantive operations of its own (i.e., a holding company) ***and*** any of the SEC staff's conditions described previously regarding the push down of acquisition debt exist following a substantial change in ownership, the substance of the transaction is that the debt is effectively that of the target because it assumed the same obligations and responsibilities as if it were the direct obligor of the acquisition debt. As a result, we believe the financial statements of the target should reflect the substance of the transaction and include the buyer's acquisition debt (i.e., the buyer's debt should be pushed down to the target's financial statements). This is the case even if the non-SEC registrant did not elect to apply push-down accounting.

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Appendix D: Differences Between Topic 805 and Prior Guidance

Introduction

The purpose of this appendix is to discuss the significant changes to business combination accounting that the FASB brought about when it issued Statement 141R in late 2007. This standard fundamentally affected how virtually all companies account for mergers or acquisitions of businesses.

For the vast majority of companies, Statement 141R went into effect for their annual reporting periods that began in 2009. For example, for a calendar year-end company, the standard went into effect on January 1, 2009 and for a June 30th year-end company, the standard went into effect on July 1, 2009. The FASB released the Codification after the issuance of Statement 141R. The guidance in Statement 141R, as well as any amendments made to that guidance since its issuance, is included in Topic 805. This guidance will be referred to collectively as the "current guidance" in this appendix.

The guidance in place prior to the issuance of Statement 141R was captured in Statement 141 and a number of other pieces of accounting literature. Upon the effective date of Statement 141R, Statement 141 and over 30 other pieces of accounting literature were nullified in their entirety. In addition, Statement 141R amended more than 60 other pieces of accounting literature. The guidance in place before the effective date of Statement 141R will be referred to collectively as the "prior guidance" in this appendix.

This appendix only discusses the significant differences between the current guidance and the prior guidance on accounting for business combinations. If you have a question on the current guidance applicable to the accounting for business combinations, refer to the section of this guide that discusses the topic of your question in more detail. If you have a question on the prior guidance applicable to the accounting for business combinations, use this appendix as a starting point for your research. However, you should also review the relevant superseded authoritative literature.

Fundamental changes

The method used to account for business combinations fundamentally changed when the current guidance became effective. One fundamental change involved the overall method used to account for a business combination. Current guidance uses the acquisition method, while prior guidance used the purchase method. While there are some similarities between the acquisition method and the purchase method, there are many more differences. One of the most profound differences between the acquisition method and the purchase method is the use of a "fair-value" model under the acquisition method to measure the assets acquired and liabilities assumed in a business combination rather than a "cost allocation" model, which was used under the purchase method. Use of a fair-value model represented a paradigm shift in the accounting for a business combination. This shift was consistent with the overall movement towards fair value accounting in the accounting standard-setting arena.

Another profound difference between the acquisition method and purchase method stems from recognizing 100% of the goodwill associated with a business combination under the acquisition method. Under the acquisition method, 100% of the net assets (measured predominantly at fair value) are recognized. 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 noncontrolling interest. This approach results in the buyer recognizing both its and the

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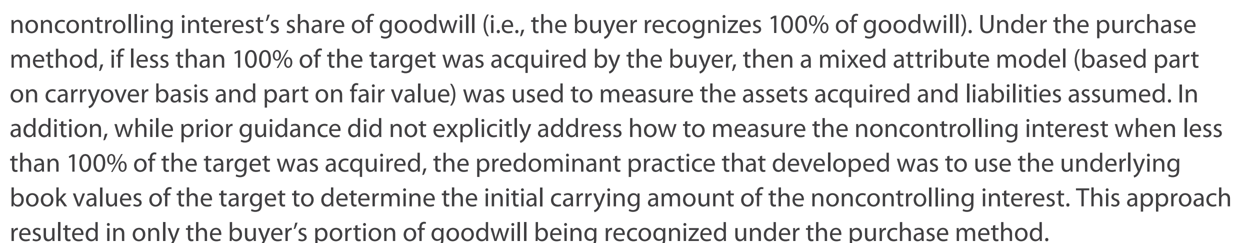

noncontrolling interest's share of goodwill (i.e., the buyer recognizes 100% of goodwill). Under the purchase method, if less than 100% of the target was acquired by the buyer, then a mixed attribute model (based part on carryover basis and part on fair value) was used to measure the assets acquired and liabilities assumed. In addition, while prior guidance did not explicitly address how to measure the noncontrolling interest when less than 100% of the target was acquired, the predominant practice that developed was to use the underlying book values of the target to determine the initial carrying amount of the noncontrolling interest. This approach resulted in only the buyer's portion of goodwill being recognized under the purchase method.

Refer to Sections 2.2, 7.1, 8.1 and 12.1 for additional discussion of the acquisition method and the fundamental principles involved in the accounting for a business combination under current guidance.

Changes to scope

Definition of a business

Significant changes were made to the definition of a business. Under current guidance, for the transferred set to be considered a business, it must include inputs and processes that are ***capable of*** producing outputs. Outputs do not have to be part of the transferred set under current guidance. In contrast, under prior guidance, the transferred set had to include inputs, processes, and outputs to be considered a business. In other words, outputs had to be part of the transferred set under prior guidance.

Under current guidance, the market participant must have the capability of achieving the purposes of the business with the acquired inputs, processes, and outputs. This does not mean that all of the inputs and processes used by the seller to produce outputs had to have been acquired by the buyer to conclude that a business was acquired. In other words, the threshold for concluding that a business was acquired is something less than the acquisition of a standalone business enterprise. However, under prior guidance, an acquired group of net assets had to be self-sustaining to conclude that a business was acquired.

One of the repercussions of the change in the definition of a business relates to development stage entities. Under current guidance, a development stage entity may be considered a business depending on the facts and circumstances. However, under prior guidance, it was presumed that a development stage entity was not a business.

In general, the changes made to the definition of a business have resulted in more acquired groups of net assets being considered businesses and being accounted for as business combinations.

The effects of the change to the definition of a business were not limited to determining whether an acquisition should be accounted for as a business combination. Because the definition of a reporting unit relies on the definition of a business for purposes of goodwill impairment testing, the change in the definition of a business caused entities to re-evaluate their reporting unit determinations. To the extent an entity's reporting unit determinations changed as a result of this re-evaluation, then the entity had to reassign the assets, liabilities, and goodwill to those changed reporting units. In addition, the change in the definition of a business might also affect how an entity accounts for the disposition of a portion of a reporting unit. If the portion of a reporting unit that is being disposed of meets the definition of a business, then goodwill is allocated to that portion of the reporting unit for purposes of determining the gain or loss on disposal. Under prior guidance, the old definition of a business was used for this purpose while under current guidance the new definition of a business is used for this purpose.

Refer to Sections 2.1, 3.1 and 4.1 for additional discussion of the definition of a business under the current guidance and the scope of the current guidance.

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Business combinations without the transfer of consideration

Under current guidance, a business combination occurs when the buyer obtains control of a business through a transaction or other event. As such, a business combination can occur without the buyer being involved in a transaction or without the buyer transferring any consideration. For example, a business combination can result when:

- 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; and
- The buyer is the existing majority (but noncontrolling) owner and obtains control of the target as a result of minority veto rights lapsing.

Under prior guidance, these other events would not have been considered business combinations because control was not obtained by the buyer through the acquisition of net assets or equity interests. The practice that developed under prior guidance to account for some of these other events (e.g., the buyer obtaining control through contract alone) was to account for them as if they were business combinations.

Refer to Section 12.5 for additional discussion of the current guidance applicable to accounting for a business combination that occurs without the transfer of consideration.

Other scope-related changes

Under current guidance, all of the following are accounted for as business combinations using the acquisition method: (a) leveraged buyouts, (b) combinations between two or more mutual entities, and (c) the initial consolidation of a VIE when the VIE and PB are not under common control and the VIE is a business. Under prior guidance, none of these events were accounted for as business combinations. Different accounting guidance existed for each of these events under prior guidance.

Refer to Section 3.1 for additional discussion of the scope of the current guidance and the current guidance applicable to the initial consolidation of a VIE.

Changes to determining the acquisition date

Under current guidance, the acquisition date is the date the buyer obtains control of the target, which is usually the closing date. The acquisition date may only be different from the closing date if there is a written agreement transferring control of the target to the buyer on a date other than the closing date. Under prior guidance, the buyer could use an "effective date" for the acquisition date if, on that date, substantively unrestricted control of the target was given to the buyer in writing. In those situations in which this occurred and the buyer used the effective date as the date to begin accounting for the business combination, the buyer would have had to make adjustments to the cost of the acquired entity and its net income to take into consideration the fact that income was recognized before any consideration was transferred. These adjustments involved reducing the cost of the target and net income for the imputed interest on the consideration transferred to acquire the target, including assets transferred, liabilities assumed, liabilities incurred, and (or) preferred shares distributed.

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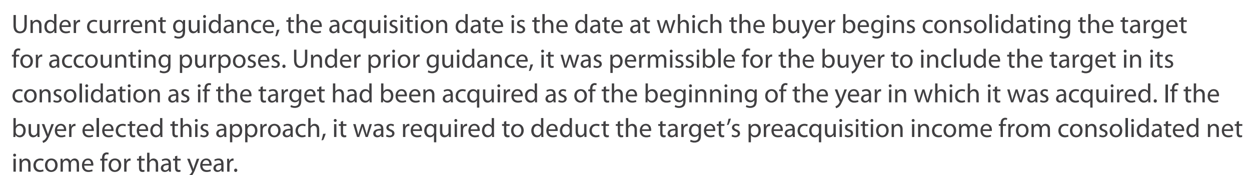

Under current guidance, the acquisition date is the date at which the buyer begins consolidating the target for accounting purposes. Under prior guidance, it was permissible for the buyer to include the target in its consolidation as if the target had been acquired as of the beginning of the year in which it was acquired. If the buyer elected this approach, it was required to deduct the target's preacquisition income from consolidated net income for that year.

Refer to Section 6.1 for additional discussion of the current guidance applicable to determining the acquisition date.

Changes to recognition and measurement of assets acquired and liabilities assumed

Overall change in recognition guidance

Under current guidance, assets and liabilities recognized in the accounting for a business combination must meet the definitions of assets and liabilities provided in paragraphs 25 and 35 of CON 6. With only limited exceptions, each item acquired in a business combination that meets one of these definitions should be recognized in the accounting for the business combination. Under prior guidance, this overall recognition principle was not used. In fact, under prior guidance, certain items were recognized as an asset or liability even though they did not meet the definition of an asset or liability in CON 6 (e.g., liability for costs of expected restructuring activities focused on the target's operations). In other words, under prior guidance, these items were recognized ***as if*** they were an asset or liability. This approach was taken in the prior guidance because the emphasis was on recognizing the cost of the target instead of recognizing the fair value of the assets acquired and liabilities assumed. In addition, under prior guidance, certain items were not recognized as an asset or liability even though they did meet the definition of an asset or liability in CON 6 (e.g., IPR&D acquired in a business combination).

The repercussions of the overall change in recognition guidance on specific assets and liabilities are captured later in this appendix.

Refer to Section 7.1 for additional discussion of the overall recognition principle used in the current guidance to account for a business combination.

Overall change in measurement guidance

Under current guidance, the measurement principle applied in the accounting for a business combination is fair value. With only limited exceptions, the assets and liabilities recognized, along with any noncontrolling interest recognized, are measured at their fair value. Under prior guidance, the measurement principle used a cost allocation model that only partially relied on fair value measurements. The fair value measurements were used in the cost allocation model to allocate the cost of the acquisition to the assets acquired and liabilities assumed.

Under current guidance, the fair value of an asset acquired in a business combination should be determined using a market participant's perspective and by taking into consideration the highest and best use of the asset. 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. Under prior guidance, whether and (or) how the buyer's intended use of the acquired asset should have affected the fair value measurement of that asset was not explicitly addressed. However, in paragraph B262 of Statement 141R, the FASB indicated that: "The intention of both Statement 141 and IFRS 3 was that assets, both tangible and intangible, be measured at their fair values regardless of how or whether the acquirer intends to use them." Despite the FASB's

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intention, practice under prior guidance was varied on whether and (or) how the buyer's intended use of the acquired asset affected the fair value measurement of that asset.

Changes in the measurement of certain assets and liabilities recognized in the accounting for a business combination are discussed later in this appendix.

Refer to Section 8.1 for additional discussion of the overall measurement principle used in the current guidance to account for a business combination.

Subsequent accounting guidance

For the vast majority of the assets and liabilities recognized in the accounting for a business combination, other guidance in the Codification should be applied for subsequent accounting purposes. For example, property, plant and equipment recognized in the accounting for a business combination would subsequently be depreciated like any other property, plant and equipment. That said, under current guidance, there is some specific subsequent accounting guidance provided for certain assets and liabilities recognized in conjunction with a business combination. For example, current guidance indicates that adjustments to the carrying amount of an indemnification asset recognized in the accounting for a business combination should generally follow any adjustments made to the accounting for the underlying indemnified item. Under prior guidance, there was also some (but a lesser amount of) specific subsequent accounting guidance provided for certain assets and liabilities recognized in conjunction with a business combination.

Changes in the subsequent accounting guidance applicable to certain assets and liabilities recognized in the accounting for a business combination are discussed later in this appendix.

Refer to Section 8.2 for a list of the assets and liabilities recognized in the accounting for a business combination for which the current guidance provides subsequent accounting guidance.

Effects of changes in recognition and measurement guidance and subsequent accounting guidance

The table that follows captures examples of specific items involved in the accounting for a business combination for which there is a difference between current guidance and prior guidance:

Item	Current guidance	Relevant guide section	Prior guidance
Expected costs for restructuring activities focused on the target's operations (e.g., involuntary severance costs, employee relocation costs)	Typically, recognize as a liability after the business combination occurs and outside of the accounting for the business combination when the requirements in Topic 420 are satisfied. A liability would only be recognized in the accounting for the business combination in the extraordinarily rare situation in which both of the following are satisfied on the acquisition date: (a) the definition of a liability in CON 6 and (b) the requirements in Topic 420.	10.8	Recognized a liability in the accounting for the business combination provided certain conditions were met.

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Item	Current guidance	Relevant guide section	Prior guidance
IPR&D	Recognize as an indefinite-lived intangible asset (measured at its fair value) and test at least annually for impairment until completion or abandonment of the project. Upon completion, amortize the asset over its useful life. Upon abandonment, write-down the asset as appropriate.	10.7	Included fair value in purchase price allocation and then immediately expensed the allocated amount unless it had an alternative future use.
Excess of tax-deductible goodwill over financial reporting goodwill	Recognize a deferred tax asset for the excess of tax-deductible goodwill over goodwill for book purposes, which requires the use of a simultaneous equation to determine the amount of the deferred tax asset and the ultimate amount of goodwill to recognize for book purposes.	11.4.5	Prohibited from recognizing a deferred tax asset for the amount by which tax-deductible goodwill was more than goodwill for book purposes as of the acquisition date.
Decrease in the buyer's pre-existing deferred tax asset valuation allowance as a result of the business combination	Recognize as an income tax benefit or as a credit to contributed capital, as appropriate (i.e., do not recognize as part of the accounting for the business combination).	11.4.3	Recognized first as a reduction to goodwill or certain noncurrent assets and then as negative goodwill or an increase to negative goodwill (i.e., was recognized as part of the accounting for the business combination).
Effects of expected plan amendments, terminations, or curtailments of pension plans or other postretirement benefit plans (which the employer has no obligation to make on the acquisition date) on the funded status of the plan.	Not taken into consideration when recognizing an asset or liability for the funded status of the plan in the accounting for the business combination.	11.5	Taken into consideration when recognizing an asset or liability for the funded status of the plan in the accounting for the business combination.
Measurement of accounts receivable or loans originated by the target	Measure at fair value, which means that recognition of a separate valuation allowance on the acquisition date is not necessary or permitted.	10.14.2	Measured based on the present value of the contractual cash flows using current interest rates, which often resulted in the recognition of a separate valuation allowance in the accounting for the business combination.

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Item	Current guidance	Relevant guide section	Prior guidance
Subsequent decrease in the valuation allowance on deferred tax assets recognized in the acquisition-date accounting for the business combination (does not include subsequent decreases in valuation allowances that are considered measurement period adjustments)	Recognize as an income tax benefit or as a credit to contributed capital, as appropriate (i.e., do not recognize as part of the accounting for the business combination).	11.4.7	Used first to reduce goodwill to zero, then to reduce other noncurrent intangible assets acquired in the business combination to zero, then to reduce income tax expense.
Subsequent increase or decrease in the amount(s) recognized in the accounting for a business combination that is (are) affected by an uncertain tax position (e.g., deferred tax assets or liabilities, payables to or receivables from taxing authorities, or a liability for unrecognized tax benefits) (does not include subsequent increases or decreases that are considered measurement period adjustments)	Recognize in accordance with the guidance generally applicable to subsequent increases or decreases in the amount(s) affected by uncertain tax positions (i.e., the accounting for the business combination is not affected).	11.4.7	Used first to adjust goodwill. If goodwill was reduced to zero as a result of the adjustment, then the remaining adjustment was used to reduce other noncurrent intangible assets acquired in the business combination to zero. If other noncurrent intangible assets were reduced to zero, then the remaining adjustment was reflected in income.

Changes to recognition of goodwill or a gain from a bargain purchase

Under current guidance, the amount of goodwill or, in rare cases, gain from a bargain purchase to be recognized in conjunction with a business combination is determined as follows:

	Consideration transferred (measured predominantly at fair value)
+	Acquisition-date fair value of noncontrolling interest (in the case of a partial acquisition)
+	Acquisition-date fair value of the buyer's previously held equity interest in the target (in the case of a step acquisition)
=	Total (i.e., fair value of the target as a whole)
-	Net assets acquired by the buyer (which is 100% of the target's net assets measured predominantly at fair value)
=	Goodwill (if positive); Gain from a bargain purchase (if negative)

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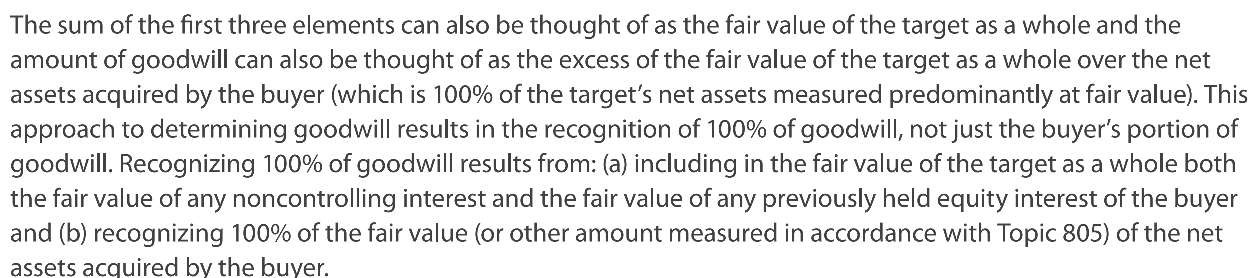

The sum of the first three elements can also be thought of as the fair value of the target as a whole and the amount of goodwill can also be thought of as the excess of the fair value of the target as a whole over the net assets acquired by the buyer (which is 100% of the target's net assets measured predominantly at fair value). This approach to determining goodwill results in the recognition of 100% of goodwill, not just the buyer's portion of goodwill. Recognizing 100% of goodwill results from: (a) including in the fair value of the target as a whole both the fair value of any noncontrolling interest and the fair value of any previously held equity interest of the buyer and (b) recognizing 100% of the fair value (or other amount measured in accordance with Topic 805) of the net assets acquired by the buyer.

Under prior guidance, the following two amounts were compared to determine the amount of goodwill or negative goodwill to be recognized: (a) the cost of the target and (b) the net assets acquired by the buyer, which were allocated amounts based only partially on fair value. If the cost exceeded net assets, then the excess was recognized as goodwill. If the net assets exceeded the cost, then the excess (i.e., negative goodwill) was used to reduce, on a pro rata basis, the amounts otherwise assigned to the majority of the noncurrent assets acquired by the buyer. The noncurrent assets that were not reduced as part of this exercise were: (a) financial assets (except for equity method investments), (b) assets held for sale, (c) deferred tax assets, and (d) prepaid assets related to pension and (or) other postretirement benefit plans. If negative goodwill continued to exist after the appropriate noncurrent assets were reduced to zero, then the remaining amount of negative goodwill was recognized as an extraordinary gain. However, the amount of the extraordinary gain might have been reduced if the business combination involved contingent consideration that ultimately affected the cost of the target. When less than 100% of the target was acquired by the buyer, this approach to determining goodwill resulted only in the buyer's portion of goodwill being recognized because: (a) a mixed attribute model (based part on carryover basis and part on fair value) was used to measure the assets acquired and liabilities assumed and (b) the noncontrolling interest was measured using carryover basis.

Differences between current guidance and prior guidance on specific elements involved in the determination of goodwill are captured in the topics that follow.

Refer to Section 12.1 for additional discussion of the current guidance applicable to determining whether goodwill or a gain from a bargain purchase should be recognized in the accounting for a business combination.

Equity securities transferred

Under current guidance, 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. Under prior guidance, equity securities that were part of the consideration transferred by the buyer in a business combination were measured using the fair value of the securities a few days before and a few days after the ***announcement date.***

Refer to Section 12.3.3 for additional discussion of the current guidance applicable to equity securities transferred as consideration in a business combination.

Contingent consideration

Under current guidance, contingent consideration is recognized in the acquisition-date accounting for the business combination and measured at its fair value on the acquisition date. In addition, current guidance provides subsequent accounting guidance for contingent consideration. Under that guidance, the subsequent accounting for contingent consideration depends on whether the contingent consideration is classified as: (a) equity or (b) an asset or liability. Contingent consideration classified as equity is not remeasured in subsequent accounting periods. Contingent consideration classified as an asset or a liability is remeasured to its fair value at each reporting date. If the contingent consideration asset or liability is not a derivative, the change in fair value is reflected on the income statement in a line item that is included within operating expense or operating

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income. If the contingent consideration asset or liability is a derivative, the line item in which the change in fair value is reflected on the income statement depends on the facts and circumstances. This subsequent accounting guidance only applies if the adjustment to contingent consideration is not a measurement period adjustment.

Under prior guidance, contingent consideration was usually recognized upon resolution of the contingency and upon the consideration being issued or becoming issuable. The effects of recognizing contingent consideration (e.g., should it be reflected in the cost of the target) depended on the nature of the contingency.

Refer to Section 12.4 for additional discussion of the current guidance applicable to contingent consideration in a business combination.

Replacement share-based payment awards

In a business combination, the buyer may replace share-based payment awards held by employees of the target with its own share-based payment awards. Current guidance provides substantive incremental accounting guidance and examples on how to account for these replacement awards. While prior guidance indicated that the issuance of replacement awards in a business combination should have been treated as a modification, it did not provide any explicit accounting guidance for that type of modification.

Under current guidance, the measurement principle and related guidance in Topic 718 should be used when measuring replacement awards. Under prior guidance, Statement 123R was used when measuring replacement awards. Statement 123R served as the primary source for the guidance in Topic 718. As such, there was not a significant change to the approach used to measure the value of replacement awards. However, there is a difference in the date on which the value of the replacement awards is determined. Under current guidance, the value of the replacement awards is determined as of the acquisition date. Under prior guidance, the value of the replacement awards was determined as of a few days before and a few days after the announcement date.

Under both current guidance and prior guidance, the buyer has to go through the exercise of determining the portion of the replacement awards that should be treated as consideration vs. compensation. Consistent with the different overall accounting methods used (i.e., the acquisition method under current guidance and the purchase method under prior guidance), the portion of the replacement awards that should be treated as consideration under current guidance is included in the consideration transferred, whereas under prior guidance it was included in the purchase cost of the target. The current guidance and the prior guidance also differ on the allocation of the replacement awards' value between consideration and compensation when awards for which the requisite service period has not been completed (i.e., unvested awards) are replaced with awards for which there is no requisite service period (i.e., vested awards). Under current guidance:

- The amount attributable to precombination service and included in consideration transferred (i.e., the accounting for the business combination) is based on the value of the target's awards at the acquisition date and the ratio of the precombination service period to the longer of the total service period and the target's awards' service period.
- The amount attributable to postcombination service and treated as compensation cost for post-acquisition services (i.e., it is not included in the accounting for the business combination) is the difference between the value of the buyer's replacement awards at the acquisition date and the amount attributable to precombination service (which is included in consideration transferred [i.e., the accounting for the business combination]).

Application of this current guidance when there is no requisite service period for the replacement awards would result in the amount attributable to postcombination service being recognized as compensation cost immediately after the acquisition takes effect. Under prior guidance, the replacement awards' value would

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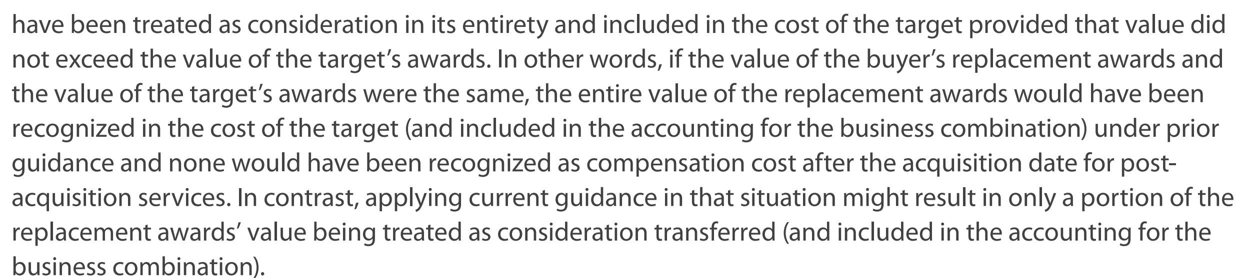

have been treated as consideration in its entirety and included in the cost of the target provided that value did not exceed the value of the target's awards. In other words, if the value of the buyer's replacement awards and the value of the target's awards were the same, the entire value of the replacement awards would have been recognized in the cost of the target (and included in the accounting for the business combination) under prior guidance and none would have been recognized as compensation cost after the acquisition date for post-acquisition services. In contrast, applying current guidance in that situation might result in only a portion of the replacement awards' value being treated as consideration transferred (and included in the accounting for the business combination).

Refer to Section 11.7 and Section 13.4 for additional discussion of the current guidance applicable to replacement share-based payment awards issued in connection with a business combination.

Noncontrolling interest

Under current guidance, any noncontrolling interest is initially measured at its acquisition-date fair value. Under prior guidance, any noncontrolling interest was typically calculated as the noncontrolling interest's share of the book value of the net assets acquired.

Refer to Section 10.20 for additional discussion of the current guidance applicable to the noncontrolling interest (if any) recognized in the accounting for a business combination.

Bargain purchases

In the rare case in which a gain from a bargain purchase results from the buyer's accounting for a business combination, current guidance requires the buyer to perform a thorough self-review of: (a) the accuracy and completeness of the identifiable assets acquired and liabilities assumed and (b) the appropriateness of the procedures used to measure the individual components within each element of the goodwill calculation and the results of applying those procedures. If a gain from a bargain purchase still exists after the buyer performs this thorough self-review, then the buyer would recognize a gain from a bargain purchase. Prior guidance did not specifically require the buyer to perform a thorough self-review prior to the recognition of a gain from a bargain purchase.

Refer to Section 12.2 for additional discussion of the current guidance applicable to recognizing a gain from a bargain purchase in the accounting for a business combination.

Step acquisitions

A step acquisition occurs when the buyer in a business combination acquires a controlling interest in a target in which it had a previously held equity interest. For example, the buyer may already own 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.

Under current guidance, when a step acquisition occurs, the buyer must recognize either: (a) a gain for the excess of the acquisition-date fair value of the buyer's previously held equity interest in the target over the carrying value of that interest or (b) a loss for the excess of the carrying value of the buyer's previously held equity interest in the target over the acquisition-date fair value of that interest. In addition, as discussed earlier in this appendix, regardless of whether the buyer previously held an equity interest in the target (which would have had its own cost basis), the assets acquired and liabilities assumed in a business combination are recorded at 100% of their fair value or other amount measured in accordance with Topic 805. Prior guidance on the accounting for step acquisitions used a mixed attribute model to measure the assets acquired and liabilities

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assumed in a step acquisition. Each "step" or tranche acquired by the buyer was accounted for using business combination accounting. In other words, each tranche was accounted for based on its cost and the fair value of the proportionate amount of assets acquired and liabilities assumed by the buyer in purchasing that tranche. Business combination accounting would not have been applied to the buyer's previous proportionate interest in the assets and liabilities of the target when the new tranche was purchased. Instead, the carrying value of the buyer's previous proportionate interest in the assets and liabilities would have continued to be part of the basis of those assets and liabilities. Use of business combination accounting on the new tranche and carry-over basis accounting for the pre-existing tranche(s) resulted in each asset acquired and liability assumed being measured using a mixture of: (a) current cost and fair value information for the most recent tranche purchased and (b) carrying values for the previously purchased tranches.

Refer to Section 12.6 for additional discussion of the current guidance applicable to step acquisitions.

Changes to accounting for measurement period adjustments

The buyer may not be able to complete its accounting for a business combination by the time it has to issue its financial statements that include the acquisition date. If this is the case, then the buyer would recognize provisional amounts in its financial statements. Under current guidance, the buyer would have up to one year to finalize those amounts. Under prior guidance, the duration of the allocation period was usually no longer than one year.

Under current guidance, measurement period adjustments affect the acquisition-date accounting for the business combination. The adjustments are reflected retroactively back to the acquisition date. When financial statements that include the acquisition date are reissued, they must be adjusted to reflect the effects of any measurement period adjustments recorded since the acquisition date. While measurement period adjustments are reflected retroactively, they are not considered restatements in the negative sense. While prior guidance was silent on whether allocation period adjustments should have been retroactively applied, the practice that developed was not to apply them retroactively.

Refer to Section 12.7 for additional discussion of the current guidance applicable to provisional amounts and measurement period adjustments recognized in the accounting for a business combination.

Changes to determining whether a transaction or event should be accounted for separate from the business combination

Current guidance provides a framework for determining whether there are any transactions or events (perhaps occurring in the same timeframe or at the same time as the business combination) that should be accounted for separate from the business combination. Examples of such transactions or other events include payments made to settle pre-existing relationships between the buyer and the target and payments made to the target's employees or former owners for future services. Current and prior guidance for these two examples are generally consistent with each other. However, prior guidance covered these two examples on a piecemeal basis. In other words, prior guidance did not provide an overall framework for determining whether there are any transactions or events that should be accounted for separate from the business combination.

Refer to Section 13.1 for additional discussion of the current guidance applicable to determining whether a transaction or event should be accounted for separate from the business combination.

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Transaction costs

Under current guidance, transaction costs are not treated as part of the consideration transferred in a business combination. These costs are expensed as incurred and when the related services have been received by the buyer unless other U.S. GAAP provide different guidance, as is the case for debt and equity issuance costs. Under prior guidance, direct acquisition-related costs were included in the cost of the target, which resulted in most of the direct acquisition-related costs effectively being included in goodwill. For this purpose, direct costs included incremental costs (i.e., costs that would not otherwise have been incurred if not for the business combination), such as finder's fees and professional or consulting fees for advisory, legal, accounting, valuation, and other services. Current guidance and prior guidance are consistent with respect to the treatment of internal costs associated with a business combination as they both required these costs to be expensed when incurred.

Refer to Section 13.5 for additional discussion of the current guidance applicable to accounting for acquisition costs incurred in connection with a business combination.

Changes to disclosures

Current guidance requires significantly more disclosures related to a business combination than were required under prior guidance. Many of the incremental disclosures required under current guidance are related to the differences between current and prior guidance. For example, given that contingent consideration is accounted for at fair value under current guidance, many more disclosures related to contingent consideration are required under current guidance.

Refer to Chapter 14 for additional discussion of the current disclosure requirements applicable to a business combination.

Transitioning from prior guidance to current guidance

The current guidance (i.e., the guidance in Topic 805) is typically applied on a prospective basis. In general, this means that the subsequent accounting for items involved in the accounting for a business combination whose acquisition date fell prior to the effective date of Topic 805 should follow the guidance in effect prior to the effective date of Topic 805. In other words, the subsequent accounting guidance in Topic 805 should generally not be applied to assets and liabilities recognized in the accounting for business combinations that occurred prior to its effective date. One exception relates to the accounting for changes to valuation allowances on deferred tax assets and changes to income tax positions acquired in a business combination that occurred prior to the effective date of Topic 805. After the effective date of Topic 805, changes to valuation allowances on deferred tax assets and changes to income tax positions acquired in a business combination that occurred prior to the effective date of Topic 805 should be accounted for using the guidance in effect after the effective date of Topic 805 (i.e., the current guidance). In the case of changes to valuation allowances on deferred tax assets recognized in the accounting for a business combination, this transition exception results in the effects of such changes being reflected in income tax expense (or in certain limited situations, as a direct adjustment to contributed capital as required by FASB ASC 740-10-45-20). If the transition exception had not been provided, then the prospective transition guidance would have resulted in a decrease in the valuation allowance affecting the accounting for the business combination from which the valuation allowance arose (which was the guidance in place prior to the effective date of Topic 805 [i.e., the prior guidance]).

Refer to Section 11.4.8 for additional discussion of the applicability of the current guidance to the accounting for business combinations that occurred prior to the effective date of Topic 805.

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Appendix E: Audit Implications of Business Combinations

Introduction

The measurement principle included in the business combination accounting guidance (i.e., Topic 805) is fair value. With only limited exceptions, the assets acquired, liabilities assumed, and consideration transferred in a business combination are measured at fair value along with any noncontrolling interest in the target that remains after the business combination. When the guidance in Topic 805 was originally introduced, it quickly became apparent that implementing its fair value measurement principle was going to present significant challenges for auditors. These challenges would stem from the considerable judgment management would be required to exercise in arriving at its fair value estimates and the considerable judgment the auditor would be required to exercise in auditing management's fair value estimates. In addition, given the complexities that would be involved in estimating the fair value of items such as contingent consideration, it also quickly became apparent that management's and the auditor's use of valuation specialists was going to increase. Insights gained as a result of the guidance in Topic 805 being in effect since 2009 confirmed the increased involvement of valuation specialists in the accounting for a business combination – both related to management's process for estimating fair values and the auditor's testing of management's fair value estimates. Another insight gained as a result of the application of this guidance in practice since 2009 is the importance of assessing, as ***early*** in the audit process as possible, whether a business has been acquired. The importance of this assessment stems from the effects it can have on the auditor's approach to testing the transaction.

Business combinations give rise to many audit implications. This appendix seeks to highlight those audit implications that are particularly noteworthy because of their pervasive nature or degree of complexity. Areas the auditor would need to consider in assessing management's compliance with the business combination accounting guidance include:

- Management's understanding of the business combination accounting guidance;
- Management's understanding of who the reporting entity is and the basis of accounting used by the reporting entity;
- Management's determination as to whether the buyer acquired a business or a group of assets (or net assets);
- Management's determination of the appropriate acquisition date;
- Management's processes for estimating fair value measurements and relevant controls;
- Resources used by management to measure fair values;
- Data and assumptions used in management's fair value measurements;
- Management's responsibility for classifications and required disclosures;
- Management's recognition and measurement of contingent consideration;
- Management's identification of the tax treatment of the business combination;
- Management's recognition and measurement of preacquisition contingencies;

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- Completeness of the separately identifiable intangible assets recognized by management;
- Management's application of measurement guidance to working capital accounts;
- Management's determination as to whether acquired operating leases are favorable or unfavorable;
- Management's identification of and accounting for transactions outside the scope of the business combination, such as compensation arrangements, acquisition costs and other transactions;
- Management's recognition and valuation of R&D assets;
- Management's recognition of provisional amounts; and
- Management's accounting for adjustments made during the measurement period.

Management's understanding of the business combination accounting guidance

Given the complexities involved in the accounting for a business combination, it is important to gain insight into how well management understands the business combination accounting guidance. To obtain this insight, the auditor should hold discussions with management early in the audit process to determine the degree to which management understands the accounting guidance. The more familiar that management is with the accounting guidance, the more likely it is that management will properly apply its provisions. By the same token, the less familiar that management is with the guidance, the more likely it is that management will not properly apply its provisions. The auditor's understanding of management's level of familiarity with the business combination accounting guidance should be taken into consideration when determining the specific audit procedures to be performed with respect to a business combination. The auditors can assist management with the understanding of the accounting guidance, but should not put themselves in a position where they end up auditing their own work by actually identifying all the assets and liabilities, estimating fair values and recording the transaction.

Management's understanding of who the reporting entity is and the basis of accounting used by the reporting entity

The auditor should have a clear understanding of the reporting entity that is subject to its audit so that an evaluation can be performed as to whether the appropriate basis of accounting (i.e., carryover basis or fair value) is being used to reflect the acquisition in the reporting entity's audited financial statements. If the buyer is the reporting entity, the auditor should determine whether the target's assets and liabilities have been reflected in the buyer's consolidated financial statements at the amounts measured in accordance with Topic 805 (which results in measuring the acquired assets and assumed liabilities predominantly at fair value). If the target is the reporting entity, the auditor should evaluate management's conclusion with respect to whether push-down accounting is prohibited, permitted or required. If the decision to ***not*** apply push-down accounting is appropriate, the auditor should determine whether the target's assets and liabilities continue to be reflected in the target's standalone financial statements at their carryover basis and that those assets and liabilities were not stepped up to their fair values. If the decision to apply push-down accounting is appropriate, the auditor should determine whether the buyer's basis in the target's assets and liabilities (which would be based predominantly on fair value) have been pushed down to the target's standalone financial statements. In other words, if push-down accounting is applied, the assets and liabilities in the target's standalone financial statements should be stepped up to the amounts recognized by the buyer in accordance with Topic 805. Appendix C provides discussion on when it is appropriate to apply push-down accounting and how to apply push-down accounting.

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Management's determination as to whether the buyer acquired a business or a group of assets (or net assets)

There are significant differences between the accounting for a business combination and the accounting for an acquisition of a group of assets (or net assets). For example: (a) goodwill or a gain from a bargain purchase arises in a business combination, while neither would arise in an acquisition of a group of assets (or net assets); (b) acquisition costs are generally expensed when incurred and when the related services have been received by the buyer in a business combination, while such costs are considered part of the cost of the assets (or net assets) in an acquisition of a group of assets (or net assets); and (c) assets acquired and liabilities assumed in a business combination are measured predominantly at fair value, while assets acquired and liabilities assumed in an acquisition of a group of assets (or net assets) are measured by allocating the total cost of the net assets based on the fair values of the individual assets acquired and liabilities assumed. These examples illustrate that making the appropriate determination up-front as to whether a business or a group of assets (or net assets) was acquired is critical to the accounting that follows. As such, the auditor should gain a complete understanding of what was transferred to the buyer in the transaction (or other event) and evaluate management's conclusion regarding whether that transferred set constitutes a business. Performing these steps early in the audit process will allow the auditor to efficiently and effectively: (a) identify any risks of material misstatement that might exist within management's assessment and (b) properly respond to any of those identified risks. Section 4.1 provides discussion and examples of what constitutes a business and Section 15.1 provides discussion on accounting for an acquisition of a group of assets (or net assets).

Management's determination of the appropriate acquisition date

The acquisition date is the date on which the buyer obtains control of the target, which is usually the closing date. The auditor should review the acquisition agreement and other related agreements to obtain supporting evidence of when the buyer obtained control of the target and determine whether that was the acquisition date used for accounting purposes. Identifying the appropriate acquisition date is critical to the accounting for the business combination as it is the date on which all of the relevant amounts are measured (e.g., assets acquired, liabilities assumed, any noncontrolling interest, and consideration transferred) and the date on which the buyer begins consolidating the target for accounting purposes. Section 6.1 provides additional discussion on determining the acquisition date for a business combination.

Management's processes for estimating fair value measurements and relevant controls

The underlying measurement principle in the business combination accounting guidance is fair value. As such, with some exceptions, the assets acquired, liabilities assumed, and consideration transferred are measured predominantly at fair value along with any noncontrolling interest in the target that remains after the business combination. The business combination accounting guidance relies on the guidance in Topic 820 for purposes of defining and measuring fair value. Given the interrelated nature of the business combination accounting guidance and fair value measurement guidance, it is important for the auditor to gain insight into how management develops its fair value estimates as well as the relevant controls it has over the fair value estimation process. With respect to controls over the fair value estimation process, examples of questions the auditor may consider include:

- What types of controls does management have over data used in the fair value measurement process?
- Does management have appropriate segregation of duties for those involved in measuring and recording fair values?

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- What role does the buyer's information technology play in the process?
- How does management develop and document its assumptions?

The auditor's understanding of management's processes and controls over fair value measurements has a direct effect on the auditor's determination of the specific audit procedures to be performed with respect to evaluating management's fair value measurements. The auditor's documentation of their assessment of the appropriateness of management's estimates and assumptions is critical in performing an audit in accordance with GAAS.

Resources used by management to measure fair values

Given that the business combination accounting guidance relies on the use of fair value measurements, the auditor should consider the qualifications, experience, and expertise of the valuation resources used by management. For example, the auditor may contact professional societies regarding the standing of external valuation resources and check the references provided by those resources. Understanding the qualifications of the valuation resources is necessary regardless of whether such resources are internal or external to the buyer. In addition, the auditor should consider the relationship of the valuation resources to the buyer to assess the resources' objectivity. When valuation resources are the buyer's employees, the auditor may need to perform different, and likely more extensive, auditing procedures than when management uses an external resource.

Data and assumptions used in management's fair value measurements

Two critical aspects of an auditor's evaluation of management's fair value measurements are: (a) testing data used in the measurement and (b) evaluating the soundness of any assumptions made for purposes of measuring fair value. With respect to data used in management's fair value measurements, the auditor should consider the accuracy, completeness, and relevance of the data and whether the fair value measurement has been properly estimated using that data. These tests might include verifying the source of the data and mathematical recomputations. With respect to testing significant assumptions used in measuring fair value, the auditor should consider (and document):

- Whether those assumptions are supportable and reasonable;
- Whether those assumptions reflect market conditions;
- How the assumptions compare to actual historical results;
- Whether the assumptions used to measure one asset or liability are internally consistent with assumptions used to measure a related or similar asset or liability; and
- Whether assumptions used to measure assets and liabilities acquired and assumed in a business combination occurring within the current period should be and, if so, are consistent with assumptions used to measure similar assets and liabilities acquired and assumed in: (a) another business combination occurring within the current period and (or) (b) a business combination that occurred in a prior period.

Management's responsibility for classifications and required disclosures

It is management's responsibility to ensure that: (a) the amounts recognized in the accounting for the business combination are properly and consistently classified in the financial statements in accordance with U.S. GAAP and (b) the disclosures within the financial statements are complete and accurate in accordance with U.S. GAAP. To form an opinion with respect to the financial statements taken as a whole, the auditor should

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perform appropriate procedures to determine that management has properly discharged these responsibilities. Professional judgment should be exercised when selecting the procedures necessary to determine whether the financial statements and accompanying notes contain any material misclassifications or omit material disclosures required by U.S. GAAP. Section 14.1 provides discussion of the required disclosures for a business combination.

Management's recognition and measurement of contingent consideration

Ensuring that all forms of contingent consideration have been identified by management requires a detailed review of the acquisition agreement and any other agreements between the buyer and the target and (or) the sellers. Measuring the fair value and determining the proper classification of contingent consideration presents additional challenges and requires the auditor to exercise considerable judgment.

Because contingent consideration classified as an asset/liability is remeasured to its fair value at the end of each reporting period, dealing with the complexities that arise in auditing the fair value of contingent consideration will likely not be a one-time exercise for the auditor. Section 12.4 provides discussion on and examples of accounting for contingent consideration.

Management's identification of the tax treatment of the business combination

It is important to determine early in the acquisition process the tax treatment of a business combination. Business combinations may result from either the buyer acquiring the equity interests in a corporation or the buyer acquiring a group of assets and liabilities. When the business combination results from the buyer acquiring the equity interests in a corporation, it is referred to as a stock acquisition or nontaxable transaction for tax purposes. When the business combination results from the buyer acquiring a group of assets and liabilities, it is referred to as an asset acquisition or taxable transaction for tax purposes. In addition, to the extent a business combination results from a stock acquisition (or nontaxable transaction), the buyer and sellers may elect to treat the transaction as a taxable transaction under Section 338 of the U.S. Income Tax Code, which is often referred to as a "338 Election." Whether a business combination results from a taxable or nontaxable transaction affects the deferred tax assets and liabilities recognized in the accounting for a business combination.

If a business combination results from a stock acquisition (a nontaxable transaction) and the buyer and seller do not exercise the 338 Election, there will generally be significant deferred tax calculations involved in the accounting for the business combination. This is because the buyer's book basis changes due to accounting for the business combination in accordance with Topic 805, while the buyer's tax basis does not change. In these situations, the auditor should test and document the carryover tax basis in the target's assets and liabilities, and the tax elections, carryover deductions and credits of the target.

If a business combination results from an asset acquisition (a taxable transaction) or a stock acquisition in which the buyer and seller exercise the 338 Election, the buyer will generally have the same basis in the target's assets and liabilities for tax purposes as it has for book purposes, with some complex exceptions related to items such as contingencies and contingent consideration. As a result, there will be limited deferred tax calculations involved in the accounting for the business combination. The same situation would arise if the target were a partnership or a limited liability company. In these situations, the auditor should test and document the tax basis in the target's assets and liabilities.

The auditor should perform audit procedures with the assistance of qualified tax professionals to assess the appropriateness of the tax treatment of the business combination and the deferred taxes recorded by management in connection with the accounting for the business combination. Section 11.4 provides extensive discussion of the buyer's accounting for the income tax effects of a business combination.

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Management's recognition and measurement of preacquisition contingencies

A significant amount of judgment and expertise is required of management in accounting for contingencies acquired in a business combination. The auditor should obtain information from the buyer's and (or) target's legal counsel related to the existence of contingencies, their nature, and the likelihood of different outcomes. Obtaining this information from legal counsel is critical to the auditor's assessment of the completeness and valuation of the contingent assets and liabilities recognized by management. Obtaining information from legal counsel is also necessary for purposes of assessing the information disclosed by the buyer for recognized and unrecognized contingencies, which should also be subject to audit procedures. Section 11.2 provides discussion on and examples of accounting for preacquisition contingencies.

Completeness of the separately identifiable intangible assets recognized by management

The business combination accounting guidance places emphasis on recognizing identifiable intangible assets separately from goodwill. In determining whether management has identified and recognized all of the intangible assets acquired, the auditor should consider: (a) comparing the list of intangible assets recognized by management to the intangible assets listed and discussed in FASB ASC 805-20-55-11 through 45; (b) reviewing the acquisition agreement for specific contractual or legal rights transferred to the buyer; and (c) reviewing the information obtained during due diligence.

One specific category of separately identifiable intangible assets that the auditor should pay particular attention to are customer-related intangible assets. For this category of assets, the auditor should consider whether management has recognized separate intangible assets (as appropriate) in the accounting for the business combination for customer contracts, backlog, customer relationships, and customer lists.

A common risk of material misstatement in auditing a business combination is the overstatement of goodwill. The overstatement of goodwill results from the understatement of assets acquired or overstatement of liabilities assumed. The risk that goodwill is overstated and separately identifiable intangible assets are understated also leads to the risk that future earnings are overstated because goodwill is not amortized while most separately identifiable intangible assets are amortized. The auditor should identify these risks when planning to audit a business combination. Assessing the completeness of separately identifiable intangible assets will help the auditor address these risks.

Management's application of measurement guidance to working capital accounts

Generally, assets and liabilities acquired in a business combination should be measured at fair value, which includes working capital accounts such as accounts receivable, accounts payable and accrued liabilities. The auditor should exercise care in circumstances where management asserts that the target's book value for such accounts approximates fair value and apply appropriate audit procedures to obtain the necessary evidence to conclude whether management's estimate is reasonable.

When evaluating the fair value estimate related to accounts receivable, the auditor should apply the appropriate procedures to obtain sufficient evidence to determine whether collection risk, payment timing and market participant profit have been appropriately reflected in management's fair value estimate.

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When evaluating the fair value estimate related to accounts payable or accrued liabilities, the auditor should exercise due care and professional skepticism given the lack of market data that is typically available regarding transfer prices for such liabilities. The buyer must estimate the price that would be paid to transfer the liability to a market participant. The auditor should apply the appropriate procedures and obtain sufficient evidence to determine whether items such as nonperformance risk, payment timing and the profit required by the market participant to assume the liability were adequately considered by management in arriving at the fair value estimate. It would not be 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.

Other accounts that might be considered working capital accounts include straight-line rent liabilities and deferred revenue. Straight-line rent liabilities do not meet the definition of a liability in CON 6. In other words, they arise out of an accounting convention and do not represent an actual obligation. When reviewing the accounts and amounts recognized by management in the accounting for the business combination, the auditor should ensure that a straight-line rent liability of the target was not carried over into the accounting for the business combination.

With respect to deferred revenue, the auditor should ensure that deferred revenue is recognized by management in the accounting for the business combination only to the extent the target has legal performance obligations to its customers. The auditor should be alert for situations in which the target had deferred revenue but not corresponding legal performance obligations. In that situation, deferred revenue should not be recognized in the accounting for the business combination. Also, the auditor should determine whether the amount of deferred revenue recognized in the accounting for the business combination is based on the fair value of the legal performance obligations. The auditor should be skeptical of a situation in which management asserts that the book basis of the deferred revenue approximates the fair value of the legal performance obligations. In most cases, the fair value of the legal performance obligations that should be recognized in the accounting for the business combination is much less than the target's book basis of deferred revenue.

Section 10.14 provides additional discussion on the measurement of accounts receivable, accounts payable and other working capital accounts acquired in a business combination. Section 10.15 provides additional discussion on recognizing and measuring deferred revenue in the accounting for a business combination. Section 10.16 provides additional discussion on straight-line rent liabilities and why they should not be recognized in the accounting for the business combination.

Management's determination as to whether acquired operating leases are favorable or unfavorable

The auditor should review management's assessment of whether each operating lease is favorable or unfavorable relative to market terms and determine whether the resulting intangible asset or liability was properly recorded. Consideration should be given to the quality of market data obtained by management and the procedures necessary to corroborate that data. Section 10.11 provides discussion on accounting for operating leases acquired in a business combination.

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Management's identification of and accounting for transactions outside the scope of the business combination, such as compensation arrangements, acquisition costs and other transactions

There may be other transactions and agreements (new or pre-existing) between the buyer and the sellers and (or) employees of the target that were entered into or modified in conjunction with the business combination. The auditor should perform appropriate procedures to determine whether management has identified all such transactions and agreements with employees and (or) sellers of the target.

Management should evaluate all of the transactions and agreements between the buyer and the sellers and (or) employees of the target to determine whether such transactions and agreements should be included or excluded from the accounting for the business combination. Understanding who benefits from the transaction or agreement (e.g., the buyer and the combined entity or the seller) is critical to evaluating whether the transaction or agreement gives rise to assets and liabilities that should be included in the accounting for the business combination or whether the transaction or agreement gives rise to amounts that should be recognized separate from the accounting for the business combination (e.g., in the income statement of the buyer after the business combination). The auditor should understand these transactions and agreements and their economic purpose and document the appropriateness of management's accounting for the transaction or agreement within or separate from the business combination. Section 13.1 provides discussion on determining whether a transaction or agreement entered into (or modified) in conjunction with a business combination should be accounted for within or separate from the business combination.

Management's recognition and valuation of R&D assets

R&D assets acquired in a business combination are required to be measured at their acquisition-date fair value. Estimating the fair value of R&D assets represents a challenge that requires considerable judgment. The auditor should document their understanding of the nature of the target's R&D activities and consider documenting the nature of R&D expenditures incurred by the target prior to the acquisition, which would give the auditor a starting point for the types of R&D assets acquired by the buyer. Section 10.7 provides additional discussion on recognizing assets for R&D acquired in a business combination.

Management's recognition of provisional amounts

If the buyer in a business combination has not completed its accounting for the business combination at the time it issues financial statements that include the target, then it would use its best estimates in the initial accounting for the business combination included in these financial statements. These "provisional amounts" would subsequently be adjusted following the guidelines in the business combination accounting guidance (see Section 12.7). When provisional amounts are included in the financial statements, the buyer must disclose 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. When the initial accounting for a business combination is incomplete and the financial statements under audit include provisional amounts, the auditor should understand and adequately document: (a) how these provisional amounts and related disclosures were determined by management and (b) whether the provisional amounts and related disclosures were based on the best information available to management at the reporting date. It is not appropriate to conclude that the auditor does not have the responsibility to audit the provisional amounts with the same rigor as they will audit the final amounts. In other words, 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 can be exercised in auditing that amount.

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Management's accounting for adjustments made during the measurement period

Depending on the facts and circumstances, adjustments made during the measurement period are either treated as measurement period adjustments or as subsequent accounting adjustments. The accounting implications of this determination are significant as measurement period adjustments are reflected as part of the accounting for the business combination (and affect goodwill or a gain from a bargain purchase) whereas subsequent accounting adjustments are not reflected as part of the accounting for the business combination (and will likely affect income). The auditor should evaluate each adjustment made during the measurement period to determine whether management's treatment of that adjustment was appropriate. When evaluating whether an adjustment should have been treated as a measurement period adjustment, the auditor should consider the following questions: (a) was the accounting for the item that was the subject of the adjustment identified as "provisional" in the initial accounting and disclosure of the business combination and (b) does the information that is giving rise to the adjustment relate to the facts and circumstances that existed on the acquisition date? Section 12.7 provides additional discussion on, and examples of, measurement period adjustments.

Conclusion

These are but a sample of the audit implications that a business combination could have on the audit of financial statements. Clearly, some of the most significant implications result from measuring assets acquired and liabilities assumed (as well as other aspects of the accounting for a business combination) predominantly at fair value. However, identifying whether a business was acquired as well as accounting for specific types of assets and liabilities involved in a business combination give rise to their own unique audit implications. To ensure that any potential risks of material misstatement due to the business combination are properly identified and addressed, it is critical that the auditor understand these transactions as early as possible in the audit to plan the necessary audit procedures and to allow ample time for resolution of issues that may arise.

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