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Global edition

Business combinations and noncontrolling interests

Application of the U.S. GAAP and IFRS Standards

2014

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Acknowledgments

The *Business Combinations and Noncontrolling Interests, global edition* guide represents the efforts and ideas of many individuals within PwC. The following PwC people contributed to the contents or served as technical reviewers of the 2014 edition:

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Special thanks

Special thanks to all the other resources within PwC who contributed to the overall quality of this guide, including the final editing and production of the document.

Preface

PwC is pleased to offer this global accounting and financial reporting guide for *Business combinations and noncontrolling interests*. This guide explains the fundamental principles of accounting for business combinations and noncontrolling interests under both U.S. generally accepted accounting principles and International Financial Reporting Standards. This guide also includes our perspectives on the application of those principles, as well as our insights on the challenges of accounting for intangible assets and goodwill in the postcombination period. Each chapter discusses the relevant accounting literature and includes specific questions and examples to illustrate application.

Locating guidance on particular topics

Guidance on particular topics can be located as follows:

- Table of contents—The table of contents provides a detailed listing of the various sections in each chapter. The titles of each section are intentionally descriptive to enable users to easily find a particular topic.
- Table of questions—The table of questions includes a listing of questions and PwC responses in numerical order, by chapter.
- Table of examples—The table of examples includes a listing of examples in numerical order, by chapter.

The guide also includes a detailed index of key topics.

References to U.S. GAAP and International Financial Reporting Standards

Definitions, full paragraphs, and excerpts from the Financial Accounting Standards Board's Accounting Standards Codification and standards issued by the International Accounting Standards Board are clearly designated, either within quotes in the regular text or enclosed within a shaded box. The remaining text is PwC's original content.

References to specific paragraphs within the codification in U.S. GAAP and a standard in IFRS appear in brackets. References in brackets detail the codification section or particular standard and paragraph within that standard that is being referenced. For example, a reference to paragraph 2 of IFRS 3 is displayed as [IFRS 3.2].

Wording differences between U.S. GAAP and IFRS standards

When information in the text of each chapter appears in [ ], the bracketed text identifies wording in IFRS that is different from the wording in the U.S. GAAP codification.

General references to specific standards

Throughout this guide, the phrase "the Standards" is used to refer to ASC 805 and IFRS 3. The phrase "the NCI Standards" is used to refer to ASC 810-10 and IFRS 10. The phrase "the Fair Value Standards" is used to refer to ASC 820 and IFRS 13.

References to other chapters and sections in this guide

Where relevant, the discussion includes general and specific references to other chapters of the guide that provide additional information. References to another chapter or particular section within a chapter are indicated by the abbreviation "BCG" followed by the specific section number (e.g., BCG 2.2.2 refers to section 2.2.2 in chapter 2 of this guide).

References to other PwC guidance

This guide focuses on the specific accounting and financial reporting for business combinations and noncontrolling interests. It supplements information provided by the authoritative accounting literature and other PwC guidance. This guide provides general and specific references to chapters in other PwC guides to assist users in finding other relevant information. References to other guides are indicated by the applicable guide abbreviation followed by the specific section number. The other PwC guides referred to in this guide, including their abbreviations are:

- *Derivative instruments and hedging activities (DH)*
- *Fair value measurements, global edition (FV)*
- *Financial statement presentation (FSP)*
- *Financing transactions: debt, equity and the instruments in between (FG)*
- *Income taxes (TX)*
- *Variable interest entities (VE)*

In addition, PwC's *Accounting and reporting manual* (the ARM) provides information about various accounting matters in U.S. GAAP. All references to the other guides and ARM are to the latest editions noted in the PwC Guide Library.

Copies of the other PwC guides may be obtained through CFOdirect, PwC's comprehensive online resource for financial executives (www.cfodirect.com), a subscription to Comperio, PwC's online accounting and financial reporting reference tools, or by contacting a PwC representative.

Guidance date

As the accounting guidance changes or is clarified, so will the content in this guide. This guide considers existing guidance as of April 30, 2014. Future editions will be released to keep pace with significant developments. In addition, this guide supersedes all previously issued PwC guidance, including the 2013 edition of PwC's *A Global Guide to Accounting for Business Combinations and Noncontrolling Interests*.

Certain events such as the issuance of a new pronouncement by the FASB, a consensus (and ensuing endorsement by the FASB) of the Emerging Issues Task Force, a new standard by the IASB, a new interpretation by the IFRS IC, or new SEC rules or guidance, may necessitate an update or supplement to the guide. Updates, or supplements that may be in the form of other PwC communications, can be found on CFOdirect (www.cfodirect.com) or PwC's online accounting and financial reporting reference tools.

Other information

The appendices to this guide include guidance on professional literature, a listing of technical references and abbreviations, definitions of key terms, and a summary of significant changes from the previous edition.

* * * * *

This guide has been prepared to support you as you consider the accounting for transactions and address the accounting, financial reporting, and related regulatory matters relevant to business combinations and noncontrolling interests. It should be used in combination with a thorough analysis of the relevant facts and circumstances, review of the authoritative accounting literature, and appropriate professional and technical advice. We hope you find the information and insights in this guide useful. We will continue to share with you additional perspectives and interpretations as they develop.

Paul Kepple
U.S. Chief Accountant

2014

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Chapter 1: Scope

1.1 Chapter overview

This chapter discusses the key characteristics of a **business** and identifies which transactions require the application of **business combination** accounting. Business combination accounting is referred to as the "**acquisition method**" in ASC 805, *Business Combinations* (ASC 805), and in International Financial Reporting Standard 3 (revised 2008), *Business Combinations* (IFRS 3) (collectively, the "Standards"). Determining whether the acquisition method applies to a transaction begins with understanding whether the transaction involves the acquisition of one or more businesses and whether it is a business combination within the scope of the Standards.

Some differences exist between the definitions of a business combination under U.S. generally accepted accounting principles (U.S. GAAP) and International Financial Reporting Standards (IFRS). The converged definitions use terms that U.S. GAAP and IFRS define differently in other nonconverged standards. For example, the Standards state that for a business combination to occur, an **acquirer** must obtain **control** over a business. U.S. GAAP and IFRS define control differently. That difference may lead to divergent accounting results. For example, recently issued IFRS 10, *Consolidated Financial Statements* (IFRS 10), incorporates the concepts of effective control and substantive potential voting rights, whereas U.S. GAAP does not.

Active FASB and IASB (collectively, the "Boards") projects may result in amendments to existing guidance. These projects include the FASB's response to the Financial Accounting Foundation's (FAF) post implementation review of ASC 805 as well as the IASB and IFRS Interpretations Committee's (IFRS IC) post implementation review of IFRS 3. Amendments from these projects, if any, may impact the guidance in this chapter. The FASB has also undertaken projects related to principal versus agent assessments in consolidations and the definition of a business. Final standards for these projects have not yet been released as of 31 December 2013.

Following is a summary of the FASB projects:

- Consolidation: The proposal would provide guidance for determining whether a decision maker is acting as a principal or an agent for another entity. A decision maker acting as a principal consolidates the other entity, while a decision maker acting as an agent generally does not. The proposal is largely consistent with the principal versus agent guidance in the IASB's recently issued consolidation standard, IFRS 10. The proposed changes to the consolidation model also would rescind the deferral of the current consolidation guidance, ASC 810, *Consolidations* (ASC 810), for certain investment entities. A final accounting standard update for this project is expected to be issued in 2014.

- Clarifying the Definition of a Business: In May 2013 the FASB added a project intended to clarify the definition of a business. The project will include clarifying the guidance for partial sales or transfers and the corresponding acquisition of partial interests in a nonfinancial asset or assets.

The key takeaways from this chapter are:

- **Differentiating between a business and a group of assets can be challenging.** The different accounting for asset acquisitions and business combinations can have a substantial impact on the financial statements. A business consists of inputs and processes applied to those inputs that have the ability to create outputs. Many transactions will be obvious business combinations or obvious asset transactions. However, the assessment becomes difficult when an acquired group excludes some inputs or processes.

- **The scope of the Standards covers all situations where control of a business is obtained.** Business combination accounting applies to more than the purchase of a business for consideration. A business combination occurs when control is obtained through the execution of a contract, by an action by the acquiree, without the exchange of consideration, or through transactions that combine multiple companies to form a single company. The Standards' scope excludes joint venture formations because by definition no party obtains control.

- **There are differences between U.S. GAAP and IFRS.** The Standards are largely converged, but use terms that are defined differently in other nonconverged standards. Different control models, for example, exist under U.S. GAAP and IFRS, and the definition of control is important in identifing a business combination. These differences may lead to different conclusions about whether a business combination has occurred.

1.2 Definition of a business

All transactions in which an entity obtains control of one or more businesses qualify as business combinations. The Standards establish the following principle for identifying a business combination:

Excerpts from ASC 805-10-25-1 and IFRS 3.3

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

It is straightforward in most cases to determine whether a group of acquired assets and assumed liabilities (i.e., an integrated set of activities and assets) is a business. However, this determination can be complicated in some instances, including when the **fair value** of the **acquired group** is concentrated in just one or a few assets, or when the acquired group produces little or no revenue.

An acquired group must have inputs and processes that make it capable of generating a return or economic benefit for the acquirer's investors to be considered a business [ASC 805-10-55-4; IFRS 3.B7]. Economic benefits can occur in many forms, such as dividends, capital appreciation, or cost reductions.

The Standards define a business, inputs, processes, and outputs as follows:

Excerpts from ASC 805-10-20, ASC 805-10-55-4 and IFRS 3.A, IFRS 3.B7

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

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

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

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

c. Output: The result of inputs and processes applied to those inputs that provide 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.

Inputs and processes that are not used to create outputs are generally not considered significant to the determination of whether the acquired group is a business. For example, whether the acquired group includes or excludes certain administrative or support processes, such as accounting, payroll, and other administrative systems, generally will not impact the determination of whether a business exists [ASC 805-10-55-4; IFRS 3.B7].

Not all of the inputs and associated processes used by the seller need to be transferred to be considered a business. A business exists if a **market-participant** (see BCG 1.2.4) is capable of continuing to manage the acquired group to provide a return (e.g., the buyer would be able to integrate the acquired group with its own inputs and processes) [ASC 805-10-55-5; IFRS 3.B8]. Inputs and associated processes used by the seller that were not transferred, but that can be easily obtained, indicate the acquired group is a business. See BCG 1.2.4 for further information.

The nature of the elements (i.e., inputs, processes, and outputs) of a business varies based on industry, structure (i.e., locations of operations), and stage of development. The analysis of whether the necessary elements in an acquired group constitute a business is fact specific. A new or developing business may not have or need as many inputs, processes, or outputs as a larger established business. Additionally, the absence of an element generally found in a business does not mean that the acquired group does not constitute a business. For example, nearly all businesses have liabilities, but an acquired group need not have any liabilities to be considered a business [ASC 805-10-55-6; IFRS 3.B9]. An acquired group or acquired input that contains no processes is not a business.

ASC 805-10-55-5 and IFRS 3.B8

To be capable of being conducted and managed for the purposes defined, an integrated set of activities and assets requires two essential elements—inputs and processes applied to those inputs, which together are or will be used to create outputs. However, a business need not include all of the inputs or processes that the seller used in operating that business if market participants are capable of acquiring the business and continuing to produce outputs, for example, by integrating the business with their own inputs and processes.

The acquirer's intended use of an acquired group of activities and assets is not a factor in the determination of whether an acquired group constitutes a business; nor is it relevant whether the seller operated the acquired group as a business [ASC 805-10-55-8; IFRS 3.B11]. For example, the fact that the acquirer intends to split the acquired group into components, sell some of the components, and integrate the remaining ones, does not impact the determination of whether the acquired group as a whole is a business.

1.2.1 Development stage enterprises

Development stage enterprises that have no revenues may still be considered businesses. To determine if a development stage enterprise is a business, consider key factors, including whether:

- Planned principal operations have begun
- Employees, intellectual property, and other inputs and processes are present
- A plan to produce outputs is being pursued
- Access to customers that will purchase the outputs can be obtained [ASC 805-10-55-7; IFRS 3.B10]

Not all of these conditions need to exist for a development stage enterprise to qualify as a business. For example, under previous U.S. GAAP, a development stage enterprise typically was not considered a business until it had commenced its planned principal operations. Although a factor to consider, that would not be a prerequisite under the Standards. Generally, a development stage enterprise that has employees capable of developing a product will be considered a business.

1.2.2 *The presence of goodwill*

It is presumed that a business exists when **goodwill** is present in the acquired group. Evidence to the contrary would be needed to overcome this presumption [ASC 805-10-55-9; IFRS 3.B12]. Therefore, the presence of goodwill in the acquired group implies that the acquired group is a business, and any inputs or processes that may be missing are unlikely to prevent the acquired group from providing a return to its investors. An acquirer should consider whether all of the tangible and **intangible assets** in the acquired group have been specifically identified, recognised, and correctly valued before determining whether goodwill is present.

The lack of goodwill in an acquired group does not create a presumption that the acquired group is not a business. An acquired group may constitute a business without any goodwill being present (e.g., a bargain purchase as discussed in BCG 2.6.2).

1.2.3 *Distinguishing a business from an asset or group of assets*

Uncertainty may exist as to whether a transaction is the acquisition of a business or a group of assets. The Standards provide a framework for making this determination. Under this framework, an entity:

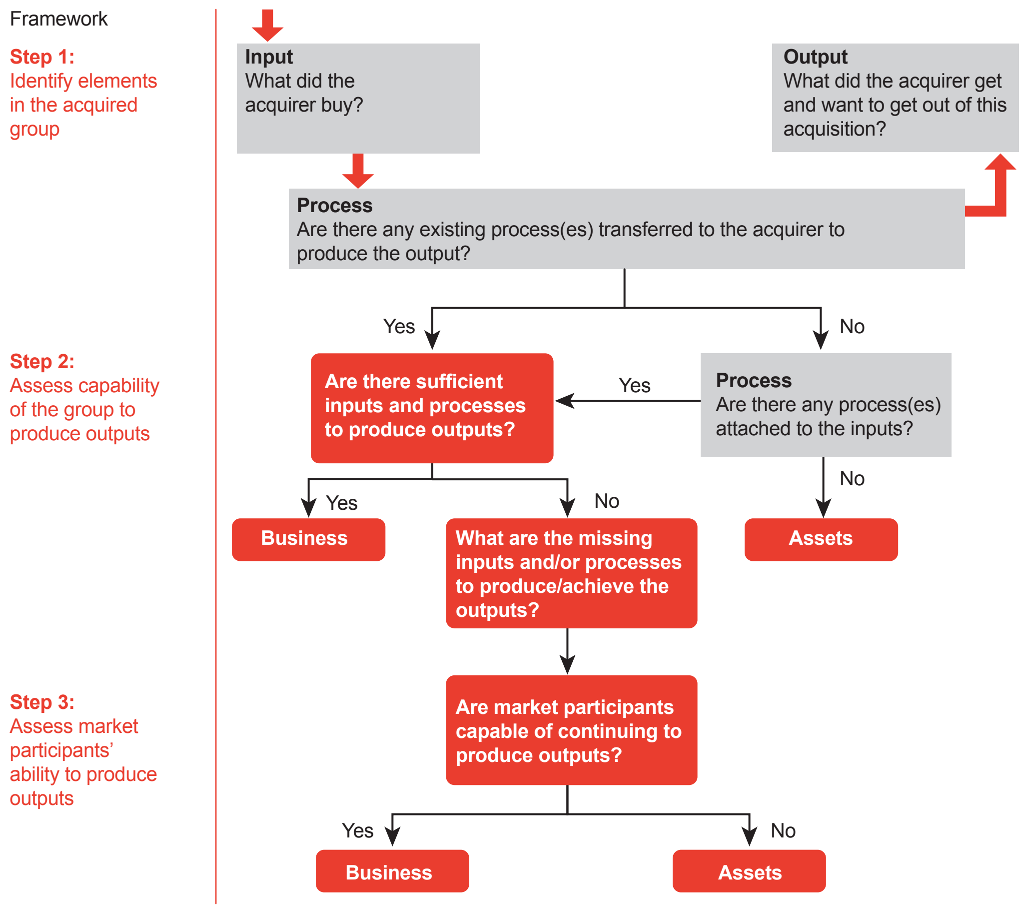
- Identifies the elements in the acquired group
- Assesses the capability of the acquired group to produce outputs
- Assesses the impact that any missing elements have on a market participant's ability to produce outputs with the acquired group

An entity should first identify the elements in the acquired group. If an asset or group of assets (physical or intangible) is not accompanied by any associated processes, the acquired group is likely a group of assets, not a business. Identifying the accompanying inputs and associated processes might be difficult. For example, a company that purchases a hotel might consider the purchase to be a single asset. However, in most cases, the company also acquires other inputs (e.g., employees, computer equipment, furniture and fixtures, and other assets) and associated processes (e.g., a reservation system, operating systems, procedures, and policies). Also, the acquired hotel may be a longstanding operation that has a recognised name and regular customers. These factors taken together indicate that the hotel is a business.

Next, the entity should analyse the acquired group's capability to produce outputs—that is, to generate a return to its investors, which may include dividends, capital appreciation, and cost reductions. If it is determined that the acquired group is not capable of producing outputs, the entity would need to identify the missing elements that will make the acquired group capable of doing so. After identifying the missing elements, the entity should determine whether those elements can be provided by market participants. A market participant may be able to replace the missing elements by integrating the acquired group into its own operations [ASC 805-10-55-5; IFRS 3.B8]. Missing elements that can be easily replicated or obtained should be considered replaceable by market participants. If market participants are not expected to be able to replace the missing elements and, thus, manage the acquired group in a way that would provide a return to its investors, the acquired group would not be considered a business [ASC 805-10-55-5; IFRS 3.B8]. The ability of market participants to continue to manage the acquired group to provide a return without the missing inputs and processes is a matter of judgment and is based on the individual facts and circumstances.

Figure 1-1 provides a framework to help determine whether a transaction is the acquisition of a business or a group of assets.

Figure 1-1
Distinguishing a business from an asset or group of assets



1.2.4 *Identifying market participants when determining whether an acquired group is a business*

Missing elements in the acquired group should be evaluated from a market participant's perspective. A market participant must be able to operate the acquired group to provide an economic return for a business to exist. Both U.S. GAAP and IFRS define market participants as buyers and sellers in the principal (or most advantageous) market for an asset or a liability that are independent, knowledgeable, able, and willing parties [ASC 820-10-20; IFRS 13.A]. Chapter 7 further discusses the determination of market participants for this purpose and for the purpose of valuing certain assets acquired and liabilities assumed in a business combination (see BCG 7.1.5).

1.2.5 Distinguishing a business from an asset or group of assets

Examples 1-1 through 1-9 may be helpful in determining whether a transaction involves the acquisition of a business or an asset (or a group of assets).

EXAMPLE 1-1

Distinguishing a business from an asset or group of assets: acquired assets and operations without outputs

Video Game Software Company has been formed to design video games. The current activities of the company include researching and developing its first product and creating a market for the product. Since its inception, the company has not generated any revenues and has received funding from third parties. With a workforce composed primarily of engineers, the company has the intellectual property needed to design the video game, as well as the software and fixed assets required to develop it. The company does not have commitments from customers to buy any games. The company is being purchased by a financial investor, a venture capital fund, which intends to take the company public.

Analysis

It is likely that the company would be considered a business. The elements in the acquisition contain both inputs and processes. The inputs include the intellectual property used to design the software, fixed assets, and employees. The processes include strategic and operational processes for developing the software. It is likely that the acquired group (i.e., the company) includes all of the inputs and processes necessary to manage and produce outputs. The lack of outputs, such as a product, does not prevent the company from being considered a business.

EXAMPLE 1-2

Acquired assets and operations missing an element

Company A purchases the organic food operations of Company B, a large multinational conglomerate, with the intent of continuing the organic food operations as a separate division. Company B is organised so that the organic food operations are separate legal entities in some countries and separate divisions in other countries. Management, employees, product distribution agreements, brand names, copyrights, and key systems (e.g., ordering, billing, and inventory) are included in the acquired organic food operations. However, the sales force that sells Company B's products is not part of the transaction.

Analysis

It is likely that the organic food operations would be considered a business. The elements in the acquisition include both inputs (namely, product distribution agreements, brand names, management, and some employees) and processes (e.g., key operating systems, procedures, and protocols). Since the sales force was not acquired, the acquired group did not include all of the inputs and associated processes necessary to manage and produce outputs. The lack of a sales force (one capable of initiating sales and creating revenues) impacts the acquired group's ability to produce economic benefits.

Company A may determine that the likely market participants would be strategic buyers that have an existing sales force. Therefore, the missing sales force would not prevent the acquired group from being a business. Company A's intent to continue the organic food operations as a business does not affect the evaluation of whether the acquired group is a business. The acquired group would still be considered a business, even if Company A entered into the transaction with the intent to eliminate a competitor and cease the operations of the acquired group.

Even if the market participant does not have an existing sales force, the acquired group might still be considered a business if the missing input (i.e., sales force) can be easily replicated or obtained. This will require judgment and will be based on the facts and circumstances in each situation.

EXAMPLE 1-3

Acquired assets and operations using an outsourcing arrangement

Outsource Company provides information technology outsourcing services. State Utility generates and supplies electricity. State Utility's billing and other information technology systems consume significant computer and staff resources. State Utility also uses these systems to provide billing and accounting services to a number of smaller utilities. The company and State Utility have entered into an agreement under which the company will provide all of State Utility's information technology services for 15 years. The company will acquire all of State Utility's back-office computer equipment, related buildings, and third-party service contracts. All staff currently employed by State Utility in its information technology function will transfer to the company. The company will, in addition to providing information technology services, restructure the information technology operations to improve efficiency and reduce the number of employees.

Analysis

It is likely that the assets and related operations acquired by the company would constitute a business. The elements in the acquisition include inputs (e.g., buildings, employees, and computer equipment), processes (e.g., computer systems and operating processes), and outputs (e.g., the existing contracts with other utilities and the new service contract with State Utility). As a result, the acquired group is able to generate a return. In this situation, identification of the market participants is unnecessary, because there are no missing elements in the acquired group.

EXAMPLE 1-4

Acquisition in the oil and gas industry

Company C is an oil and gas exploration and production company that owns a proven but undeveloped property. Company C has performed enough exploration activities to determine that the property is proven, but has not yet begun to extract the mineral reserves from the property. Additionally, Company C has constructed transportation infrastructure that will be used to transport the mineral reserves. However, this infrastructure has not yet been placed into operation. Company D is an oil and gas production company that operates a large portfolio of producing properties. Company D acquires Company C.

Analysis

It is likely that the acquired group would be a business. The acquired group includes inputs (e.g., proven property and transportation infrastructure) and processes (supporting the exploration activities). However, the acquired group is missing some of the elements required to produce outputs. Company D may determine that the likely market participants would have or could easily obtain the necessary operational processes to manage the acquired group in a way that would provide a return to investors. Therefore, the missing elements would not prevent the acquired group from being a business. This assessment will require judgment and will be based on facts and circumstances in each situation.

EXAMPLE 1-5

Acquisition in the pharmaceutical industry

Company E is a pharmaceutical company that owns the rights to several product candidates (drug compounds). Company E's current activities include researching and developing the product candidates. Company E does not have a manufacturing facility and has no revenues or commitments from customers if and when any of the product candidates become marketable. Company E employs management and administrative personnel, as well as scientists who conduct product testing and development and have established protocols and procedures to carry out these functions. Company F is an established pharmaceutical company with a large sales force. Company F acquires certain assets of Company E, including the rights to the product candidates and related testing and development equipment. Company F also hires the scientists formerly employed by Company E.

Analysis

It is likely that the acquired group would be a business. The acquired group includes inputs (e.g., the rights to the product candidates and the related testing and development equipment) and processes (e.g., operating protocols and procedures developed and applied by the scientists). While certain elements were not acquired (e.g., manufacturing capabilities, management and sales personnel), Company F may determine that the likely market participants would be strategic buyers that have these missing elements or could easily obtain them. Therefore, these missing elements would not prevent the acquired group from being a business. In addition, the determination of whether Company E is a development stage enterprise would not preclude an assessment that the acquired group constitutes a business. This assessment will require judgment and will be based on facts and circumstances in each situation.

EXAMPLE 1-6

Acquisition in the hotel industry

A multinational hotel group enters into a purchase agreement with a local hotel group in country A. The local hotel group owns and operates hotels in country A and wishes to refocus its operations to concentrate on key hotels. The local hotel group agrees to sell a number of non-core hotels to the multinational hotel group. Customer lists, fixtures and fittings, and staff employed at each property will be transferred to the multinational hotel group. The multinational group will be entitled to all revenue on any bookings existing at the agreement date. The multinational hotel group will rebrand the hotels and transfer the systems of the hotels to its own systems and processes.

Analysis

It is likely that the acquired group would be a business. The acquired group contains inputs (e.g., properties accompanied by fixtures and fittings, customer lists, and an existing order book) and processes (e.g., management and operational processes as a result of acquiring staff required to operate each hotel). The key elements present that enable the acquired group to produce outputs are the internal structure of each property as a hotel with the appropriate fixtures and fittings, staff, customer lists, and processes. This assessment will require judgment and will be based on facts and circumstances in each situation.

EXAMPLE 1-7

Acquisition in the real estate industry

Company W owns and manages a group of commercial real estate rental properties. Company W purchases a commercial office property in a large city. The purchased property is 90% occupied, and Company W will become a party to the lease agreements upon acquisition. Company W will replace existing security, cleaning, and maintenance contracts with new contracts. In addition, the existing property management agreement will be terminated and Company W will undertake all property management functions, such as collecting rent and supervising work. In connection with the transaction, Company W will also hire the current leasing and other personnel involved with the operations of the property.

Analysis

It is likely that the acquired group would be a business. Company W acquired inputs (e.g., commercial property, lease agreements, and key leasing and management personnel) and processes (e.g., personnel with requisite skills and experience). Further, rental income (i.e., an output) is present immediately after the acquisition. Company W concluded that other market participants would have existing property management expertise. Therefore, the missing elements would not prevent the acquired group from being a business. This assessment will require judgment and will be based on facts and circumstances in each situation.

EXAMPLE 1-8

Acquisition in the port industry

An international shipping company purchased a storage and warehouse facility at an Asian port, including all of the related assets except software. The warehouse earned rental income on storage units and associated service fees by using its existing assets and workforce prior to the acquisition. The international shipping company retained the management team and workforce for their experience and relationship with local port authorities, but did not retain any customers as the warehouse will only be used by the acquirer to offer extended services to its own customers.

Analysis

It is likely that the acquired group would be a business. The acquired group includes inputs (e.g., facility infrastructure and machinery and equipment) and some processes (e.g., operational procedures and expertise and industry knowledge through the retention of the management team and workforce). Though the software may be considered fundamental to the business, the international shipping company determined that likely market participants could easily purchase new software or replicate the existing software. Therefore, the missing software would not prevent the acquired group from being a business. This assessment will require judgment and will be based on facts and circumstances in each situation.

EXAMPLE 1-9

Asset acquisition

A shipping and warehousing company provides shipping and storage services to various third parties. A consumer retail company plans to purchase several warehouses from the shipping and warehousing company and intends to use the warehouses to enhance its inventory distribution system. The acquired group includes only the land and warehouses. It does not include warehousing contracts with third parties, nor does it include employees, warehouse equipment, or information technology systems, such as inventory-tracking systems.

Analysis

It is unlikely that the acquired group would be a business. The acquirer will purchase only inputs (i.e., the physical assets) and no accompanying processes. The acquired group is missing significant inputs and processes. Without these missing elements, the acquired group is not likely to meet the definition of a business. This assessment will require judgment and will be based on facts and circumstances in each situation.

1.3 *Identifying a business combination*

A business combination is defined as an entity obtaining control of one or more businesses. The most common business combination is a purchase transaction in which the acquirer purchases the net assets or **equity interests** of a business for some combination of cash or shares. An entity may also obtain control of a business (1) through the execution of a contract, (2) due to an action by the **acquiree**, (3) without the exchange of consideration, or (4) through transactions that combine multiple companies to form a single company. The acquisition method, which is discussed in Chapter 2, should be applied to all business combinations within the scope of the Standards.

ASC 805-10-55-2, ASC 805-10-55-3, and IFRS 3.B5,B6

Paragraph 805-10-25-1 requires an entity to determine whether a transaction or event is a business combination. [This IFRS defines a business combination as a transaction or other event in which the acquirer obtains control of one or more businesses]. In a business combination, an acquirer might obtain control of an acquiree in a variety of ways, including any of the following [for example]:

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

b. By incurring liabilities

c. By issuing equity interests

d. By providing more than one type of consideration [or]

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

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

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

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

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

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

Examples 1-10 through 1-12 illustrate transactions (other than purchase transactions) that are considered business combinations.

EXAMPLE 1-10

Share repurchase by investee

A company (investor) owns an equity investment in an investee. The investee repurchases its own shares from other parties, which increases the investor's proportional interest, and causes the investor to obtain control of the investee.

Analysis

This transaction qualifies as a business combination, and the acquisition method (i.e., business combination accounting) would be applied by the investor as a result of the investee's share repurchase transaction.

EXAMPLE 1-11

Change in the rights of noncontrolling interest holders

Company A owns a majority share of its investee's voting equity interests, but is precluded from exercising control of the investee due to contractual rights held by the noncontrolling interest (i.e., minority interest) holders in the investee (e.g., veto rights, board membership rights, or other substantive participation rights).

Analysis

The elimination or expiration of these rights causes Company A to obtain control of the investee. This event qualifies as a business combination, and the acquisition method would be applied by Company A.

EXAMPLE 1-12

Contracts or other arrangements

Company A and Company B enter into a contractual arrangement to combine their businesses. Company A will control the operations of both Company A and Company B.

Analysis

Company A obtains control of Company B. This transaction qualifies as a business combination, and the acquisition method would be applied to the arrangement.

1.3.1 Stapling transactions and dual-listed companies

Stapling transactions and the formation of dual-listed companies are considered business combinations and should be accounted for using the acquisition method.

Stapling transactions and dual-listed companies are rare and occur only in certain territories. A stapling transaction occurs as a result of a contractual arrangement between two legal entities whereby one legal entity issues equity securities that are combined with (i.e., stapled to) the securities issued by the other legal entity. The stapled securities are quoted at a single price and cannot be traded or transferred independently.

A dual-listed company is typically an arrangement between two listed legal entities in which their activities are managed under contractual arrangements as a single economic entity. The separate legal identity of each of the combining companies is retained. The securities of each entity normally are quoted, traded, and transferred independently in different capital markets. In this case, one entity has not acquired an ownership interest in the other entity, and the individual legal entities have not been combined to form a new legal entity. However, this is considered a business combination from an accounting perspective [ASC 805-10-25-11; IFRS 3.43].

1.3.2 Merger of equals, mutual enterprises, and "roll-up" or "put-together" transactions

A merger of equals, in which two entities of approximately equal size combine and share control over the combined entity, is considered a business combination that falls within the scope of the Standards [ASC 805-10-20; IFRS 3.A]. The Boards concluded it was not feasible to develop a separate accounting framework for these transactions due to the difficulty in distinguishing between a merger of equals and other business combinations [FAS 141(R).B35; IFRS 3.BC35]. Accordingly, in a merger of equals, the entity deemed to be the acquirer should account for the transaction using the acquisition method.

Combinations of mutual enterprises are also within the scope of the Standards. The Boards also acknowledged some differences between mutual enterprises and corporate business enterprises, but determined that such differences were not substantial enough to warrant separate accounting. Accordingly, in a combination of mutual enterprises, the entity deemed to be the acquirer should account for the transaction using the acquisition method.

"Roll-up" or "put-together" transactions typically result when several unrelated companies in the same market or in similar markets combine to form a larger company. The Boards concluded that, although these transactions might not cause a single entity to obtain control of the combined entity, they are similar to other types of business combinations and the acquirer should account for the transaction using the acquisition method.

1.3.3 Exchanges of assets between companies

Companies that exchange assets other than cash (i.e., nonmonetary assets) should apply the acquisition method if the result is the acquisition of a business. For example, Company A transfers a radio broadcast license to Company B in exchange for a radio station. Company A determines that the radio station it receives is a business, while Company B determines that the radio broadcast license it receives is an asset. Company A would account for the acquired radio station as a business combination by applying the acquisition method. Company B would account for the radio broadcast license as an **asset acquisition** under the applicable U.S. GAAP or IFRS.

1.3.4 *Multiple transactions that result in the acquisition of a business*

Legal, tax, or regulatory considerations frequently affect the structure of a business combination. A series of transactions might be used to combine two businesses in the most economically advantageous way. An arrangement to acquire a business through a series of transactions that are linked is a business combination and should be accounted for using the acquisition method. Determining whether a series of transactions is linked and whether they should be combined and viewed as a single arrangement is a matter of judgment and should be based on specific facts and circumstances.

For example, Company A (an international media group) has agreed to acquire Entity P's television broadcast and production operations. For tax reasons, Company A will not acquire Entity P's shares, but the programme rights will be purchased by one **subsidiary** of Company A. The production facilities and workforce that are located in the various countries will be acquired by separate operating subsidiaries of Company A in those locations. None of the transactions will be completed unless all of the other transactions are also completed. The separation of the acquisition of Entity P's television broadcast and production operations into several transactions does not affect the substance of the arrangement, which is a single business combination.

The IASB and IFRS IC considered the accounting for mandatory tender offers for the purchase of the noncontrolling interests in business combinations; however, the IASB plans to address the topic in the future when it addresses the measurement of put options written on noncontrolling interests.

There is currently no explicit guidance addressing the accounting for mandatory tender offers under U.S. GAAP.

Question 1-1

When a company temporarily obtains control of a business (e.g., a financial institution taking temporary control in a bankruptcy proceeding or an entity acquired for resale), must business combination accounting be followed by the acquiring company?

PwC response

Generally, any transaction in which an entity obtains control of one or more businesses qualifies as a business combination under the Standards. However, there is one industry scope exception in U.S. GAAP for a transaction in which control is only temporarily obtained. A parent entity that is a broker-dealer within the scope of ASC 940, *Financial Services—Broker and Dealers* (ASC 940), is not required to consolidate a majority-owned subsidiary in which the parent entity has a controlling financial interest and control is likely to be temporary [ASC 810-10-15-10]. Otherwise, there are no scope exceptions for a transaction in which control is only temporarily obtained under the Standards.

1.3.5 *Transactions excluded from the scope of ASC 805 and IFRS 3*

The following types of transactions are specifically excluded from the scope of the Standards:

- **Formation of joint ventures [joint arrangements–IFRS]:** By definition, no one party obtains control in the creation of a joint venture [joint arrangement]. The key characteristic is participants' joint control over the decision-making process through equal ownership (e.g., 50 percent each) or through the unanimous consent of all parties regarding strategic and operating decisions (see BCG 1.4 for further discussion of joint ventures and joint arrangements).

- **Acquisition of an asset or a group of assets that does not constitute a business:** Consistent with the principles governing the accounting for business combinations, the acquisition of an asset or a group of assets that is not a business should not be accounted for as a business combination (accounting for asset acquisitions is discussed in Chapter 9 of this guide).

- **Combinations involving entities or businesses under common control:** When entities or businesses that already share a parent company (i.e., are under common control) combine, there is no business combination at the parent company level, even though there is a combination for the combining businesses [ASC 805-10-15-4; IFRS 3.2]. The accounting for such a transaction under U.S. GAAP and IFRS is discussed further in Chapter 8 of this guide.

- ***For U.S. GAAP only*—combinations between not-for-profit organisations and acquisitions made by not-for-profit organisations:** Combinations between and acquisitions by not-for-profit organisations are excluded from ASC 805 [ASC 805-10-15-4]. Due to the nature and purpose of these organisations, these combinations might not involve the exchange of equal economic values. Such combinations are accounted for in accordance with ASC 958, *Not-for-Profit Entities* (ASC 958).

1.4 *Identifying a joint venture [joint arrangement]*

The scope exception for the creation or formation of a joint venture [joint arrangement] applies only if the transaction meets the definition of a joint venture under the applicable U.S. GAAP or joint arrangement under IFRS. For U.S. GAAP companies, ASC 323, *Investments-Equity Method and Joint Ventures* (ASC 323), defines a corporate joint venture as "a corporation owned and operated by a small group of businesses as a separate and specific business or project for the mutual benefit of the members of the group." ASC 323 continues: "A corporate joint venture also usually provides an arrangement under which each joint venturer may participate, directly or indirectly, in the overall management of the joint venture. Joint venturers, thus, have an interest or relationship other than as passive investors. An entity that is a subsidiary of one of the 'joint venturers' is not a corporate joint venture" [ASC 323-10-20].

While ASC 323 deals only with corporate arrangements, joint ventures may also include partnerships, arrangements involving undivided interests, and project-financing arrangements. However, they do not include arrangements between entities under common control because the joint venture would be considered a subsidiary for purposes of the **consolidated financial statements**. ASC 323 also specifies that joint control over the decision-making process is the most significant attribute of joint ventures, regardless of the form of legal ownership or the voting interest held.

The SEC historically has objected to the use of joint venture accounting (i.e., **carryover basis**) if two operating businesses are combined and the only distinguishing feature of whether the transaction is a business combination or the formation of a joint venture is the presence of joint control. However, joint control is not the only factor that defines a joint venture; and there must be other factors present to distinguish a joint venture formation transaction from a business combination. Other relevant factors include the purpose behind the formation of the joint venture and the economic benefits that each joint venturer expects to achieve.

For IFRS companies, IFRS 11 applies to all entities that are a party to a joint arrangement. A joint arrangement is defined as an arrangement where two or more parties contractually agree to share control. Joint control exists only when the decisions about activities that significantly affect the returns of an arrangement require the unanimous consent of the parties sharing control.

All parties to a joint arrangement must recognise their rights and obligations arising from the arrangement. The focus is not on the legal structure of joint arrangements, but rather on how the rights and obligations are shared by the parties to the joint arrangement.

There are two types of joint arrangements: joint operations and joint ventures. A joint operation is a joint arrangement that gives parties to the arrangement direct rights to the assets and obligations for the liabilities. A joint operator will recognise its interest based on its involvement in the joint operation (e.g., based on its direct rights and obligations), rather than on the participation interest it has in the joint arrangement. A joint venture, in contrast, gives the parties rights to the net assets or outcome of the arrangement. A joint venturer does not have rights to individual assets or obligations for individual liabilities of the joint venture. Instead, joint venturers share in the net assets and, in turn, the outcome (profit or loss) of the activity undertaken by the joint venture. Equity accounting is mandatory for participants in joint ventures.

1.5 Common control business combinations

Common control transactions are transfers and exchanges between entities that are under the control of the same parent, or are transactions in which all of the combining entities are controlled by the same party or parties before and after the transaction and that control is not transitory. The extent of a minority interest is not relevant [ASC 805-50-15-6, IFRS 3.B1].

The accounting for common control transactions can differ between U.S. GAAP and IFRS companies. U.S. GAAP companies are required to account for these transactions by using the carryover basis. In contrast, IFRS companies may make an accounting policy election to consistently account for these types of transactions using either the acquisition method or the **predecessor-values method**, which is similar to using the carryover basis under U.S. GAAP. BCG 8 of this guide defines common control business combinations and describes the appropriate method of accounting in more detail under U.S. GAAP and IFRS.

1.6 U.S. GAAP and IFRS differences: definition of control

The guidance for determining when control is achieved differs under U.S. GAAP and IFRS. Consequently, the same transaction may be accounted for as a business combination under U.S. GAAP but not under IFRS, or vice versa.

1.6.1 U.S. GAAP

Under ASC 805, control is defined as a controlling financial interest, as discussed in ASC 810. According to ASC 810, control is based on one of two common transaction characteristics. The transaction characteristics determine whether the applicable accounting approach is the **variable-interest-entity** approach or the voting interest approach.

The variable-interest-entity approach should be applied if the entity is determined to be a variable interest entity (VIE). ASC 810 provides specific rules for determining whether an entity is considered a VIE.

The reporting entity has control of the VIE if the reporting entity has both of the following:

- The power over those decisions that most significantly impact the economic activities of the VIE.
- The potential to receive significant benefits or absorb significant losses of the VIE.

Therefore, a reporting entity that has the above characteristics should consolidate the VIE under the variable-interest entity approach. The reporting entity could be a debt investor, an equity investor or the counterparty to a contractual arrangement with the VIE. ASC 810 requires a detailed analysis of which reporting entity, if any, should consolidate the VIE under the variable-interest-entity approach.

The **voting interest** approach should be applied if the entity is not a VIE. When the reporting entity has a majority voting interest and there are no agreements to the contrary, the reporting entity can exert control by:

- Appointing a majority of the board members
- Hiring and firing management
- Making strategic and operational decisions

Therefore, a reporting entity that has the above characteristics should consolidate the entity under the voting interest approach.

Companies reporting under U.S. GAAP must use the acquisition method upon the consolidation of a VIE when control is obtained if the VIE is determined to be a business.

ASC 810 provides guidance on determining whether a majority **owner** or a general partner controls an investee based upon rights granted to the investee's minority shareholders or limited partners.

1.6.2 *IFRS*

Under IFRS 10, an entity has control over an investee when all of the following elements are present:

- Power over the investee
- Exposure, or rights, to variable returns from its involvement with the investee
- The ability to use its power over the investee to affect the amount of the investor's returns

A reporting entity holding less than half of the voting rights in an investee might have control based on other factors, including:

- A contractual arrangement between the reporting entity and other vote holders
- Rights arising from other contractual arrangements
- Potential voting rights
- Holding sufficient voting rights to give it control based on other factors (de facto control)

Substantive potential voting rights are taken into account. A potential voting right is substantive if it is exercisable when decisions that significantly affect the returns need to be made.

IFRS 10 provides further guidance on whether a decision-maker is an agent or a principal. The assessment is made based on the overall relationship between the decision-maker, the investee, and the other parties involved with the investee. The factors to consider include:

- Scope of decision-maker's authority over the investee
- Rights held by other parties
- Remuneration of the decision-maker

- The decision-maker's exposure to variability of returns from other interests in the investee

Figure 1-2 highlights various considerations in determining control under U.S. GAAP and IFRS.

Figure 1-2
Determining control

ASC 810 U.S. GAAP	IFRS 10 IFRS
□ Consolidation decisions are evaluated first under the VIE model □ Qualitatively assess if the variable interest meets both criteria: o Power to direct activities that most significantly impact economic performance o Potential to receive significant benefits or absorb significant losses □ All other entities are evaluated under the voting interest model	□ Must have all of the following: o Power o Exposure, or rights, to variable returns o Ability to use power to affect the returns

1.6.3 *New investment entity standard—IFRS*

The IASB issued *Investment Entities (Amendments to IFRS 10, IFRS 12 and IAS 27*) in October 2012. The purpose of the amendments was to provide an exception for investment entities from the existing requirement to consolidate certain subsidiaries. Investment entities will now report all investments at fair value. The amendments also introduce new disclosure requirements for an investment entity's unconsolidated interest in a subsidiary.

An investment entity is defined as an entity that does the following:

- Obtains funds from one or more investors for the purpose of providing those investor(s) with investment management services

- Commits to its investor(s) that its business purpose is to invest funds solely for returns from capital appreciation, investment income, or both

- Measures and evaluates the performance of substantially all of its investments on a fair value basis

Entities are also required to consider whether they have the typical characteristics of an investment entity, such as multiple investments and investors, non-related party investors, and ownership in the form of equity or similar interests. The absence of any of these typical characteristics does not necessarily disqualify an entity from being classified as an investment entity. However, an investment entity that does not have all of these typical characteristics would be required to disclose the reasons it concluded it is an investment entity.

Those entities meeting the definition of an investment entity will account for their portfolio investments at fair value, even where they have significant influence or a controlling financial interest in the investee. However, the exception from consolidation is not available to a non-investment entity parent with a controlling interest in an investment entity. Rather, a non-investment entity parent of an investment entity must consolidate all entities it controls, including those controlled through an investment entity.

The amendments are effective 1 January 2014, with early adoption permitted. Entities are required to apply the amendments retrospectively, subject to certain transition relief.

1.6.4 New investment companies standard—U.S. GAAP

The FASB issued Accounting Standards Update No. 2013-08, *Financial Services—Investment Companies (Topic 946): Amendments to the Scope, Measurement and Disclosure Requirements* in June 2013. This standard modifies the criteria used in defining an investment company under U.S. GAAP. In order to qualify as an investment company, an entity needs to obtain funds from one or more investors and provide the investors with investment management services, its business purpose and only substantive activities are investing for capital appreciation, investment income or both and the entity (and its affiliates) does not obtain returns or benefits that are not normally attributable to ownership interests.

To be an investment company, in addition to the requirements on the nature of the investment activity noted above, it is expected that an entity will have the following characteristics:

- It has more than one investment and more than one investor.
- It has investors that are not related parties of the entity or the investment manager.
- It has ownership interests in the form of equity or partnership interests.
- It manages substantially all of its investments on a fair value basis.

While the definition requires an entity must meet the “business purpose” requirement noted above, an entity will need to apply judgment in situations where one or more typical characteristics are not present. If an entity is missing a characteristic, it does not automatically preclude it from qualifying as an investment company. The standard is effective for interim and annual reporting periods in fiscal years that begin after December 15, 2013. Early application is prohibited.

Chapter 2: Acquisition method

2.1 Chapter overview

The Standards require the application of the **acquisition method** to all **business combinations**. This chapter outlines the steps in applying the acquisition method, including the accounting for assets acquired and liabilities assumed, and the recognition of gains and losses in a business combination (e.g., bargain purchases, **step acquisitions**).

The Standards are mostly converged, but some differences remain between U.S. GAAP and IFRS pertaining to: (1) the definitions of **control**, (2) recognition of certain assets and liabilities based on the reliably measurable criterion, (3) accounting for acquired contingencies, and (4) accounting for the **noncontrolling interest**. In addition, the interaction of other U.S. GAAP and IFRS standards may cause differences in, for example, the classification of **contingent consideration**, the recognition and measurement of share-based payment awards, and deferred taxes. The Boards' have established a single source of guidance on fair value measurements and a converged definition of **fair value**. See Chapter 7 for more information on the fair value standards.

Active and recently completed FASB and IASB projects may result in amendments to existing guidance. These possible amendments may impact the guidance in this chapter.

In addition to the projects highlighted in Chapter 1, possible amendments also include:

- The Boards' projects on financial instruments are intended to address the classification and measurement, impairment of financial instruments, and hedge accounting. In November 2013, the IASB issued a final standard on hedge accounting and amendments to IFRS 9. The timing for exposure of the remaining financial instrument standards is uncertain at this time.

The key takeaways from this chapter are:

- **Assets and liabilities of the acquiree are recorded at fair value with limited exceptions.** The acquiring company recognises and measures (at fair value in most cases) 100 percent of the assets and liabilities of the acquiree even if less than 100 percent of the acquiree was obtained. The acquirer's intended use does not affect the fair value measurement of the acquiree's assets. Goodwill is recognised and measured as a residual.

  For U.S. GAAP companies, the noncontrolling interest, if there is any, is recorded at fair value. Goodwill includes amounts related to both the controlling and noncontrolling interests.

  IFRS companies may choose to measure the noncontrolling interest at (1) its fair value, resulting in the measurement of 100 percent of the acquired net assets at fair value and goodwill relating to the controlling and noncontrolling interests; or (2) at its proportionate share of the acquiree's identifiable net assets, resulting in the measurement of 100 percent of the identifiable net assets at fair value and the measurement of goodwill for only the controlling interest.

- **The fair value of the consideration transferred, including any equity securities, is determined on the acquisition date.** Consideration transferred includes: the acquisition date fair values of the assets transferred by the acquirer, the liabilities incurred by the acquirer to former owners of the acquiree, and the equity interests issued by the acquirer. The measurement date for consideration transferred is the acquisition date (the date control is obtained), which is generally the closing date.

- **Certain contingencies assumed in a business combination are recorded at fair value on the acquisition date.** Under U.S. GAAP, assets acquired and liabilities assumed in a business combination that arise from contingencies should be recognised at fair value on the acquisition date if fair value can be determined during the measurement period. Otherwise, companies generally should account for acquired contingencies in accordance with ASC 450, *Contingencies*.

  IFRS 3 requires the recognition of contingent liabilities (i.e., present obligations) on the acquisition date at fair value if they are reliably measurable, irrespective of whether the obligations are probable. IFRS 3 does not allow for the recognition of contingent assets.

- **Contingent consideration is recognised and measured on the acquisition date.** Contingent consideration is classified as an asset, liability, or equity and measured at fair value on the acquisition date. In the postcombination period, contingent consideration classified as an asset or liability is remeasured to fair value each reporting period, with changes generally included in earnings [profit or loss]. Contingent consideration classified as equity is not remeasured in the postcombination period.

- **Acquisition and restructuring costs are accounted for separately from the business combination.** Acquisition-related costs are not included as part of the consideration transferred, but rather expensed as incurred. Restructuring costs an acquirer expects to incur but is not obligated to incur at the acquisition date are not liabilities assumed as part of the business combination.

- **Business combinations may trigger the recognition of gains and losses.** Any previously held equity interest in the acquiree in a business combination is remeasured to fair value, and any gain or loss is recognised in earnings [profit or loss] at the acquisition date. A bargain purchase always results in the recognition of a gain on the acquisition date.

- **Measurement period adjustments require retroactive adjustment of prior periods.** If adjustments to the initial acquisition accounting are recorded during the measurement period, the acquirer should revise prior period financial information when it is reissued in subsequent financial statements.

2.2 The acquisition method

The Standards provide the following principle with regard to the application of the acquisition method:

ASC 805-10-25-1, ASC 805-10-05-4 and IFRS 3.4, 5

An entity shall account for each business combination by applying the acquisition method.

Applying the acquisition method requires all of the following steps:

a. Identifying the acquirer;

b. Determining the acquisition date;

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

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

Each of the above will be discussed in detail in this chapter.

Specific issues surrounding the application of the acquisition method for **partial** and **step acquisitions** and the recognition and measurement of the noncontrolling interest are discussed in Chapter 6.

2.3 Identifying the acquirer

The Standards provide the following principle with regard to identifying the **acquirer**:

ASC 805-10-25-4 and IFRS 3.6

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

Application of the above principle requires one of the parties in a business combination to be identified as the acquirer for accounting purposes. The process of identifying the acquirer begins with the determination of the party that obtains control based on the guidance in the consolidation standards. Those standards are ASC 810-10 for U.S. GAAP and IFRS 10 for IFRS (collectively, the NCI Standards). IAS 27 (2008), the IASB's previous consolidation standard, may still be applicable to certain entities. See BCG 1.6.2 for further information on guidance of IFRS 10.

For U.S. GAAP, the general rule is the party that directly or indirectly holds greater than 50 percent of the voting shares has control [ASC 810-10-15-8]. If a Variable Interest Entity (VIE) that is a **business** is consolidated using the VIE subsections of

ASC 810-10, the party that consolidates the VIE (i.e., primary beneficiary) is identified as the acquirer. See BCG 2.11 for further information.

For IFRS, a party that has power over the investee; exposure, or rights, to variable returns from its involvement in the investee; and the ability to use that power over the investee to affect the amount of the investor's returns has control (IFRS 10.7). See BCG 1.6.2 for further information on IFRS 10.

If the accounting acquirer is not apparent when considering the guidance in the NCI Standards, the following additional guidance is provided in the Standards to assist in the identification of the acquirer:

- The entity that transfers cash or other assets, or incurs liabilities to effect a business combination is generally identified as the acquirer [ASC 805-10-55-11; IFRS 3.B14].

The entity that issues **equity interests** is usually the acquirer in a business combination that primarily involves the exchange of equity interests. However, it is sometimes not clear which party is the acquirer if a business combination is effected through the exchange of equity interests. In these situations, the acquirer for accounting purposes may not be the legal acquirer (i.e., the entity that issues its equity interest to effect the business combination). Business combinations in which the legal acquirer is not the accounting acquirer are commonly referred to as "reverse acquisitions." See BCG 2.10 for further information. All pertinent facts and circumstances should be considered in determining the acquirer in a business combination that primarily involves the exchange of equity interests. The Standards provide the following additional factors:

Excerpts from ASC 805-10-55-12 and IFRS 3.B15

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

The weight of this factor generally increases as the portion of the voting rights held by the majority becomes more significant (e.g., split of 75 percent and 25 percent may be more determinative than a split of 51 percent and 49 percent).

Excerpts from ASC 805-10-55-12 and IFRS 3.B15

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

The existence of a party with a large minority voting interest may be a factor in determining the acquirer. For example, a newly combined entity's ownership includes a single investor with a 40 percent ownership, while the remaining 60 percent ownership is held by a widely dispersed group. The single investor that owns the 40 percent ownership in the combined entity is considered a large minority voting interest.

Excerpts from ASC 805-10-55-12 and IFRS 3.B15

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

Consideration should be given to the initial composition of the board and whether the composition of the board is subject to change within a short period of time after the **acquisition date**. Assessing the significance of this factor in the identification of the acquirer would include an understanding of which combining entity has the ability to impact the composition of the board. These include, among other things, the terms of the current members serving on the governing body, the process for replacing current members, and the committees or individuals that have a role in selecting new members for the governing body.

Excerpts from ASC 805-10-55-12 and IFRS 3.B15

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

Consideration should be given to the number of executive positions, the roles and responsibilities associated with each position, and the existence and terms of any employment contracts. The seniority of the various management positions should be given greater weight over the actual number of senior management positions in the determination of the composition of senior management.

Excerpts from ASC 805-10-55-12 and IFRS 3.B15

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

This factor is not limited to situations where the equity securities exchanged are traded in a public market. In situations where either or both securities are not publicly traded, the reliability of the fair value measure of the privately held equity securities should be considered prior to assessing whether an entity paid a premium over the precombination fair value of the other combining entity or entities.

Other factors to consider in determining the acquirer include:

- The combining entity whose relative size is significantly larger than the other combining entity or entities usually is the acquirer. Assessing relative size may include an understanding of the combining entities' assets, revenues, or earnings [profit] [ASC 805-10-55-13; IFRS 3.B16].

- An acquirer should be identified in a business combination involving more than two entities. The identification of the acquirer should consider which entity initiated the business combination, the relative size of the combining entities, and any other pertinent information [ASC 805-10-55-14; IFRS 3.B17].

- A new entity formed to effect a business combination is not necessarily the acquirer. One of the existing combining entities should be determined to be the acquirer in a business combination involving the issuance of equity interests by a newly formed entity (Newco). However, a Newco that transfers cash or other assets, or that incurs liabilities as consideration may be deemed to be the accounting acquirer in certain situations [ASC 805-10-55-15; IFRS 3.B18]. See BCG 2.3.1 for further information on Newcos.

2.3.1 New entity formed to effect a business combination

It is not uncommon for a company to use a Newco (newly formed entity) in a business combination. A Newco may be used in a business combination for legal, tax, or other business purposes.

A Newco may be determined to be the acquirer in certain situations if the Newco is considered to be substantive (i.e., when the Newco is not disregarded for accounting purposes). This determination is based on the facts and circumstances and is highly subjective. A Newco's formation, ownership, and activities prior to the business combination should be considered and may provide evidence as to whether a Newco is substantive. For example, a Newco that has assets, liabilities, or operating activities may be determined to be substantive. Neither U.S. GAAP nor IFRS provides guidance on this determination.

A Newco that is established solely to issue equity interests to effect a business combination generally will not be substantive and should normally be "looked through" to determine the acquirer. Therefore, in this case, if a Newco issues equity interests to effect a business combination, one of the existing entities or businesses shall be identified as the acquirer [ASC 805-10-55-15; IFRS 3.B18].

For U.S. GAAP companies, see BCG 13 for further information on pushdown accounting for certain Newco transactions.

Examples 2-1 and 2-2 illustrate how to determine whether a Newco is the acquirer.

EXAMPLE 2-1

Newco is determined to be the acquirer

A Newco is formed by various unrelated investors for the purpose of acquiring a business. Newco issues equity to the investors for cash. Using the cash received, Newco purchases 100 percent of the equity of a company.

Analysis

Newco is identified as the accounting acquirer. Newco, itself, obtained control of a business and is not controlled by the former shareholders of the acquired company. In addition, Newco independently raised the necessary cash to fund the acquisition. Based on these facts, Newco is considered to be substantive and is identified as the accounting acquirer.

EXAMPLE 2-2

Newco is determined not to be the acquirer

A Newco is formed by Company A to effect the combination of Company A and Company B. Newco issues 100 percent of its equity interests to the owners of the combining companies in exchange for all of their outstanding equity interests.

Analysis

The transaction is, in substance, no different than a transaction where one of the combining entities directly acquires the other [FAS 141(R).B100; IFRS 3.BC100]. Newco is not considered substantive in this situation and is disregarded for accounting purposes. Therefore, Newco is not identified as the accounting acquirer; rather, one of the other combining entities shall be determined to be the acquirer.

2.3.2 *Other considerations in identifying the acquirer*

The Standards provide general guidance for identifying the acquirer. Certain circumstances can complicate the identification of the acquirer. For example:

- **Acquisitions involving companies with common [ordinary] shareholders:** The effect of common ownership (but not **common control**) among the shareholders of the combining entities should be considered in the identification of the accounting acquirer. The analysis of the relative voting rights in a business combination involving entities with common shareholders should consider the former shareholder groups of the combining entities and not the individual **owners** that are common to the combining entities. The former shareholder group that retains or receives the largest portion of the voting rights in the combined entity would be the accounting acquirer, absent the consideration of any of the other factors provided in the Standards.

- **Options, warrants, and convertible instruments:** Options, warrants, and convertible instruments assumed or exchanged in a business combination are considered in the determination of the accounting acquirer if the holders of these instruments are viewed to be essentially the same as common shareholders. Options, warrants, and convertible instruments that are in the money and are vested, exercisable, or convertible may be included in the determination of the relative voting rights in the combined entity.

- **Debt holders that receive common shares:** Debt holders that receive common shares in a business combination should be considered in the determination of the accounting acquirer if the debt holders are viewed to have attributes similar to common shareholders prior to the acquisition. The holders of debt that is exchanged for shares in a business combination may be included in the determination of the relative voting rights in the combined entity if the debt is convertible and in the money prior to the acquisition.

Examples 2-3 and 2-4 illustrate the impact on the determination of relative voting rights in the combined entity if debt holders receive common shares in a business combination.

EXAMPLE 2-3

Debt holders that exchange their interest for common shares that do not impact the determination of relative voting rights

Company A acquires Company B in a business combination by exchanging equity interests. Company B has nonconvertible debt that Company A does not wish to assume in the acquisition. Company A reaches an agreement with Company B's nonconvertible debt holders to extinguish the debt for Company A's common shares. The nonconvertible debt holders hold no other financial interests in Company B.

Analysis

The extinguishment of the debt is a separate transaction from the business combination. The determination of relative voting rights in the combined entity would not include the equity interests received by Company B's nonconvertible debt holders. Prior to the business combination, Company B's nonconvertible debt holders do not have attributes similar to other shareholders. The debt holders have no voting rights and have a different economic interest in Company B compared to Company B's shareholders before the business combination.

EXAMPLE 2-4

Debt holders that exchange their interest for common shares that impact the determination of relative voting rights

Company A acquires Company B in a business combination by exchanging equity interests. Company B has convertible debt. The conversion feature is "deep in the money" and the underlying fair value of the convertible debt is primarily based on the common shares into which the debt may be converted. Company A does not wish to assume the convertible debt in the acquisition. Company A reaches an agreement with

Company B's convertible debt holders to exchange the convertible debt for Company A's common shares.

Analysis

The determination of relative voting rights in the combined entity would include the equity interests received by Company B's convertible debt holders. Prior to the business combination, these debt holders have attributes similar to common shareholders. The debt holders have voting rights that can be exercised by converting the debt into common shares, and the underlying fair value of the debt is primarily based on the common shares into which the debt may be converted. This would indicate that the convertible debt holders have a similar economic interest in Company B compared to Company B's common shareholders prior to the business combination.

2.4 Determining the acquisition date

The Standards provide the following principle with regard to determining the acquisition date:

Excerpts from ASC 805-10-25-6 and IFRS 3.8

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

The acquisition date is the date on which the acquirer obtains control of the **acquiree**, which is generally the closing date. However, if control of the acquiree transfers to the acquirer through a written agreement, the acquisition date can be before or after the closing date. All pertinent facts and circumstances surrounding a business combination should be considered in assessing when the acquirer has obtained control of the acquiree [ASC 805-10-25-7; IFRS 3.9].

2.4.1 Determining the acquisition date for a business combination achieved without the transfer of consideration

An acquirer may obtain control through a transaction or event without the purchase of a controlling ownership interest (i.e., a business combination achieved without the transfer of consideration). The acquisition date for these business combinations is the date control is obtained through the other transaction or event. This situation may arise, for example, if an investee enters into a share buy-back arrangement with certain investors and, as a result, control of the investee changes. In this example, the acquisition date should be the date on which the share repurchase (and cancellation) occurs, resulting in an investor obtaining control over the investee.

2.5 Recognising and measuring the identifiable assets acquired, liabilities assumed, and any noncontrolling interest in the acquiree

The Standards provide the following recognition principle for assets acquired, liabilities assumed, and any noncontrolling interest in the acquiree:

Excerpts from ASC 805-20-25-1 and IFRS 3.10

As of the acquisition date, the acquirer shall recognise, separately from goodwill, the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree. Recognition of identifiable assets acquired and liabilities assumed is subject to the conditions specified in paragraphs 805-20-25-2 through 25-3. [IFRS 3.11 and 12].

An acquirer should recognise the **identifiable** assets acquired and the liabilities assumed on the acquisition date if they meet the definitions of assets and liabilities in FASB Concepts Statement No. 6, *Elements of Financial Statements* (CON 6) for U.S. GAAP, and the *Framework for the Preparation and Presentation of Financial Statements* for IFRS. For example, costs that an acquirer expects to incur but is not obligated to incur at the acquisition date (e.g., restructuring costs) are not liabilities assumed [ASC 805-20-25-2; IFRS 3.11]. An acquirer may also recognise assets and liabilities that are not recognised by the acquiree in its financial statements prior to the acquisition date, due to differences between the recognition principles in a business combination and other U.S. GAAP or IFRS. This can result in the recognition of **intangible assets** in a business combination, such as a brand name or customer relationship, which the acquiree would not recognise in its financial statements because these intangible assets were internally generated [ASC 805-20-25-4; IFRS 3.13].

Certain assets acquired and liabilities assumed in connection with a business combination may not be considered part of the assets and liabilities exchanged in the business combination and will be recognised as separate transactions in accordance with other U.S. GAAP or IFRS [ASC 805-20-25-3; IFRS 3.12].

The Standards provide the following principle with regard to the measurement of assets acquired and liabilities assumed and any noncontrolling interest in the acquiree:

Excerpt from ASC 805-20-30-1

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

Excerpt from IFRS 3

18. The acquirer shall measure the identifiable assets acquired and the liabilities assumed at their acquisition-date fair values.

19. For each business combination, the acquirer shall measure any noncontrolling interest in the acquiree either at fair value or at the noncontrolling interest's proportionate share of the acquiree's identifiable net assets.

The measurement of the identifiable assets acquired and liabilities assumed is at fair value, with limited exceptions as provided for in the Standards. For U.S. GAAP, fair value is based on the definition in ASC 820-10-20 as the price that would be received from the sale of an asset or paid to transfer a liability in an orderly transaction between **market-participants** [ASC Glossary]. For IFRS, the definition of fair value is the amount that an asset could be exchanged or a liability settled between knowledgeable, willing parties in an arm's length transaction [IFRS 3.A]. See Chapter 7 for a discussion of the valuation techniques and issues related to the fair value measurement of the identifiable assets acquired and liabilities assumed.

The following table provides a summary of the exceptions to the recognition and fair value measurement principles in the Standards, along with references to where these exceptions are discussed in this chapter.

Summary of exceptions to the recognition and fair value measurement principles

Measurement principle	▫ Reacquired rights (BCG 2.5.6) ▫ Assets held-for-sale (BCG 2.5.9) ▫ Share-based payment awards (BCG 2.6.3.1)
Recognition and measurement principles	▫ Income taxes (BCG 2.5.8) ▫ Employee benefits (BCG 2.5.10) ▫ Contingencies (BCG 2.5.13) ▫ Indemnification assets (BCG 2.5.14)

The recognition and measurement of particular assets acquired and liabilities assumed are discussed in BCG 2.5.1 through BCG 2.5.19.2.

2.5.1 Assets that the acquirer does not intend to use

An acquirer, for competitive or other reasons, may not use an acquired asset or may intend to use the asset in a way that is not its highest and best use (i.e., different from the way other market-participants would use the asset). The Standards specify that the intended use of an asset by the acquirer does not affect its fair value [ASC 805 20-30-6; IFRS 3.B43]. See BCG 4.5 for further information on the subsequent measurement of assets that the acquirer does not intend to use.

2.5.1.1 Defensive intangible assets

A company may acquire intangible assets in a business combination that it has no intention to actively use but intends to hold (lock up) to prevent others from obtaining access to them (**defensive intangible assets**). Defensive intangible assets may include assets that the entity will never actively use, as well as assets that will be actively used by the entity only during a transition period. In either case, the company will lock up the defensive intangible assets to prevent others from obtaining access to them for a period longer than the period of active use. Examples of defensive intangible assets include brand names and trademarks. A company should utilise market-participant assumptions, not acquirer-specific assumptions, in determining the fair value of defensive intangible assets.

Determining the **useful life** of defensive intangible assets can be challenging. The value of defensive intangible assets will likely diminish over a period of time as a result of the lack of market exposure or competitive environment or other factors. Therefore, the immediate write-off of defensive intangible assets would not be appropriate. It would also be rare for such assets to have an indefinite life. See BCG 4.5, BCG 10.4, and BCG 12.4.2.5 for further information on the initial and subsequent measurement of defensive intangible assets.

2.5.2 Asset valuation allowances

Separate valuation allowances are not recognised for acquired assets that are measured at fair value, as any uncertainties about future cash flows are included in their fair value measurement [ASC 805-20-30-4; IFRS 3.B41]. This precludes the separate recognition of an allowance for doubtful accounts or an allowance for loan losses. Companies may need to separately track contractual receivables and any valuation losses to comply with certain disclosure and other regulatory requirements in industries such as financial services. In the reporting period during which the business combination occurs, the acquirer should disclose the fair value of the acquired receivables, their gross contractual amounts and an estimate of cash flows not expected to be collected [ASC 805-20-50-1(b); IFRS 3.B64(h)].

The use of a separate valuation allowance is permitted for assets that are not measured at fair value on the acquisition date (e.g., certain indemnification assets). Consequently, for U.S. GAAP companies, a valuation allowance for deferred income tax assets is allowed.

2.5.3 Inventory

Acquired inventory can be in the form of finished goods, work in progress, and raw materials. The Standards require that inventory be measured at its fair value on the acquisition date. Ordinarily, the amount recognised for inventory at fair value by the acquirer will be higher than the amount recognised by the acquiree before the business combination. See BCG 7 for further information on valuation methods.

2.5.4 *Contracts*

Contracts (e.g., leases, sales contracts, supply contracts) assumed in a business combination may give rise to assets or liabilities. An intangible asset or liability may be recognised for contract terms that are **favourable** or **unfavourable** compared to current market transactions, or related to identifiable economic benefits for contract terms that are at market. See Chapter 4 for further discussion of the accounting for contract-related intangible assets.

2.5.4.1 *Loss contracts*

A **loss [onerous] contract** occurs if the unavoidable costs of meeting the obligations under a contract exceed the expected future economic benefits to be received [ASC 805-10-55-21; IFRS 3.B52]. However, unprofitable operations of an acquired business do not necessarily indicate that the contracts of the acquired business are loss [onerous] contracts.

A loss [onerous] contract should be recognised as a liability at fair value if the contract is a loss [onerous] contract to the acquiree at the acquisition date. An acquirer should have support for certain key assumptions, such as market price and the unavoidable costs to fulfil the contract (e.g., manufacturing costs, service costs), if a liability for a loss [onerous] contract is recognised. For example, Company A acquires Company B in a business combination. Company B is contractually obligated to fulfil a previous fixed-price contract to produce a fixed number of components for one of its customers. However, Company B's unavoidable costs to manufacture the component exceed the sales price in the contract. As a result, Company B has incurred losses on the sale of this product and the combined entity is expected to continue to do so in the future. Company B's contract is considered a loss [onerous] contract that is assumed by Company A in the acquisition. Therefore, Company A would record a liability for the loss [onerous] contract assumed in the business combination.

When measuring a loss [onerous] contract, an acquirer should consider whether the amount to be recognised should be adjusted for any intangible assets or liabilities already recognised for contract terms that are favourable or unfavourable compared to current market terms. A contract assumed in a business combination that becomes a loss [onerous] contract as a result of the acquirer's actions or intentions should be recognised through earnings [profit or loss] in the postcombination period based on the applicable framework in U.S. GAAP or IFRS.

2.5.5 *Intangible assets*

All identifiable intangible assets that are acquired in a business combination should be recognised at fair value on the acquisition date. Identifiable intangible assets are recognised separately if they arise from contractual or other legal rights or if they are separable (i.e., capable of being sold, transferred, licensed, rented, or exchanged separately from the entity). See Chapter 4 for guidance on the recognition and measurement of intangible assets.

2.5.6 Reacquired rights

An acquirer may reacquire a right that it had previously granted to the acquiree to use one or more of the acquirer's recognised or unrecognised assets. Examples of such rights include a right to use the acquirer's trade name under a franchise agreement or a right to use the acquirer's technology under a technology licensing agreement. Such **reacquired rights** generally are identifiable intangible assets that the acquirer separately recognises from **goodwill** [ASC 805-20-25-14; IFRS 3.B35]. The reacquisition must be evaluated separately to determine if a gain or loss on the settlement should be recognised. See BCG 2.7.3.1 for further information.

Understanding the facts and circumstances, including those surrounding the original relationship between the parties prior to the business combination, is necessary to determine whether the reacquired right constitutes an identifiable intangible asset. Some considerations include:

- How was the original relationship structured and accounted for? What was the intent of both parties at inception?
- Was the original relationship an outright sale with immediate revenue recognition, or was deferred revenue recorded as a result? Was an up-front, one-time payment made, or was the payment stream ongoing? Was the original relationship an arm's-length transaction, or was the original transaction set up to benefit a majority-owned **subsidiary** or joint venture entity with off-market terms?
- Was the original relationship created through a capital transaction, or was it created through an operating (executory) arrangement? Did it result in the ability or right to resell some tangible or intangible rights?
- Has there been any enhanced or incremental value to the acquirer since the original transaction?
- Is the reacquired right exclusive or nonexclusive?

Contracts giving rise to reacquired rights that include a royalty or other type of payment provision should be assessed for contract terms that are favourable or unfavourable when compared to pricing for current market transactions. A settlement gain or loss should be recognised and measured at the acquisition date for any **favourable or unfavourable contract terms** identified [ASC 805-20-25-15; IFRS 3.B36]. A settlement gain or loss related to a reacquired right should be measured consistently with the guidance for the settlement of **preexisting relationships.** See BCG 2.7.3.1 for further information. The amount of any settlement gain or loss should not impact the measurement of the fair value of any intangible asset related to the reacquired right.

The acquisition of a reacquired right may be accompanied by the acquisition of other intangibles that should be recognised separately from both the reacquired right and goodwill. For example, a company grants a franchise to a franchisee to develop a business in a particular country. The franchise agreement includes the right to use the company's trade name and proprietary technology. After a few years, the company decides to reacquire the franchise in a business combination for an amount greater than the fair value of a new franchise right. The excess of the value transferred over the franchise right is an indicator that other intangibles, such as customer relationships, customer contracts, and additional technology, could have been acquired along with the reacquired right.

2.5.6.1 Determining the value and useful life of reacquired rights

Reacquired rights are identified as an exception to the fair value measurement principle, because the value recognised for reacquired rights is not based on market-participant assumptions. The value of a reacquired right is determined based on the estimated cash flows over the remaining contractual life, even if market-participants would reflect expected renewals in their measurement of that right [ASC 805-20-30-20; IFRS 3.29]. The basis for this measurement exception is that a contractual right acquired from a third party is not the same as a reacquired right [FAS 141(R).B309; IFRS 3.BC309]. Because a reacquired right is no longer a contract with a third party, an acquirer that controls a reacquired right could assume indefinite renewals of its contractual term, effectively making the reacquired right an indefinite-lived intangible asset.

Assets acquired and liabilities assumed, including any reacquired rights, should be measured using a valuation technique that considers cash flows after payment of a royalty rate to the acquirer for the right that is being reacquired because the acquiring entity is already entitled to this royalty. The amount of consideration that the acquirer would be willing to pay for the acquiree is based on the cash flows that the acquiree is able to generate above and beyond the royalty rate that the acquirer is already entitled to under the agreement.

The Boards concluded that a right reacquired from an acquiree in substance has a finite life (i.e., the contract term); a renewal of the contractual term after the business combination is not part of what was acquired in the business combination [FAS 141(R).B308; IFRS 3.BC308].

Therefore, consistent with the measurement of the acquisition date value of reacquired rights, the useful life over which the reacquired right is amortised in the postcombination period should be based on the remaining contractual term without consideration of any contractual renewals. In the event of a reissuance of the reacquired right to a third party in the postcombination period, any remaining unamortised amount related to the reacquired right should be included in the determination of any gain or loss upon reissuance [ASC 805-20-35-2; IFRS 3.55].

In some cases, the reacquired right may not have any contractual renewals and the remaining contractual life may not be clear, such as with a perpetual franchise right. An assessment should be made as to whether the reacquired right is an indefinite-lived intangible asset that would not be amortised, but subject to periodic **impairment** testing. If it is determined that the reacquired right is not an indefinite-lived intangible asset, then the reacquired right should be amortised over its economic useful life. See Chapter 10 for guidance on identifying the useful life of an intangible asset.

Example 2-5 illustrates the recognition and measurement of a reacquired right in a business combination.

EXAMPLE 2-5

Recognition and measurement of a reacquired right

Company A owns and operates a chain of retail coffee stores. Company A also licenses the use of its trade name to unrelated third parties through franchise agreements, typically for renewable five-year terms. In addition to on-going fees for cooperative advertising, these franchise agreements require the franchisee to pay Company A an up-front fee and an on-going percentage of revenue for continued use of the trade name.

Company B is a franchisee with the exclusive right to use Company A's trade name and operate coffee stores in a specific market. Pursuant to its franchise agreement, Company B pays to Company A a royalty rate equal to 6% of revenue. Company B does not have the ability to transfer or assign the franchise right without the express permission of Company A.

Company A acquires Company B for cash consideration. Company B has three years remaining on the initial five-year term of its franchise agreement with Company A as of the acquisition date. There is no unfavourable/favourable element of the contract.

Analysis

Company A will recognise a separate intangible asset at the acquisition date related to the reacquired franchise right, which will be amortised over the remaining three-year period. The value ascribed to the reacquired franchise right under the acquisition method should exclude the value of potential renewals. The royalty payments under the franchise agreement should not be used to value the reacquired right, as Company A already owns the trade name and is entitled to the royalty payments under the franchise agreement. Instead, Company A's valuation of the reacquired right should consider Company B's applicable net cash flows after payment of the 6% royalty. In addition to the reacquired franchise rights, other assets acquired and liabilities assumed by Company A should also be measured using a valuation technique that considers Company B's cash flows after payment of the royalty rate to Company A.

2.5.7 *Property, plant, and equipment*

Property, plant, and equipment acquired in a business combination should be recognised and measured at fair value. Accumulated depreciation of the acquiree is not carried forward in a business combination. See BCG 7.7.2 for further information on the measurement of property, plant, and equipment.

2.5.7.1 *Government grants*

Assets acquired with funding from a government grant should be recognised at fair value without regard to the government grant. Similarly, if the government grant provides an ongoing right to receive future benefits, that right should be measured at its acquisition date fair value and separately recognised. For a government grant to be recognised as an asset, the grant should be uniquely available to the acquirer and not dependent on future actions. The terms of the government grant should be evaluated to determine whether there are on-going conditions or requirements that would indicate that a liability exists. If a liability exists, the liability should be recognised at its fair value on the acquisition date.

2.5.7.2 Consideration of decommissioning and site restoration costs

An acquirer may obtain long-lived assets, such as property, plant, and equipment, that upon retirement require the acquirer to dismantle or remove the assets and restore the site on which it is located (i.e., retirement obligations). If a retirement obligation exists, it must be recognised at fair value (using market-participant assumptions), which may be different than the amount recognised by the acquiree. If the fair value of the asset is based on a quoted market price, and that market price implicitly includes the costs that will be incurred in retiring the asset, then the fair value of the asset retirement obligation will need to be added back to the net fair value of the asset.

For example, a nuclear power plant is acquired in a business combination. The acquirer determines that a retirement obligation of CU100 million (fair value) associated with the power plant exists. The appraiser has included the expected cash outflows of the retirement obligation in the cash flow model, establishing the value of the plant at CU500 million. That is, the appraised value of the power plant would be CU100 million higher if the retirement obligation is disregarded. The acquirer would record the power plant at its fair value of CU600 million and a liability of CU100 million for the retirement obligation.

2.5.8 Income taxes

Income taxes are identified as an exception to the recognition and fair value measurement principles. The acquirer should record all **deferred tax assets**, liabilities, and valuation allowances (U.S. GAAP) of the acquiree that are related to any **temporary differences**, tax **carryforwards**, and uncertain tax positions in accordance with ASC 740, *Income Taxes* (ASC 740) or IAS 12, *Income Taxes* (IAS 12), [ASC 805-740-25-2 and ASC 805-740-30-1; IFRS 3.24,25].

Deferred tax liabilities are not recognised for nontax-deductible goodwill under U.S. GAAP or IFRS. However, deferred tax liabilities should be recognised for differences between the book and tax basis of indefinite-lived intangible assets.

Subsequent changes to deferred tax assets, liabilities, valuation allowances, or liabilities for any income tax uncertainties of the acquiree will impact income tax expense in the postcombination period unless the change is determined to be a measurement period adjustment. See BCG 2.9 for further information on measurement period adjustments.

Adjustments or changes to the acquirer's deferred tax assets or liabilities as a result of a business combination should be reflected in earnings [profit or loss] or, if specifically permitted, charged to equity in the period subsequent to the acquisition.

See BCG 5 for further information on the recognition of income taxes and other tax issues.

2.5.9 Recognition of assets held-for-sale

Assets held-for-sale are an exception to the fair value measurement principle, because they are measured at **fair value less costs to sell (FVLCTS**). A long-lived asset [noncurrent asset] or group of assets (**disposal group**) may be classified and measured as assets held-for-sale at the acquisition date if, from the acquirer's perspective, the classification criteria of the following have been met: ASC 360-10, *Property, Plant, and Equipment* (ASC 360-10), for U.S. GAAP, and IFRS 5, *Non-current Assets Held-for-sale and Discontinued Operations* (IFRS 5), for IFRS.

ASC 360-10-45-12 and IFRS 5 provide specific criteria which, if met, would require the acquirer to present newly-acquired assets as assets held-for-sale. The criteria require a plan to dispose of the assets within a year and that it be probable [highly probable] that the acquirer will meet the other held-for-sale criteria within a short period of time after the acquisition date (usually within three months). The other criteria include (1) management having the authority to approve an action commits to sell the assets; (2) assets are available for immediate sale in their present condition, subject only to sales terms that are usual and customary; (3) an active programme to locate a buyer and actions to complete the sale are initiated; (4) assets are being actively marketed; and (5) it is unlikely there will be significant changes to, or withdrawal from, the plan to sell the assets [ASC 360-10-45-9; IFRS 5.7-8]. If the criteria are not met, those assets should not be classified as assets held-for-sale until all applicable criteria have been met. See BCG 10 for further information on accounting for assets held-for-sale under U.S. GAAP.

2.5.10 Employee benefit plans

Employee benefit plans are an exception to the recognition and fair value measurement principles. Employee benefit plan obligations are recognised and measured in accordance with the guidance in applicable U.S. GAAP and IFRS, rather than at fair value [ASC 805-20-25-22; IFRS 3.26]. Applicable guidance under U.S. GAAP and IFRS includes:

- ASC 420, *Exit or Disposal Cost* (ASC 420)
- ASC 710, *Compensation—General* (ASC 710)
- ASC 712, *Compensation—Nonretirement Postemployment Benefits* (ASC 712)
- ASC 715*, Compensation—Retirement Benefits* (ASC 715) [805-20-25-23 through 25-26]
- IAS 19, *Employee Benefits* (IAS 19) [IFRS 3.26]

For companies applying U.S. GAAP, an acquirer should recognise an asset or liability on the acquisition date for the funded status of any single-employer defined-benefit plan sponsored by the acquiree that the acquirer will assume as part of a business combination. These plans include defined-benefit pension plans and other postretirement and postemployment benefit plans. The funded status is measured as the difference between the projected benefit obligation and the fair value of the plan assets. ASC 805 amends ASC 715 to require that when measuring the funded status of these plans, the acquirer exclude the effects of expected amendments, curtailments, or terminations that the acquirer has no obligation to make in connection with the business combination. However, the measurement of the projected benefit obligation (pensions) or accumulated postretirement benefit obligation (postretirement benefits other than pensions) and the fair value of the plan assets on the acquisition date should reflect any other necessary changes in discount rates or other assumptions based on the acquirer's assessment of relevant future events [ASC 805-20-25-23, ASC 805-20-25-25, and ASC 805-20-30-15]. As a result, acquiree balances for unrecognised prior service costs, actuarial gains or losses, or any remaining transition obligations should not be carried forward on the acquisition date.

For U.S. GAAP under ASC 712, some employers may apply the recognition and measurement guidance in ASC 715 to nonretirement postemployment benefit plans (e.g., severance arrangements). In these situations, the ASC 712 plans of an acquiree should be accounted for by the acquirer in a manner similar to the accounting for ASC 715 plans in a business combination.

For multiemployer plans, ASC 805 clarifies that the acquirer recognises a withdrawal liability on the acquisition date under ASC 450 if it is probable at that date that the acquirer will withdraw from a multiemployer plan in which the acquiree participates [ASC 805-20-25-23]. The FASB acknowledged that the provisions for single-employer and multiemployer plans are not necessarily consistent [FAS 141(R).B298].

For IFRS, if a business combination involves the assumption of defined-benefit pension plans or other similar postretirement benefit plans, the acquirer should use the present value of the defined-benefit obligations less the fair value of any plan assets to determine the net employee benefit assets or liabilities to be recognised. Similar to U.S. GAAP, acquiree balances should not be carried forward on the acquisition date.

If there is a net employee-benefit asset, it is recognised only to the extent that it will be available to the acquirer in the form of refunds from the plan or a reduction in future contributions [IAS 19.64(b); IFRIC 14].

Settlements or curtailments are recognised in the measurement of the plan's benefit obligations only if the settlement or curtailment event has occurred by the acquisition date [IAS 19.110]. A settlement occurs when an entity enters into a transaction that eliminates all further legal or constructive obligation for all or part of the benefits provided under a defined-benefit plan [IAS 19.111]. A curtailment occurs when an entity is demonstrably committed to make a material reduction in the number of employees covered by a plan, amends a defined-benefit plan's terms such that a material element of future service by current employees will no longer qualify for benefits or will qualify only for reduced benefits [IAS 19.111]. Consistent with the guidance in IAS 19, it would not be appropriate to recognise a settlement or curtailment on the basis that it was probable. That is, expected settlements or curtailments by the acquirer of the acquiree's plans would not be recognised until the relevant requirements in IAS 19 are met.

Question 2-1

Can modifications to defined benefit pension plans be included as part of the acquisition accounting in a business combination if the modifications are written into the acquisition agreement as an obligation of the acquirer?

PwC response

The Standards generally require employee compensation costs for future services, including pension costs, to be recognised in earnings [profit or loss] in the postcombination period. Modifications to defined benefit pension plans are usually done for the benefit of the acquirer. A transaction that primarily benefits the acquirer is likely to be a separate transaction. Additionally, modifications to a defined benefit pension plan would typically relate to future services of the employees. It is not appropriate to analogize this situation to the exception in the Standards dealing with share-based compensation arrangements. That exception allows the acquirer to include a portion of the fair value based measure of replacement share-based payment awards as consideration in acquisition accounting through an obligation created by a provision written into the acquisition agreement. Such an exception should not be applied to modifications to defined benefit pension plans under the scenario described.

ASC 805-10-55-18 [IFRS 3.B50] provides further interpretive guidance of factors to consider when evaluating what is part of a business combination, such as the reason for the transaction, who initiated the transaction and the timing of the transaction. See BCG 3.2 for further information on accounting for compensation arrangements.

2.5.11 Payables and debt

An acquiree's payables and debt assumed by the acquirer are recognised at fair value in a business combination. Short-term payables may be recorded based on their settlement amounts in most situations since settlement amounts would be expected to approximate fair value. However, the measurement of debt at fair value may result in an amount different from what was recognised by the acquiree before the business combination. See Chapter 7 for further discussion of the measurement of debt at fair value.

Question 2-2

How should unamortized deferred financing costs of the acquiree be accounted for in a business combination?

PwC response

Debt legally assumed by the acquirer in the acquisition should be recorded at fair value, and any existing deferred financing costs would be eliminated. The accounting treatment of the deferred financing costs in the financial statements of the acquiree requires careful consideration, particularly when debt is extinguished in connection with the transaction.

2.5.12 Guarantees

All guarantees assumed in a business combination are recognised at fair value. Under U.S. GAAP, the acquiree may not have recognised all of its guarantees under ASC 460, *Guarantees* (ASC 460), as a result of the standard's transition requirements, which applied prospectively to guarantees issued or modified after 31 December 2002. The transition provision does not apply to business combinations occurring after 31 December 2002 since all assumed guarantees are considered new arrangements for the acquirer. Under ASC 460, an acquirer would relieve the guarantee liability through earnings [profit or loss] using a systematic and rational manner as it is released from risk unless the guarantee is not subject to the recognition provisions of ASC 460 [ASC 460-10-25-1].

IFRS companies would follow IAS 39, *Financial Instruments: Recognition and Measurement* (IAS 39), which requires guarantees to be subsequently accounted for (unless they are measured at fair value with changes in fair value reported through profit or loss, if permitted) at the higher of the amount determined in accordance with IAS 37, and the amount initially recognised less, when appropriate, amortisation recognised in accordance with IAS 18, *Revenue* (IAS 18).

2.5.13 Contingencies

Contingencies are existing conditions, situations, or sets of circumstances resulting in uncertainty about a possible gain or loss that will be resolved if one or more future events occur or fail to occur. The following is a summary of the accounting for acquired contingencies under the Standards.

Summary of accounting for contingencies

U.S. GAAP	Assets and liabilities
Initial accounting (acquisition date):	Record at fair value if the acquisition date fair value can be determined during the measurement period. If the acquisition date fair value cannot be determined during the measurement period, the asset or liability should be recognised at the acquisition date if both of the following criteria are met: □ Information available before the end of the measurement period indicates that it is probable that an asset existed or a liability had been incurred at the acquisition date. It is implicit in this condition that it must be probable at the acquisition date that one or more future events confirming the existence of the asset or liability will occur. □ The amount of the asset or liability can be reasonably estimated. The above recognition criteria should be applied using guidance provided in ASC 450 for the application of the similar criteria in ASC 450-20-25-2. If the above criteria are not met using information that is available during the measurement period about facts and circumstances that existed as of the acquisition date, the acquirer should not recognise an asset or liability at the acquisition date.
Subsequent accounting (postcombination):	If recognised at fair value on the acquisition date, the acquirer should develop a systematic and rational basis for subsequently measuring and accounting for assets and liabilities arising from contingencies depending on their nature. If recorded under ASC 450 on the acquisition date, continue to follow the guidance in ASC 450. If the acquirer does not recognise an asset or liability at the acquisition date because none of the recognition criteria are met, the acquirer should account for such assets or liabilities in accordance with other GAAP, including ASC 450, as appropriate.

Summary of accounting for contingencies

IFRS	Liabilities only
Initial accounting (acquisition date):	Record at fair value if it meets the definition of a present obligation and is reliably measurable. Recognised regardless of whether it is probable that an outflow of resources will be required to settle the obligation.
Subsequent accounting (postcombination):	Recognised at the higher of (1) best estimate or (2) acquisition date fair value less amortisation at the end of each reporting period, with changes in value included in profit or loss until settled.

2.5.13.1 Initial recognition and measurement—U.S. GAAP

Assets acquired and liabilities assumed in a business combination that arise from contingencies will be recognised at fair value at the acquisition date if fair value can be determined during the measurement period.

An acquirer often will have sufficient information to determine the fair value of warranty obligations assumed in a business combination. Generally, an acquirer also has sufficient information to determine the fair value of other contractual contingencies assumed in a business combination, such as penalty provisions in a leasing agreement. In contrast, the fair value of most legal contingencies assumed in a business combination is not likely to be determinable.

If the acquisition date fair value of such assets acquired or liabilities assumed cannot be determined during the measurement period, the asset or liability should be recognised at the acquisition date if both of the following criteria are met:

- Information available before the end of the measurement period indicates that it is probable that an asset existed or a liability had been incurred at the acquisition date. It is implicit in this condition that it must be probable at the acquisition date that one or more future events confirming the existence of the asset or liability will occur.

- The amount of asset or liability can be reasonably estimated.

The above recognition criteria should be applied using guidance provided in ASC 450 for the application of the similar criteria in ASC 450-20-25-2.

If the above criteria are not met based on information that is available during the measurement period about facts and circumstances that existed as of the acquisition date, the acquirer cannot recognise an asset or liability at the acquisition date. In periods after the acquisition date, the acquirer should account for such assets or liabilities in accordance with other GAAP, including ASC 450, as appropriate. Contingent assets generally do not meet the ASC 450 recognition criteria.

2.5.13.2 Subsequent measurement—U.S. GAAP

The acquirer should develop a systematic and rational approach for subsequently measuring and accounting for assets and liabilities arising from contingencies that may have been recognised at fair value on the date of acquisition. The approach should be consistent with the nature of the asset or liability. For example, the method developed for the subsequent accounting for warranty obligations may be similar to methods that have been used in practice to subsequently account for guarantees that are initially recognised at fair value under ASC 460-10-35-2. Judgment is required to determine the method for subsequently accounting for assets and liabilities arising from contingencies. However, it would not be appropriate to recognise an acquired contingency at fair value on the acquisition date and then in the immediate subsequent period value the acquired contingency in accordance with ASC 450, with a resulting gain or loss for the difference. In addition, subsequently measuring an acquired asset or liability at fair value is not considered to be a systematic or rational approach, unless required by other GAAP.

Companies will need to develop policies for transitioning from the initial fair value measurement of assets or liabilities arising from contingencies on the acquisition date to subsequent measurement and accounting at amounts other than fair value, in accordance with other GAAP.

Examples 2-6 to 2-8 illustrate the recognition and measurement of acquired contingencies under three scenarios.

EXAMPLE 2-6

Recognition and measurement of a warranty obligation—fair value can be determined on the acquisition date

On 30 June 20X4, Company A purchases all of Company B's outstanding equity shares for cash. Company B's products include a standard three-year warranty. An active market does not exist for the transfer of the warranty obligation or similar warranty obligations. Company A expects that the majority of the warranty expenditures associated with products sold in the last three years will be incurred in the remainder of 20X4 and in 20X5 and that all will be incurred by the end of 20X6. Based on Company B's historical experience with the products in question and Company A's own experience with similar products, Company A estimates the potential undiscounted amount of all future payments that it could be required to make under the warranty arrangements.

Analysis

Company A has the ability to estimate the expenditures associated with the warranty obligation assumed from Company B as well as the period over which those expenditures will be incurred. Company A would generally conclude that the fair value of the liability arising from the warranty obligation can be determined at the acquisition date and would determine the fair value of the liability to be recognised at the acquisition date by applying a valuation technique prescribed by ASC 820. In the postcombination period, Company A would subsequently account for and measure the warranty obligation using a systematic and rational approach. A consideration in developing such an approach is Company A's historical experience and the expected value of claims in each period as compared to the total expected claims over the entire period.

EXAMPLE 2-7

Recognition and measurement of a litigation related contingency—fair value cannot be determined on the acquisition date

In a business combination, Company C assumes a contingency of Company D related to employee litigation. Based upon discovery proceedings to date and advice from its legal counsel, Company C believes that it is reasonably possible that Company D is legally responsible and will be required to pay damages. Neither Company C nor Company D have had previous experience in dealing with this type of employee litigation, and Company C's attorney has advised that results in this type of case can vary significantly depending on the specific facts and circumstances of the case. An active market does not exist to transfer the potential liability arising from this type of lawsuit to a third party. Company C has concluded that on the acquisition date, and at the end of the measurement period, adequate information is not available to determine the fair value of the lawsuit.

Analysis

A contingent liability for the employee litigation is not recognised at fair value on the acquisition date. Company C would not record a liability by analogy to ASC 450-20-25-2, because it has determined that an unfavourable outcome is reasonably possible, but not probable. Therefore, Company C would recognise a liability in the postcombination period when the recognition and measurement criteria in ASC 450 are met.

EXAMPLE 2-8

Recognition and measurement of a litigation related contingency—decision to settle on the acquisition date

Assume the same fact pattern in Example 2-7 above, except that Company C has decided to pay CU1 million to settle the liability on the acquisition date to avoid damage to its brand or further costs associated with the allocation of resources and time to defend the case in the future.

Analysis

Company C would record the liability on the acquisition date at CU1 million. Company C's decision to pay a settlement amount indicates that it is now probable that Company C has incurred a liability on the acquisition date and that the amount of the liability can be reasonably estimated in accordance with ASC 450.

2.5.13.3 *Contingent liabilities—IFRS*

Contingent liabilities are either possible or present obligations as defined in IAS 37. Possible obligations are obligations that arise from past events whose existence will be confirmed only by the occurrence or nonoccurrence of one or more uncertain future events not wholly within the control of any entity [IFRS 3.22]. Present obligations are legal or constructive obligations that result from a past event [IFRS 3.22].

An acquirer recognises at fair value on the acquisition date all contingent liabilities assumed that are present obligations that also are reliably measurable [IFRS 3.23]. Contingent assets and possible obligations assumed are not recognised by the acquirer on the acquisition date.

In the reporting periods subsequent to the acquisition date, contingencies recognised at the acquisition date are measured at the higher of (1) the amount that would be recognised under IAS 37 (i.e., best estimate) or (2) the amount initially recorded less cumulative amortisation recognised in accordance with IAS 18 [IFRS 3.56].

2.5.14 *Indemnification assets*

Indemnification assets are an exception to the recognition and fair value measurement principles because indemnification assets are recognised and measured differently than other contingent assets. Indemnification assets (sometimes referred to as seller indemnifications) may be recognised if the seller contractually indemnifies, in whole or in part, the buyer for a particular uncertainty, such as a contingent liability or an uncertain tax position.

The recognition and measurement of an indemnification asset is based on the related indemnified item. That is, the acquirer should recognise an indemnification asset at the same time that it recognises the indemnified item, measured on the same basis as the indemnified item, subject to collectibility or contractual limitations on the indemnified amount. Therefore, if the indemnification relates to an asset or a liability that is recognised at the acquisition date and measured at its acquisition date fair value, the acquirer should recognise the indemnification asset at its acquisition date fair value on the acquisition date. If an indemnification asset is measured at fair value, a separate valuation allowance is not necessary because its fair value measurement will reflect any uncertainties in future cash flows resulting from collectibility considerations [ASC 805-20-30-18; IFRS 3.27]. Indemnification assets recognised on the acquisition date (or at the same time as the indemnified item) continue to be measured on the same basis as the related indemnified item subject to collectibility and contractual limitations on the indemnified amount until they are collected, sold, cancelled, or expire in the postcombination period [ASC 805-20-35-4, ASC 805-20-40-3; IFRS 3.57].

Question 2-3

How should a buyer account for an indemnification from the seller when the indemnified item has not met the criteria to be recognised on the acquisition date?

PwC response

The Standards state that an indemnification asset should be recognised at the same time as the indemnified item. Therefore, if the indemnified item has not met the recognition criteria as of the acquisition date, an indemnification asset should not be recognised. If the indemnified item is recognised subsequent to the acquisition, the indemnification asset would then also be recognised on the same basis as the indemnified item subject to management's assessment of the collectibility of the indemnification asset and any contractual limitations on the indemnified amount. This accounting would be applicable even if the indemnified item is recognised outside of the measurement period.

Question 2-4

Does an indemnification arrangement need to be specified in the acquisition agreement to achieve indemnification accounting?

PwC response

Indemnification accounting can still apply even if the indemnification arrangement is the subject of a separate agreement. Indemnification accounting applies as long as the arrangement is entered into on the acquisition date, is an agreement reached between the acquirer and seller, and relates to a specific contingency or uncertainty of the acquired business, or is in connection with the business combination.

Question 2-5

Should acquisition consideration held in escrow for the seller's satisfaction of general representation and warranties be accounted for as an indemnification asset?

PwC response

General representations and warranties would not typically relate to any contingency or uncertainty related to a specific asset or liability of the acquired business. Therefore, in most cases, the amounts held in escrow for the seller's satisfaction of general representations and warranties would not be accounted for as an indemnification asset.

EXAMPLE 2-9

Recognition and measurement of an indemnification asset

As part of an acquisition, the seller provides an indemnification to the acquirer for potential losses from an environmental matter related to the acquiree. The contractual terms of the seller indemnification provide for the reimbursement of any losses greater than CU100 million. There are no issues surrounding the collectibility of the arrangement from the seller. A contingent liability of CU110 million is recognised by the acquirer on the acquisition date using similar criteria to ASC 450-20-25-2 because the fair value of the contingent liability could not be determined during the measurement period. At the next reporting period, the amount recognised for the environmental liability is increased to CU115 million based on new information.

Analysis

The seller indemnification should be considered an indemnification asset and should be recognised and measured on a similar basis as the related environmental contingency. On the acquisition date, an indemnification asset of CU10 million (CU110–CU100), is recognised. At the next reporting period after the acquisition date, the indemnification asset is increased to CU15 million (CU115 less CU100), with the CU5 million adjustment offsetting the earnings [profit or loss] impact of the CU5 million increase in the contingent liability.

2.5.15 Recognition of liabilities related to restructurings or exit activities

Liabilities related to restructurings or exit activities of the acquiree should only be recognised at the acquisition date if they are preexisting liabilities of the acquiree and were not incurred for the benefit of the acquirer. Absent these conditions, including a plan for restructuring or exit activities in the purchase agreement does not create an obligation for accounting purposes to be assumed by the acquirer at the acquisition date. Liabilities and the related expense for restructurings or exit activities that are not preexisting liabilities of the acquiree should be recognised through earnings [profit or loss] in the postcombination period when all applicable criteria of ASC 420 or IAS 37 have been met [ASC 805-20-25-2; IFRS 3.11]. Liabilities related to restructuring or exit activities that were recorded by the acquiree after negotiations to sell the company began should be assessed to determine whether such restructurings or exit activities were done in contemplation of the acquisition for the benefit of the acquirer. If the restructuring activities was done for the benefit of the acquirer, the acquirer should account for the restructuring activities as a separate transaction. Refer to ASC 805-10-55-18 and IFRS 3.B50 paragraph B50 of IFRS 3 for more guidance on separate transactions.

Examples 2-10 and 2-11 illustrate the recognition and measurement of liabilities related to restructuring or exit activities.

EXAMPLE 2-10

Restructuring efforts of the acquiree vs. restructuring efforts of the acquirer

On the acquisition date, an acquiree has an existing liability/obligation related to a restructuring that was initiated one year before the business combination was contemplated. In addition, in connection with the acquisition, the acquirer identified several operating locations to close and selected employees of the acquiree to terminate to realise certain anticipated synergies from combining operations in the postcombination period. Six months after the acquisition date, the obligation for this restructuring action is recognised, as the recognition criteria under ASC 420 and IAS 37 are met.

Analysis

The acquirer would account for the two restructurings as follows:

- Restructuring initiated by the acquiree: The acquirer would recognise the previously recorded restructuring liability at fair value as part of the business combination, since it is an obligation of the acquiree at the acquisition date.

- Restructuring initiated by the acquirer: The acquirer would recognise the effect of the restructuring in earnings [profit or loss] in the postcombination period, rather than as part of the business combination. Since the restructuring is not an obligation at the acquisition date, the restructuring does not meet the definition of a liability and is not a liability assumed in the business combination.

EXAMPLE 2-11

Seller's reimbursement of acquirer's postcombination restructuring costs

The sale and purchase agreement for a business combination contains a provision for the seller to reimburse the acquirer for certain qualifying costs of restructuring the acquiree during the postcombination period. Although it is probable that qualifying restructuring costs will be incurred by the acquirer, there is no liability for restructuring that meets the recognition criteria at the combination date.

Analysis

The reimbursement right is a separate arrangement and not part of the business combination because the restructuring action was initiated by the acquirer for the future economic benefit of the combined entity. The purchase price for the business must be allocated (on a reasonable basis such as relative fair value) to the amount paid for the acquiree and the amount paid for the reimbursement right. The reimbursement right should be recognised as an asset on the acquisition date with cash receipts from the seller recognised as settlements. The acquirer should expense postcombination restructuring costs in its postcombination consolidated financial statements.

2.5.16 Deferred or unearned revenue

The acquirer recognises a liability related to deferred revenue only to the extent that the deferred revenue represents an obligation assumed by the acquirer (i.e., obligation to provide goods, services, or the right to use an asset or some other concession or consideration given to a customer). The liability related to deferred revenue should be based on the fair value of the obligation on the acquisition date, which may differ from the amount previously recognised by the acquiree. See BCG 7.7.7 for further information on deferred or unearned revenue.

2.5.17 Deferred charges arising from leases

The balance sheet of an acquiree before the acquisition date may include deferred rent related to an operating lease. The recognition of deferred rent is the result of the existing accounting guidance to generally recognise lease income (lessor) or expense (lessee) on a straight-line basis if lease terms include increasing or escalating lease payments [ASC 840-20-25-2; IAS 17.33]. The acquirer should not recognise the acquiree's deferred rent using the acquisition method because it does not meet the definition of an asset or liability. The acquirer may record deferred rent starting from the acquisition date in the postcombination period based on the terms of the assumed lease.

Example 2-12 illustrates the recognition of deferred rent in a business combination.

EXAMPLE 2-12

Recognition of deferred rent

On the acquisition date, Company A assumes an acquiree's operating lease. The acquiree is the lessee. The terms of the lease are:

- Four-year lease term
- Lease payments are:
  - Year 1: CU100
  - Year 2: CU200
  - Year 3: CU300
  - Year 4: CU400

On the acquisition date, the lease had a remaining contractual life of two years, and the acquiree had recognised a CU200[1] liability for deferred rent. For the purpose of this example, other identifiable intangible assets and liabilities related to the operating lease are ignored.

Analysis

Company A does not recognise any amounts related to the acquiree's deferred rent liability on the acquisition date. However, the terms of the acquiree's lease will give rise to deferred rent in the postcombination period. Company A will record a deferred rent liability of CU50[2] at the end of the first year after the acquisition.

[1] Deferred rent of the acquiree: straight-line expense of CU500 (((CU100 + CU200 + CU300 + CU400) / 4) x 2 years) less cash payments of CU300 (CU100 + CU200) = CU200.

[2] Deferred rent of the acquirer: straight-line expense of CU350 (((CU300 + CU400) / 2) x 1 year) less cash payments of CU300 (year 3 of lease) = CU50.

Although deferred rent of the acquiree is not recognised in a business combination, the acquirer may recognise an intangible asset or liability related to the lease, depending on its nature or terms. See Chapter 4 for additional guidance on the accounting for leases in a business combination.

2.5.18 Classifying or designating identifiable assets and liabilities

The Standards provide the following principle with regard to classifying or designating the identifiable net assets acquired:

Excerpts from ASC 805-20-25-6 and IFRS 3.15

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

The acquirer must classify or designate identifiable assets acquired, liabilities assumed, and other arrangements on the acquisition date, as necessary, to apply the appropriate accounting in the postcombination period. The classification or designation should be based on all pertinent factors, such as contractual terms, economic conditions, and the acquirer's operating or accounting policies, as of the acquisition date [ASC 805-20-25-6; IFRS 3.15]. The acquirer's designation or classification of an asset or liability may result in accounting different from the historical accounting used by the acquiree. For example:

- **Classifying assets held-for-sale:** As discussed in BCG 2.5.9, the classification of assets held-for-sale is based on whether the acquirer has met, or will meet, all of the necessary criteria.

- **Classifying investments as trading, available for sale, or held to maturity:** Investment securities are classified based on the acquirer's investment strategies and intent in accordance with ASC 320, *Investments—Debt and Equity Securities* (ASC 320), or IAS 39 [ASC 805-20-25-7; IFRS 3.16].

- **Reevaluation of the acquiree's contracts:** The identification of embedded derivatives and the determination of whether they should be recognised separately from the contract is based on the facts and circumstances existing on the acquisition date [ASC 805-20-25-7; IFRS 3.16].

- **Designation and redesignation of the acquiree's precombination hedging relationships**: The decision to apply hedge accounting is based on the acquirer's intent and the terms and value of the derivative instruments to be used as hedges on the acquisition date [ASC 805-20-25-7; IFRS 3.16].

See BCG 2.5.18.1 for further information on the classification or designation of derivatives on the acquisition date.

The Standards provide two exceptions to the classification or designation principle:

- Classification of leases as operating or capital [finance] in accordance with ASC 840, and IAS 17.

- Classification of contracts as an insurance or reinsurance contract or a deposit contract within the scope of ASC 944, *Financial Services—Insurance* (ASC 944), and IFRS 4, *Insurance Contracts* (IFRS 4). See BCG 13 for further information.

The classification of these contracts is based on either the contractual terms and other factors at contract inception or the date (which could be the acquisition date) that a modification of these contracts triggered a change in their classification in accordance with the applicable U.S. GAAP or IFRS [ASC 805-20-25-8; IFRS 3.17].

2.5.18.1 Financial instruments—classification or designation of financial instruments and hedging relationships

An acquiree may have a variety of financial instruments that meet the definition of a derivative instrument. The type and purpose of these instruments will typically depend on the nature of the acquiree's business activities and risk management practices. These financial instruments may have been (1) scoped out of ASC 815, *Derivatives and Hedging* (ASC 815), or IAS 39, (2) used in hedging relationships, (3) used in an "economic hedging relationship," or (4) used in trading operations. Generally, the pre-acquisition accounting for the acquiree's financial instruments is not relevant to the postcombination accounting by the acquirer. Several issues could arise with respect to an acquiree's financial instruments and hedging relationships and the subsequent accounting by the acquiring entity. The key issues are summarised below:

- **Reevaluation of the acquiree's contracts:** All contracts and arrangements of the acquiree need to be reevaluated at the acquisition date to determine if any contracts are derivatives or contain embedded derivatives that need to be separated and accounted for as financial instruments. This includes reviewing contracts that qualify for the normal purchases and sales exception and documenting the basis for making such an election. The determination is made based on the facts and circumstances at the date of the acquisition.

- **Designation and redesignation of the acquiree's precombination hedging relationships:** To obtain hedge accounting for the acquiree's precombination hedging relationships, the acquirer will need to designate hedging relationships anew and prepare new contemporaneous documentation for each. The derivative instrument may not match the newly designated hedged item as closely as it does the acquiree's item.

- **Potential inability to apply the short-cut method—U.S. GAAP:** Previous hedging relationships may not be eligible for the short-cut method because, upon redesignation of the hedging relationship, the derivative instrument will likely have a fair value other than zero (positive or negative) on the acquisition date, which will prevent the hedge from qualifying for the short-cut method.

2.5.19 Long-term construction contracts

An acquiree may have long-term construction contracts that are in process on the acquisition date. These contracts should be recognised at fair value, as defined in ASC 820 [IFRS 13] as. Under ASC 820 [IFRS 13], the price that would be paid (received) to transfer the obligations (rights) to a market-participant should be utilised to measure the contracts at fair value. The fair value of acquired long-term construction contracts is not impacted by the acquiree's method of accounting for the contracts before the acquisition or the acquirer's planned accounting methodology in the postcombination period (i.e., the fair value is determined using market-participant assumptions). Subsequent to the acquisition, the acquirer should account for the acquired contracts in accordance with ASC 605-35, *Construction-Type and Production-Type Contracts* (ASC 605-35) [IAS 11, *Construction Contracts* (IAS 11)]. For U.S. GAAP companies, the method chosen by the acquirer under ASC 605-35 is not an accounting policy election and should be determined based on the facts and circumstances of each contract. Intangible assets and liabilities may also arise from acquired contracts. See Chapter 4 for further discussion of the accounting for contract-related intangible assets.

2.5.19.1 Percentage of completion method

In applying ASC 605-35 [IAS 11], the estimate of the acquired contract's percentage of completion used to recognise revenue and costs should be based upon the acquirer's estimate of the remaining effort required after the acquisition date to complete the contract. Contract-related intangible assets or liabilities recognised in the business combination should be amortised over the remaining term of the contract after acquisition.

2.5.19.2 Completed contract method—U.S. GAAP only

ASC 605-35 requires billings and costs to be accumulated on the balance sheet while the contract is in progress. Once the project is complete, or substantially complete, the revenue and costs of revenue should be recognised. Upon the completion of the project, revenue recognised should equal total billings after the acquisition less the amortisation of the intangible contract asset (or liability). Costs recognised upon contract completion (costs of revenues) should equal costs incurred in the postcombination period. The intangible asset that arises as a result of the delayed revenue and costs of revenue should generally not be amortised until the project is completed. IFRS does not allow for the use of the completed contract method.

2.6 Recognising and measuring goodwill or a gain from a bargain purchase

This section will discuss the computation of goodwill, which continues to be measured as a residual. The computation of bargain purchase gains is discussed in BCG 2.6.2.

2.6.1 Goodwill

Goodwill is an asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognised [ASC 805-10-20; IFRS 3.A]. The amount of goodwill recognised is also impacted by measurement differences resulting from certain assets and liabilities not being recorded at fair value (e.g., income taxes, employee benefits).

The Standards provide the following principle to measure goodwill:

Excerpts from ASC 805-30-30-1 and IFRS 3.32

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

a. The aggregate of the following:

   1. The consideration transferred measured in accordance with this Section [IFRS], which generally requires acquisition-date fair value ([see] paragraph 805-30-30-7 [37])

   2. The fair value [amount] of any noncontrolling interest in the acquiree [measured in accordance with this IFRS; and]

   3. In a business combination achieved in stages [(see paragraphs 41 and 42)], the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree.

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

Goodwill acquired in a business combination is recognised as an asset and is not amortised. Instead, goodwill is subject to annual impairment tests, or more frequently, if there is an indication of impairment, based on the guidance in ASC 350, *Intangibles—Goodwill and Other* (ASC 350), and IAS 36, *Impairment of Assets* (IAS 36). See Chapters 10 and 11 for a discussion of goodwill impairment testing for U.S. GAAP and IFRS companies, respectively.

If the amount calculated under this approach is negative, a bargain purchase may have occurred.

2.6.2 Bargain purchase

Bargain purchases occur if the acquisition date amounts of the identifiable net assets acquired, excluding goodwill, exceed the sum of (1) the value of **consideration transferred**, (2) the value of any noncontrolling interest in the acquiree, and (3) the fair value of any **previously held equity interest** in the acquiree. The Standards require the recognition of a gain for a bargain purchase [ASC 805-30-25-2; IFRS

3.34]. The Boards believe that a bargain purchase represents an economic gain, which should be immediately recognised by the acquirer in earnings [profit or loss] [FAS 141(R).B372; IFRS 3.BC372].

If a bargain purchase is initially identified, the acquirer should reassess whether all of the assets acquired and liabilities assumed have been identified and recognised, including any additional assets and liabilities not previously identified or recognised in the acquisition accounting. Once completed, the acquirer should review the procedures used to measure the following items:

- Identifiable assets acquired and liabilities assumed
- Noncontrolling interest in the acquiree, if any
- Acquirer's previously held equity interest in the acquiree, if any
- Consideration transferred [ASC 805-30-30-5; IFRS 3.36]

The objective of reviewing the above items is to ensure that the measurements used to determine a bargain purchase gain reflect all available information as of the acquisition date [ASC 805-30-30-6; IFRS 3.36]. If after this review, a bargain purchase is still indicated, it should be recognised in earnings [profit or loss] and attributed to the acquirer [ASC 805-30-25-2; IFRS 3.34]. A bargain purchase gain is not recognised as an extraordinary item. The Standards require disclosure of (1) the amount of the gain, (2) the line item where the gain is recognised, and (3) a description of the reasons why the transaction resulted in a bargain purchase gain [ASC 805-30-50-1; IFRS 3.B64(n)].

For example, Company A acquires 100 percent of Company B for CU150 million in cash. The preliminary fair value of the identifiable net assets acquired is CU160 million. After assessing whether all the identifiable net assets have been identified and recognised and reviewing the measurement of (1) those identifiable net assets, and (2) the consideration transferred, Company A adjusted the value of the identifiable net assets acquired to CU155 million. Company A, as part of the acquisition accounting, should recognise a CU5 million bargain purchase gain (CU155–CU150), which is the amount that the acquisition date amounts of the identifiable net assets acquired exceeds the consideration transferred.

2.6.3 Measuring and recognising consideration transferred

Consideration transferred is generally measured at fair value. Consideration transferred is the sum of the acquisition date fair values of the assets transferred, the liabilities incurred by the acquirer to the former owners of the acquiree, and the equity interests issued by the acquirer to the former owners of the acquiree (except for the measurement of share-based payment awards, see BCG 2.6.3.1). Examples of consideration transferred include cash, other assets, contingent consideration, a subsidiary or a business of the acquirer transferred to the seller, common or preferred equity instruments, options, warrants, and member interests of mutual entities [ASC 805-30-30-7; IFRS 3.37].

There may be circumstances where the consideration exchanged in a business combination is only equity interests and the value of the acquiree's equity interests are more reliably measurable than the value of the acquirer's equity interest. This may occur when a private company acquires a public company with a quoted and reliable market price. If so, the acquirer shall determine the amount of goodwill by using the acquisition date fair value of the acquiree's equity interests instead of the acquisition date fair value of the equity interests transferred [ASC 805-30-30-2; IFRS 3.33].

In a business combination that does not involve the transfer of consideration, the fair value of the acquirer's interest in the acquiree (determined by using valuation techniques) should be used in the measurement of goodwill [ASC 805-30-30-3; IFRS 3.33]. See Chapter 7 for a discussion of valuation techniques.

2.6.3.1 Share-based payment awards

An acquirer may exchange its share-based payment awards for awards held by employees of the acquiree. All or a portion of the value of the share-based payment awards may be included in the measurement of consideration transferred, depending upon the various terms and provisions of the awards. Share-based payment awards are identified as a measurement exception because these awards are measured in accordance with ASC 718, *Compensation—Stock Compensation* (ASC 718), for U.S. GAAP, and IFRS 2, *Share-Based Payment* (IFRS 2) for IFRS. Recognition and measurement of share-based payments is discussed further in Chapter 3.

2.6.3.2 Consideration transferred includes other assets and liabilities of the acquirer

Other assets (e.g., nonmonetary assets) and liabilities of the acquirer may be transferred as part of the purchase consideration in some business combinations. If other assets or liabilities of the acquirer are part of the consideration transferred, the difference between the fair value and the carrying value of these other assets or liabilities is typically recognised as a gain or loss in the financial statements of the acquirer at the date of acquisition. However, sometimes the transferred assets or liabilities remain within the combined entity after the business combination (e.g., because the assets or liabilities were transferred to the acquiree rather than to its former owners), and the acquirer, therefore, retains control of them. In that situation, the acquirer shall measure those transferred assets and liabilities at their **carrying amounts** immediately before the acquisition date and shall not recognise a gain or loss in earnings [profit or loss] on assets or liabilities it controls before and after the business combination [ASC 805-30-30-8; IFRS 3.38].

2.6.4 Contingent consideration

Contingent consideration generally represents an obligation of the acquirer to transfer additional assets or equity interests to the selling shareholders if future events occur or conditions are met [ASC 805-10-20; IFRS 3.A]. Contingent consideration can also take the form of a right of the acquirer to the return of previously transferred assets or equity interests from the sellers of the acquired business. It is often used to enable the buyer and seller to agree on the terms of a business combination, even though the ultimate value of the business has not been determined. Any payments made or shares transferred to the sellers of the acquired business should be evaluated to determine whether they should be accounted for separately from the business combination. Contingent consideration that is paid to sellers that remain employed and linked to future services is generally considered compensation cost and recorded in the postcombination period. See BCG 2.6.4.4 and BCG 3 for further information on compensation arrangements.

2.6.4.1 Contingent consideration—U.S. GAAP

Contingent consideration is recognised and measured at fair value as of the acquisition date [ASC 805-30-25-5]. An acquirer's contingent right to receive a return of some consideration paid (i.e., contingently returnable consideration) is recognised as an asset and measured at fair value [ASC 805-30-25-5, ASC 805-30-25-7].

An acquirer's obligation to pay contingent consideration should be classified as a liability or in shareholders' equity in accordance with ASC 480, *Distinguishing Liabilities from Equity* (ASC 480), ASC 815, or other applicable U.S. GAAP [ASC 805-30-25-6]. A contingent consideration arrangement may be a freestanding instrument or an embedded feature within another arrangement.

The accounting for contingent consideration in the postcombination period is impacted by its classification as an asset, liability, or equity, which is determined based on the nature of the instrument. Excluding adjustments to contingent consideration that qualify as measurement period adjustments (see BCG 2.9), accounting for contingent consideration in the postcombination period is as follows:

- **Contingent consideration classified as an asset or liability:** Contingent consideration classified as either an asset or liability is measured initially and subsequently at each reporting date at fair value. Changes in the fair value of contingent consideration are recognised in earnings until the contingent consideration arrangement is resolved.

- **Contingent consideration classified as equity:** Equity-classified contingent consideration is measured initially at fair value on the acquisition date and is not remeasured subsequent to initial recognition. Settlement of the equity-classified contingent consideration is accounted for within equity. In other words, the initial value recognised for an equity-classified contingent consideration arrangement on the acquisition date is not adjusted, even if the fair value of the arrangement on the settlement date is different [ASC 805-30-35-1]. There may be situations where contingent consideration is settled by issuing an entity's own equity securities, but the arrangement is accounted for as a liability. These situations include arrangements that are settled with a variable number of an acquirer's equity shares and that create (1) a fixed obligation known at inception, (2) an obligation, the amount of which varies inversely to changes in the fair value of the acquirer's equity shares, or (3) an obligation, the amount of which varies based on something other than the fair value of the acquirer's equity shares. For example, a fixed monetary amount to be settled in a variable number of shares determined by reference to the share price on the settlement date would be a liability. See BCG 7.7.6 for further information regarding the measurement of share-settled contingent consideration.

Question 2-6

Should acquisition consideration held in escrow for the seller's satisfaction of general representation and warranties be accounted for as contingent consideration?

PwC response

Contingent consideration is defined in ASC 805-10-20 [IFRS 3] as an obligation of the acquirer to transfer additional assets or equity interests to the former owners of an acquiree as part of the exchange for control of the acquiree if specified future events occur or conditions are met. As such, payments for the settlement of consideration based on facts and circumstances that existed on the acquisition date would not meet this definition. Absent evidence to the contrary, general representations and warranties would be expected to be valid as of the acquisition date. Therefore, in most cases, the amounts held in escrow should be included in the acquisition accounting as part of the consideration transferred by the acquirer. In addition, an acquirer should carefully evaluate the legal terms of the escrow arrangement to determine whether it should present the amounts held in escrow as an asset on its balance sheet.

Question 2-7

Should consideration that will be transferred or received based on changes in working capital be considered contingent consideration?

PwC reponse

A working capital adjustment is typically included in a purchase and sale agreement as a means of agreeing on the amount of working capital that existed (and was acquired) on the acquisition date. Similar to general representation and warranty provisions, the subsequent determination of working capital that existed on the acquisition date does not relate to future events or conditions (i.e., events occurring or conditions being met after the acquisition date) and therefore is not contingent consideration. Accordingly, payments or receipts for changes in provisional amounts for working capital would be recognised as an adjustment of consideration transferred by the acquirer in its acquisition accounting.

Determining classification of contingent consideration arrangements between liabilities and equity—U.S. GAAP

A contingent consideration arrangement that is required to be settled in cash or other assets should be classified as a liability. A contingent consideration arrangement that is required to be (or at the issuer's option can be) settled in shares is classified as a liability or as equity. Determining the classification of a contingent consideration arrangement that is expected to be settled in an entity's own shares as a liability or equity at the acquisition date can be complex and will require analysis of the facts and circumstances of each transaction. A company should determine the appropriate classification of a contingent consideration arrangement only after it has evaluated the criteria in ASC 480, ASC 815-40,[1] and ASC 815-40-15.[2] The accounting guidance described below is not meant to establish a hierarchy or specific steps in the decision making process. All appropriate authoritative guidance should be considered in determining the classification of a contingent consideration arrangement.

A financial instrument in the scope of ASC 480 should be classified as a liability. Financial instruments in the scope of ASC 480 are:

- Mandatorily redeemable financial instruments
- Obligations to repurchase the issuer's equity shares by transferring assets
- Obligations to issue a variable number of shares that meet certain criteria

As it relates to the third point, an obligation to issue a variable number of shares relates to a financial instrument that embodies an unconditional obligation, or a financial instrument other than an outstanding share that embodies a conditional obligation, that the issuer must or may settle by issuing a variable number of its equity shares, if, at inception, the monetary value of the obligation is based solely or predominantly[3] on any of the following:

- A fixed monetary amount known at inception, for example, a payable settleable with a variable number of the issuer's equity shares
- Variations in something other than the fair value of the issuer's equity shares, for example, a financial instrument indexed to the S&P 500 and settleable with a variable number of the issuer's equity shares
- Variations inversely related to changes in the fair value of the issuer's equity shares, for example, a written put option that could be net share settled

If a financial instrument is not classified as a liability under ASC 480, it is not automatically classified in shareholders' equity. The financial instrument may be classified as a liability under other U.S. GAAP, such as the guidance in ASC 815, which applies to both freestanding instruments and certain embedded features. If the arrangement is in the scope of ASC 815, it would be considered a derivative instrument and classified as a liability. The arrangement would have the characteristics of a derivative instrument if it (1) has one or more underlyings and notional amounts, (2) has an initial investment that is less by more than a nominal amount[4] than the initial net investment that would be required to acquire the asset

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[1] Originally EITF 00-19.

[2] Originally EITF 07-5.

[3] Our view is that "predominantly" may be interpreted as either a threshold equivalent to "more likely than not" or may be interpreted as a relatively high threshold, provided that once a position is adopted by an entity, the position is applied consistently across all instruments and from period to period.

[4] The FASB did not provide guidance on what constitutes an initial investment that is "less by more than a nominal amount." In practice, however, an initial net investment equal to or less than 90 to 95 percent of the amount that would be exchanged to acquire the asset or incur the obligation would generally satisfy the initial net investment criterion for inclusion as a derivative in the scope of ASC 815. We believe many contingent consideration arrangements would satisfy this criterion.

and (3) can be settled net by means outside the contract such that it is readily convertible to cash (or its terms implicitly or explicitly require or permit net settlement).

Many equity-settled arrangements are in the scope of ASC 815; however, there are exceptions. The primary exception that would impact contingent consideration arrangements is found in ASC 815-10-15-74, which states that arrangements that are both (1) indexed to an entity's own shares and (2) classified in shareholders' equity in the entity's financial statements are not considered derivative instruments and would not be classified as a liability. ASC 815-40-15 provides guidance for determining whether an instrument (or embedded feature) is indexed to an entity's own shares. ASC 815-40 provides guidance for determining whether the instrument (or embedded feature), if indexed to an entity's own shares, should be classified in shareholders' equity.

Determining whether an instrument is indexed to an entity's own shares

In determining whether the instrument (or embedded feature) is indexed to an entity's own shares, ASC 815-40-15 requires an entity to apply a two-step approach. The first step relates to the evaluation of the arrangement's contingent exercise provision. An exercise contingency is a provision that entitles an entity (or counterparty) to exercise an equity-linked financial instrument (or embedded feature) based on changes in the underlying, including the occurrence (or nonoccurrence) of an event. Provisions that permit, accelerate, extend, or eliminate the entity's (or the counterparty's) ability to exercise an instrument are examples of contingent exercise provisions. The second step relates to the evaluation of the arrangement's settlement provisions.

Under the first step of ASC 815-40-15, if the exercise contingency is based on (a) an observable market, other than the market for the entity's own shares, or (b) an observable index, other than one measured solely by reference to the entity's own operations (e.g., revenue, **EBITDA**), then the presence of the exercise contingency precludes an instrument (or embedded feature) from being considered indexed to an entity's own shares.

For example, an exercise contingency based on the price of gold exceeding a certain price over a two-year period would not be considered indexed to the entity's own shares because the price of gold is an observable market, other than the market for the entity's own shares. Another example would be an exercise contingency based on the S&P 500 increasing 500 points within any given calendar year for a three-year period. This arrangement would not be considered indexed to the entity's own shares because the S&P 500 is an observable index other than an index calculated solely by reference to the entity's own operations.

Under the second step of ASC 815-40-15, if the settlement amount equals the difference between the fair value of a fixed number of the entity's equity shares and a fixed monetary amount (or a fixed amount of a debt instrument issued by the entity), then the instrument (or embedded feature) would be considered indexed to an entity's own shares. The settlement amount is not fixed if the terms of the instrument (or embedded feature) allow for any potential adjustments, regardless of the probability of the adjustment being made or whether the entity can control the adjustments. If the instrument's exercise price or the number of shares used to calculate the settlement amount are not fixed, the instrument (or embedded feature) would still be considered indexed to an entity's own shares if the only variables that could affect the settlement amount are variables that are typically used to determine the fair value of a fixed-for-fixed forward or option on equity shares. The fair value inputs of a fixed-for-fixed forward or option on equity shares may include the entity's share price, the exercise price of the instrument, the term of the instrument, expected dividends or other dilutive activities, costs to borrow shares, interest rates, share price volatility, the entity's credit spread, and the ability to maintain a standard hedge position in the underlying shares. If the settlement amount incorporates variables other than those used to determine the fair value of a fixed-for-fixed forward or option on equity shares, or if the instrument (or embedded feature) contains a leverage factor that increases the exposure to an otherwise acceptable additional variable in a manner that is inconsistent with a fixed-for-fixed forward or option on equity shares, then the instrument (or embedded feature) would not be considered indexed to the entity's own shares.

Settlement adjustments designed to protect a holder's position from being diluted will generally not prevent an instrument (or embedded feature) from being considered indexed to the entity's own stock provided the adjustments are limited to the effect that the dilutive event has on the shares underlying the instrument. Adjustments for events such as the occurrence of a stock split, rights offering, dividend, or a spin-off would typically be inputs to the fair value of a fixed-for-fixed forward or option on equity shares.

In most contingent consideration arrangements, the exercise contingency and settlement provisions are likely based on the acquired entity's postcombination performance and not that of the combined entity as a whole. U.S. GAAP does not preclude an instrument from being indexed to the parent's own stock if the instrument's payoff is based, in whole or in part, on the stock of a consolidated subsidiary and that subsidiary is a substantive entity. Similarlyy, an index measured solely by reference to an entity's own operations can be based on the operations of a consolidated subsidiary of the entity.

For arrangements that include more than one performance target, it must be determined whether the **unit of account** is the overall contract or separate contracts for each performance target within that overall contract. To be assessed as separate contracts, each performance target must be readily separable and independent of each other and relate to different risk exposures. The determination of whether the arrangement is separable is made without regard to how the applicable legal agreements document the arrangement (i.e., separate legal agreements entered into at the same time as the acquisition would not necessarily be accounted for as separate contracts). If separable, the contracts for each performance target may then individually result in the delivery of a fixed number of shares and as a result be classified as equity (if all other applicable criteria has been met). Otherwise, the arrangement must be viewed as one contract that results in the delivery of a variable number of shares because the number of shares that will be delivered depends upon which performance target is met. Unless the performance targets are inputs into the fair value of a fixed-for-fixed forward or an option on equity shares (which generally would not be the case), equity classification would be precluded.

Determining whether an instrument indexed to an entity's own shares should be classified in shareholders' equity

ASC 815-40-25 provides guidance for determining whether an instrument (or embedded feature), if indexed to an entity's own shares (and not within the scope of ASC 480), should be classified in shareholders' equity. The criteria for equity classification require that:

- The arrangement permit settlement in unregistered shares, or if the delivery of shares at settlement are registered at the inception of the agreement, that there are no further timely filing or registration requirements of the issuer
- The arrangement contain an explicit limit on the number of shares to be delivered
- The entity has a sufficient number of authorised and unissued shares available to settle the arrangement
- The arrangement not provide the counterparty with rights that rank higher than existing shareholders
- The arrangement not contain any requirements to post collateral at any point for any reason
- The arrangement not contain any restricted cash payments to the counterparty in the event the entity fails to make timely filings with the SEC
- The arrangement not contain any cash settled top-off or make-whole provisions

All of the above noted criteria that are relevant to the instrument must be met before the arrangement could meet the criteria to be classified in shareholders' equity.

A contingent consideration arrangement that meets the criteria in ASC 815-40-15 and ASC 815-40-25 would be classified as equity at the acquisition date (provided it is not in the scope of ASC 480). In addition, the arrangement must be assessed at each financial statement reporting date to determine whether equity classification remains appropriate. If the arrangement no longer meets the criteria for equity classification, it would be reclassified to a liability at its then current fair value.

In practice, equity classification is sometimes precluded because an entity does not have a sufficient number of authorised and unissued shares available to settle its potentially dilutive instruments. In determining whether a sufficient number of authorised shares are available, the entity will need to consider all outstanding potentially dilutive instruments (e.g., warrants, options, convertible instruments, and contingent consideration arrangements). In a situation in which the issuance of a contingent consideration arrangement in the current business combination results in an insufficient number of authorised shares to settle all of the potentially dilutive instruments, the contingent consideration arrangements and/or the other dilutive instruments will require liability classification, depending on the company's policy for allocating authorised shares to the dilutive instruments. Accordingly, the company's policy (e.g., LIFO, FIFO, or proportionate) for determining which derivative instruments or portions of derivative instruments, should be classified or reclassified should there be an overall shortage of available shares will be critical to determining whether the instant arrangement or a previously issued instrument should be classified as a liability.

2.6.4.2 Contingent consideration—IFRS

Contingent consideration is recognised and measured at fair value as of the acquisition date [IFRS 3.39]. An acquirer's contingent right to receive a return of some consideration paid (i.e., contingently returnable consideration) is recognised as an asset and measured at fair value [IFRS 3.40].

An acquirer's obligation to pay contingent consideration should be classified as a liability or equity based on the definition of an equity instrument and a financial liability in IAS No. 32, *Financial Instruments: Presentation* (IAS 32) [IFRS 3.40]. An equity instrument is a contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities [IAS 32.11]. A financial liability is a (1) contractual obligation to deliver cash or another financial instrument or exchange financial assets or liabilities under conditions that are potentially unfavourable; or (2) contract that will or may be settled in its own equity instruments and is a:

- Nonderivative for which an entity is or may be obliged to deliver a variable number of its own equity shares; or
- Derivative that will or may be settled other than by exchange of a fixed amount of cash or another financial asset for a fixed number of its own equity instruments [IAS 32.11].

The accounting for contingent consideration in the postcombination period is impacted by its classification as an asset, a liability, or equity. Excluding adjustments to contingent consideration that qualify as measurement period adjustments (see BCG 2.9), accounting for contingent consideration in the postcombination period is as follows:

- **Contingent consideration classified as a liability or an asset:** Contingent consideration classified as either an asset or a liability (financial or nonfinancial) should be remeasured to fair value at each reporting date and changes in fair value should be included in profit or loss in accordance with IAS 39 or IFRS 9.
- **Contingent consideration classified as equity:** Equity-classified contingent consideration is measured initially at fair value on the acquisition date and is not remeasured subsequent to initial recognition. Settlement of the equity-classified contingent consideration is accounted for within equity. In other words, the initial value recognised for an equity contingent consideration arrangement on the acquisition date is not adjusted, even if the fair value of the arrangement on the settlement date is different [IFRS 3.58].

Determining classification of contingent consideration arrangements between liabilities and equity—IFRS

A contingent consideration arrangement that is required to be settled in cash or other assets should be classified as a liability. There may be situations where a contingent consideration arrangement is settled with an entity's own equity shares, yet the arrangement is accounted for as a liability (e.g., a fixed amount to be paid in a variable number of shares). The classification of contingent consideration under IFRS is based primarily on the following criteria:

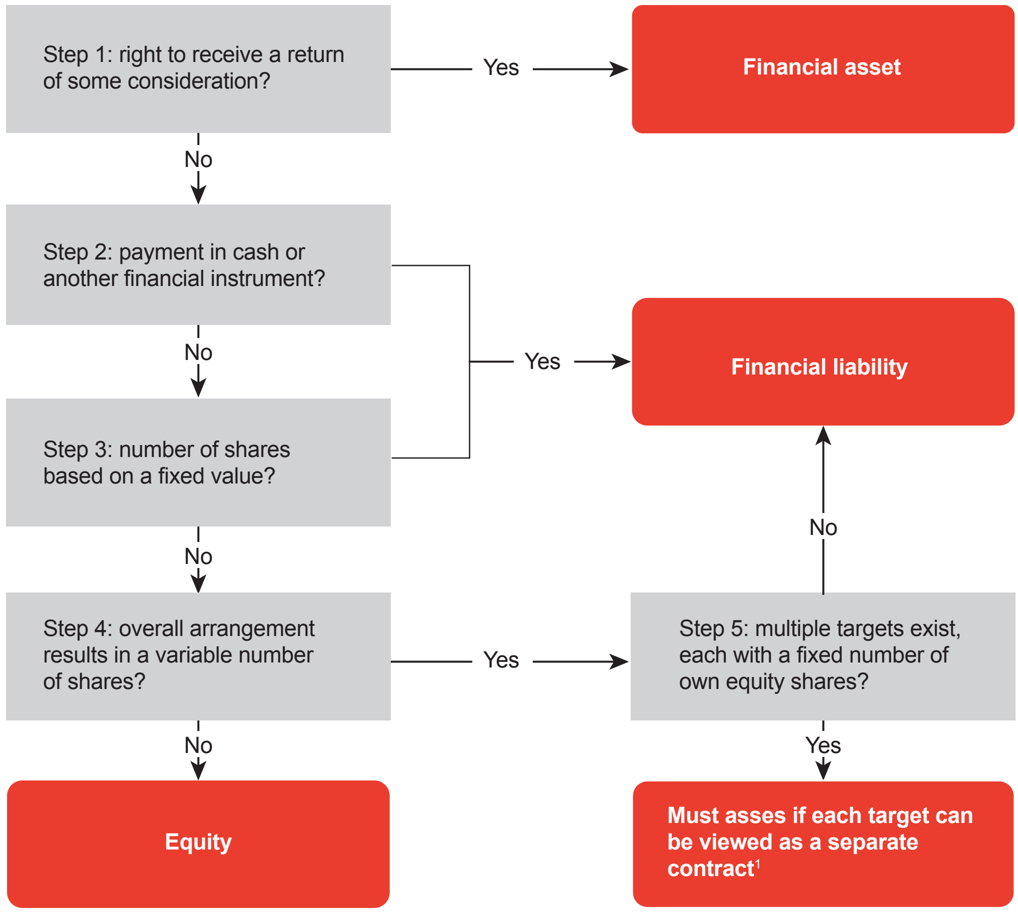
- Contingent consideration arrangements that will be settled in a fixed number of the issuer's equity instruments would be classified as equity. Otherwise, if the arrangement results in the delivery of a variable number of shares, the arrangement would be classified as a liability [IAS 32.16b].

- For arrangements that include more than one performance target, it must be determined whether the unit of account is the overall contract or separate contracts for each performance target within that overall contract. To be assessed as separate contracts, those performance targets must be readily separable and independent of each other and relate to different risk exposures [IAS 39.AG29]. If separable, these contracts may then individually result in the delivery of a fixed number of shares and as a result be classified as equity. Otherwise, the arrangement must be viewed as one contract that results in the delivery of a variable number of shares (and would be classified as a liability) because the number of shares that will be delivered depends upon which performance target is met.

- Equity classification is precluded for contingent consideration arrangements that meet the definition of a derivative if the arrangement has a settlement choice (e.g., net share or net cash), even if it is the issuer's exclusive choice [IAS 32.26].

Figure 2-1 illustrates the framework to determine the classification of contingent consideration arrangements.

Figure 2-1
Contingent consideration classification



[1] Judgment is required to determine whether the unit of account should be the overall contract or separate contracts within the overall arrangement.

2.6.4.3 *Classification of contingent consideration arrangements—U.S. GAAP and IFRS examples*

The examples below consider various contingent consideration arrangements and provide analysis for determining the classification of contingent consideration arrangements as a liability or as equity under U.S. GAAP and IFRS. The examples assume Company A is a public company and would issue the same class of shares as its publicly traded shares if the contingent performance measures are achieved. The analyses below for nonpublic entities under U.S. GAAP would generally be the same, except that most nonpublic companies would not have a means to net cash settle the arrangement outside the contract since their shares are not readily convertible to cash.[5] Without net settlement, the arrangement would not be considered a derivative within the scope of ASC 815. If an arrangement was not considered a derivative due to

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[5] However, our experience is that most contingent consideration arrangements involving nonpublic companies include net settlement provisions within the contract.

physical settlement terms or for any other reason, it would still need to be indexed to the entity's own shares following the guidance in ASC 815-40-15 to be within the scope of ASC 815-40. Only if the arrangement meets the conditions of ASC 815-40 can it be equity classified. Finally, ASC 480-10-65 indefinitely defers the provisions of ASC 480 for nonpublic entities that issue certain mandatorily redeemable securities. However, in most cases we would not expect nonpublic entities to meet the conditions necessary to be able to apply this limited scope exception. For IFRS companies, the analysis in the examples below would not differ, regardless of whether the fact pattern related to public or private companies.

See Examples 2-13 through 2-18 for determining the initial classification of contingent consideration arrangements executed in connection with a business combination.

EXAMPLE 2-13

Issuance of a fixed number of shares based on entity's performance

Company A, a publicly traded company, acquires Company B in a business combination by issuing 1 million of Company A's common shares to Company B's shareholders. Company A also agrees to issue 100,000 additional common shares to the former shareholders of Company B if Company B's revenues (as a wholly owned subsidiary of Company A) exceed CU200 million during the one-year period following the acquisition.

Company A has sufficient authorised and unissued shares available to settle the arrangement after considering all other commitments. The contingent consideration arrangement permits settlement in unregistered shares and meets all of the other criteria required by ASC 815-40 for equity classification. The company has concluded that the unit of account is the contract as a whole, since there is only one performance target.

U.S. GAAP Analysis

The common shares of Company A that have been issued at the acquisition date are recorded at fair value within equity. The contingent consideration arrangement is not within the scope of ASC 480. That is, at inception, the arrangement will not result in the issuance of a variable number of shares and the arrangement does not obligate Company A to transfer cash or other assets to settle the arrangement.

The contingent consideration arrangement meets the characteristics of a derivative because it (1) has one or more underlyings (Company B's revenues and Company A's share price) and notional amount (100,000 common shares), (2) has an initial investment that is "less by more than a nominal amount" than the initial net investment that would be required to acquire the asset, and (3) can be settled net by means outside the contract because the underlying shares are publicly traded with sufficient float so that the shares are readily convertible to cash.

In determining whether the derivative instrument is in the scope of ASC 815, the instrument must be evaluated to determine if it is subject to the exception in ASC 815-10-15-74 (i.e., the arrangement is indexed to an entity's own shares and classified in shareholders' equity). In making determining of whether the arrangement is considered indexed to Company A's own shares, the first step is to determine whether the arrangement is based on an observable market, other than the market for the issuer's shares, or an observable index, other than an index calculated solely by reference to the issuer's operations. The exercise contingency (i.e., meeting the revenue target) is based on an index calculated solely by reference to the "operations" of the issuer's consolidated subsidiary, so step one of ASC 815-40-15 does not preclude the arrangement from being considered indexed to Company A's own shares. In performing step two of ASC 815-40-15, it has been determined that the settlement of the arrangement is considered fixed-for-fixed, since the exercise price is fixed and the number of shares is fixed (i.e., the settlement amount equals the difference between the fair value of a fixed number of the entity's equity shares and a fixed monetary amount).

Based on the analysis performed, the contingent consideration arrangement would be classified as equity.

IFRS Analysis

The ordinary shares of Company A that have been issued at the acquisition date are recorded at fair value within equity. Since the contingent consideration arrangement would result in the issuance of a fixed number of equity shares of Company A, the arrangement would be classified as equity under IAS 32.16.

EXAMPLE 2-14

Issuance of a variable number of shares based on entity's performance—single measurement period

Company A, a publicly traded company, purchases Company B in a business combination by issuing 1 million of Company A's common shares to Company B's shareholders. Company A also agrees to issue 100,000 additional common shares to the former shareholders of Company B if Company B's revenues (as a wholly owned subsidiary of Company A) equal or exceed CU200 million during the one-year period following the acquisition. In addition, if Company's B's revenues exceed CU200 million, Company A will issue an additional 1,000 shares for each CU2 million increase in revenues in excess of CU200 million, not to exceed 100,000 additional shares (i.e., 200,000 total shares for revenues of CU400 million or more).

Company A has sufficient authorised and unissued shares available to settle the arrangement after considering all other commitments. The contingent consideration arrangement permits settlement in unregistered shares and meets all of the other criteria required by ASC 815-40 for equity classification.

U.S. GAAP Analysis

The common shares of Company A that have been issued at the acquisition date are recorded at fair value within equity. The contingent consideration arrangement must first be assessed to determine whether each of the performance targets represents a separate contract. Since the number of Company A shares that could be issued under the arrangement is variable and relates to the same risk exposure (i.e., the number of shares to be delivered will vary depending on which performance target is achieved in the one-year period following the acquisition), the contingent consideration arrangement would be considered one contractual arrangement. The arrangement may be within the scope of ASC 480 since it is an obligation to issue a variable number of shares and it appears to vary based on something other than the fair value of the issuer's equity shares (in this case, based on Company B's revenues). A determination would need to be made as to whether the arrangement's monetary value at inception is based solely or predominately on Company B's revenues (versus Company A's share price), which, if so, would require liability classification. This determination would be based on facts and circumstances, but generally the more substantive (i.e., difficult to achieve) the revenue target the more likely the arrangement is based predominately on the revenue target. If the arrangement is determined to be predominately based on revenues, it would be considered a liability under ASC 480. However, even if the settlement of the variable number of shares was based on revenues, but not predominately, liability classification would still be required because the arrangement would also not meet the second step of ASC 815-40-15 for equity classification. The settlement amount of the contingent consideration arrangement incorporates variables other than those used to determine the fair value of a fixed-for-fixed forward or option on equity shares (i.e., one of the key variables to determine fair value for this contingent consideration arrangement is Company B's revenues). In other words, the amount of revenues not only determines whether the exercise contingency is achieved, but also adjusts the settlement amount after the exercise contingency is met. Therefore, the contingent consideration arrangement would not be considered indexed to Company A's shares because the settlement provisions are affected by the amount of revenues which is not an input in valuing a fixed-for-fixed equity award.

IFRS Analysis

The ordinary shares of Company A that have been issued at the acquisition date are recorded at fair value within equity. The contingent consideration arrangement must first be assessed to determine whether each of the performance targets represents a separate contract. Since the number of Company A's shares that could be issued under the arrangement is variable and relates to the same risk exposure (i.e., the number of shares to be delivered will vary depending on which performance target is achieved in the one-year period following the acquisition), the contingent consideration arrangement would be considered one contractual arrangement under IAS 39.AG29. Since the arrangement will result in the issuance of a variable number of shares, it should be classified as a liability in accordance with IAS 32.11.

EXAMPLE 2-15

Contingent consideration arrangement linked to the acquisition date fair value

Company A, a publicly traded company, acquires Company B in a business combination by issuing 1 million of Company A's common shares to Company B's shareholders. At the acquisition date, Company A's share price is CU40 per share. Company A also provides Company B's former shareholders contingent consideration whereby if the common shares of Company A are trading below CU40 per share one year after the acquisition date, Company A will issue additional common shares to the former shareholders of Company B sufficient to make the current value of the acquisition date consideration equal to CU40 million (i.e., the acquisition date fair value of the consideration transferred). However, the number of shares that can be issued under the arrangement cannot exceed 2 million shares.

Company A has sufficient authorised and unissued shares available to settle the arrangement after considering all other commitments. The contingent consideration arrangement permits settlement in unregistered shares and meets all of the other criteria required by ASC 815-40 for equity classification.

U.S. GAAP Analysis

The common shares of Company A that have been issued at the acquisition date are recorded at fair value within equity. The security price guarantee feature of the contingent consideration arrangement should be assessed to determine whether it is a freestanding feature or whether it is embedded within the shares issued in the business combination. In this instance, the guarantee is a freestanding financial instrument that was entered into in conjunction with the purchase agreement and is legally detachable and separately exercisable. The guarantee arrangement is within the scope of ASC 480 (ASC 480-10-25-14(c)) since, at inception, the guarantee arrangement creates an obligation that Company A would be required to settle with a variable number of Company A's equity shares, the amount of which varies inversely to changes in the fair value of Company A's equity shares. For example, if Company A's share price decreases from CU40 per share to CU35 per share one year after the acquisition date, the amount of the obligation would be CU5 million. Therefore, the freestanding guarantee would be recorded as a liability at its fair value following the guidance in ASC 805-30-25-6 and ASC 480-10-25-8. Further, changes in the liability will be recognised in Company A's earnings until the arrangement is resolved.

IFRS Analysis

The ordinary shares of Company A that have been issued at the acquisition date are recorded at fair value within equity. Since the guarantee feature of the contingent consideration arrangement would result in the issuance of a variable number of equity shares of Company A (i.e., the number of shares to be delivered will vary depending on the issuer's share price), this arrangement should be classified as a liability under IAS 32.11.

EXAMPLE 2-16

Issuance of a variable number of shares based on issuer's share price

Company A, a publicly traded company, purchases Company B in a business combination by issuing 1 million of Company A's common shares to Company B's shareholders. Company A also agrees to issue up to 100,000 additional common shares to the former shareholders of Company B for increases in Company A's share price on the one-year anniversary of the acquisition date (Company A's share price at the acquisition date was CU40). The arrangement specifies that Company A will issue 50,000 additional shares if the share price is equal to or greater than CU45 but less than CU50 or 100,000 additional shares if the share price is equal to or greater than CU50 on the one year anniversary of the acquisition date.

Company A has sufficient authorised and unissued shares available to settle the arrangement after considering all other commitments. The contingent consideration arrangement permits settlement in unregistered shares and meets all of the other criteria required by ASC 815-40 for equity classification. Company A has concluded that the unit of account is one contract with multiple performance targets.

U.S. GAAP Analysis

The common shares of Company A that have been issued at the acquisition date are recorded at fair value within equity. The contingent consideration arrangement is not within the scope of ASC 480 since the obligation to issue a variable number of shares is not based solely or predominantly on any one of the following: (a) a fixed monetary amount known at inception, (b) variations in something other than the fair value of the issuer's equity shares, (c) variations inversely related to changes in the fair value of the Company's equity shares and the arrangement does not obligate the Company to transfer cash or other assets. Although the arrangement may be settled with a variable number of shares, because the number of Company A's (the issuer's) common shares are indexed directly to increases in its own share price, the arrangement would not require liability classification under ASC 480-10-25-14(b).

The contingent consideration arrangement meets the three characteristics of a derivative because it (1) has an underlying (Company A's share price) and notional amount (common shares of Company A), (2) has an initial investment that is "less by more than a nominal amount" than the initial net investment that would be required to acquire the asset and (3) can be settled net by means outside the contract because the underlying shares are publicly traded with sufficient float so that the shares are readily convertible to cash.

In determining whether the derivative instrument is in the scope of ASC 815, the instrument must be evaluated to determine if it is subject to the exception in ASC 815-10-15-74 (i.e., the arrangement is indexed to an entity's own shares and classified in shareholders' equity). In making the determination of whether the arrangement is considered indexed to Company A's own shares, the first step would be to determine whether the arrangement is based on an observable market, other than the market for the issuer's shares, or an observable index, other than an index calculated solely by reference to the issuer's operations. In this case, since the number of shares used to calculate the settlement amount is based upon Company A's share price, step one does not preclude the arrangement from being considered indexed to Company A's own shares. In performing step two under ASC 815-40-15, although settlement of the number of shares is variable, the variable input to the settlement amount is Company A's share price, which is an input for valuing a fixed-for-fixed forward or option on equity shares. Accordingly, the arrangement is considered indexed to Company A's own shares. The arrangement is for the issuance of common shares of Company A which are classified as shareholders' equity.

Based on the analysis performed, the contingent consideration arrangement would be classified as equity.

IFRS Analysis

The ordinary shares of Company A that have been issued at the acquisition date are recorded at fair value within equity. Since the number of Company A's shares that could be issued under the contingent consideration arrangement is variable (i.e., depends on the share price of Company A), the arrangement would be classified as a liability under IAS 32.11.

EXAMPLE 2-17

Issuance of a fixed number of shares based on another entity's operations

Company A, a publicly traded company, acquires Company B in a business combination by issuing 1 million of Company A's common shares to Company B's shareholders. Company A also agrees to issue 100,000 additional common shares to the former shareholders of Company B if Company B's operating revenues (as a wholly owned subsidiary of Company A) exceed Company X's (largest third party competitor) operating revenues by CU1 million at the end of the one-year period following the acquisition.

Company A has sufficient authorised and unissued shares available to settle the arrangement after considering all other commitments. The contingent consideration arrangement permits settlement in unregistered shares and meets all of the other criteria required by ASC 815-40 for equity classification. Company A has concluded that the unit of account is the contract as a whole since there is only one performance target.

U.S. GAAP Analysis

The common shares of Company A that have been issued at the acquisition date are recorded at fair value within equity. The contingent consideration arrangement is not within the scope of ASC 480. That is, at inception the arrangement will not result in the issuance of a variable number of shares and the arrangement does not obligate the Company to transfer cash or other assets to settle the arrangement.

The contingent consideration arrangement meets the characteristics of a derivative because it (1) has one or more underlyings (Company B's operating revenues and Company A's share price) and notional amount (100,000 common shares), (2) has an initial investment that is "less by more than a nominal amount" than the initial net investment that would be required to acquire the asset, and (3) can be settled net by means outside the contract because the underlying shares are publicly traded with sufficient float so that the shares are readily convertible to cash.

In determining whether the derivative instrument is in the scope of ASC 815, the instrument must be evaluated to determine if it is subject to the exception in ASC 815-10-15-74 (i.e., the arrangement is indexed to an entity's own shares and classified in shareholders' equity). In making the determination of whether the arrangement is considered indexed to Company A's own shares, the first step would be to determine whether the arrangement is based on an observable market, other than the market for the issuer's shares, or an observable index, other than an index calculated solely by reference to the issuer's operations. The exercise contingency requires Company B's operating revenues to exceed Company X's (largest third party competitor) operating revenues by CU1 million at the end of the one-year period following the acquisition and, therefore, is based on an index that is not calculated solely by reference to the issuer's operations (i.e., the index is a comparison to Company X's revenues). This precludes the arrangement from being considered indexed to Company A's own shares. Therefore, it is not necessary to perform the second step of ASC 815-40-15.

Since the arrangement is not considered indexed to Company A's own shares under ASC 815-40-15, the arrangement is a liability and should be accounted for as a derivative under the provisions of ASC 815-40.

IFRS Analysis

The ordinary shares of Company A that have been issued at the acquisition date are recorded at fair value within equity. Since the contingent consideration arrangement would result in the issuance of a fixed number of Company A's equity shares, the arrangement would be classified as equity under IAS 32.16 as there is no contractual obligation to deliver a variable number of shares.

EXAMPLE 2-18

Issuance of a variable number of shares based on entity's performance—multiple measurement periods

Company A, a publicly traded company, acquires Company B in a business combination by issuing 1 million of Company A's common shares to Company B's shareholders. Company A also agrees to issue 100,000 common shares to the former shareholders of Company B if Company B's revenues (as a wholly owned subsidiary of Company A) equal or exceed CU200 million during the one-year period following the acquisition. Furthermore, Company A agrees to issue an additional 50,000 common shares to the former shareholders of Company B if Company B's revenues (as a wholly-owned subsidiary of Company A) equal or exceed CU300 million during the second one-year period following the acquisition. The achievement of the earn-outs are independent of each other (i.e., outcomes could be zero, 50,000, 100,000 or 150,000 additional shares issued).

Company A has sufficient authorised and unissued shares available to settle the arrangement after considering all other commitments. The contingent consideration arrangement permits settlement in unregistered shares and meets all of the other criteria required by ASC 815-40 for equity classification.

U.S. GAAP Analysis

The common shares of Company A that have been issued at the acquisition date are recorded at fair value within equity. The contingent consideration arrangement must first be assessed to determine whether each of the performance targets represents a separate contract. Since the year one and year two outcomes are independent and do not relate to the same risk exposures (i.e., the number of shares to be delivered will vary depending on performance targets achieved in independent one-year periods following the acquisition), the arrangement would be treated as two separate contracts that would each result in the delivery of a fixed number of shares, and not as a single contract that would result in the delivery of a variable number of shares. As a result, the arrangement is not within the scope of ASC 480. That is, at inception, the separate arrangements will not result in the issuance of a variable number of shares and do not obligate Company A to transfer cash or other assets to settle the arrangement.

The contingent consideration arrangement meets the characteristics of a derivative because it (1) has one or more underlyings (Company B's revenues and Company A's share price) and a notional amount (common shares of Company A), (2) has an initial investment that is "less by more than a nominal amount" than the initial net investment that would be required to acquire the asset, and (3) can be settled net by means outside the contract because the underlying shares are publicly traded with sufficient float so that the shares are readily convertible to cash.

In determining whether the derivative instruments are in the scope of ASC 815, the instruments must be evaluated to determine if they are subject to the exception in ASC 815-10-15-74 (i.e., the arrangements are indexed to an entity's own shares and classified in shareholders' equity). In making the determination of whether the independent arrangements are considered indexed to Company A's own shares, the first step would be to determine whether each separate, independent contract is based on an observable market, other than the market for the issuer's shares, or an observable index, other than an index calculated solely by reference to the issuer's operations. The exercise contingency is not an observable market or index. The exercise contingency (i.e., meeting the revenue target) is based on an index calculated solely by reference to the "operations" of the issuer's consolidated subsidiary, so step one of ASC 815-40-15 does not preclude the arrangement from being considered indexed to Company A's own shares. In performing the second step of ASC 815-40-15, it has been determined that the settlements for each separate, independent contract would be considered fixed-for-fixed since the exercise price is fixed and the number of shares is fixed (i.e., the settlement amounts are equal to the price of a fixed number of equity shares). The arrangement is for the issuance of the common shares of Company A, which are classified as shareholders' equity.

Based on the analysis performed, each independent contract within the contingent consideration arrangement would be classified as equity.[1]

IFRS Analysis

The ordinary shares of Company A that have been issued at the acquisition date are recorded at fair value within equity. The contingent consideration arrangement must first be assessed to determine whether each of the performance targets represents a separate contract. Since the year one and year two arrangements are independent and relate to different risk exposures under IAS 39.AG29, each performance target can be viewed as a separate contract that would individually result in the issuance of a fixed number of equity shares of Company A. Therefore, each individual contract within the contingent consideration arrangement would be classified as equity under IAS 32.16 as there is no contractual obligation to deliver a variable number of shares.[1]

[1] Judgment is required to determine whether the unit of account should be the overall contract or separate contracts within the overall arrangement. For instance, an arrangement to issue 100,000 shares if revenues equal or exceed CU200 million in the one-year period following the acquisition or 110,000 shares if revenues equal or exceed CU220 million in the one-year and one-month period following the acquisition would likely be considered a single overall contract with multiple performance targets. That is, the performance targets for both the one-year and the one-year and one-month periods are largely dependent on achieving the revenue targets in the first year given the short duration of time (i.e., one month) that elapses between the end of the first period and the end of the second period. If the arrangement (or multiple performance targets) relates to the same risk exposure, the unit of account would be the overall contract rather than two separate, independent contracts.

2.6.4.4 *Contingent consideration arrangements requiring continued employment*

Certain contingent consideration arrangements may be tied to continued employment of the acquiree's employees or the selling shareholders. These arrangements are recognised as compensation expense in the postcombination period. An acquirer should consider the specific facts and circumstances of contingent consideration arrangements with selling shareholders that have no requirement for continuing employment in determining whether the payments represent part of the purchase price or are separate transactions to be recognised as compensation expense in the postcombination period. See Chapter 3 for additional discussion of compensation arrangements.

2.6.4.5 *Existing contingent consideration arrangements of an acquiree—U.S. GAAP*

Contingent consideration arrangements of an acquiree assumed by the acquirer in a business combination should be recognised initially at fair value and subsequently measured in accordance with the guidance for contingent consideration under the existing provisions of ASC 805 regardless of whether the acquiree had accounted for its business combination using the guidance in ASC 805 or prior guidance (i.e., FAS 141). The subsequent acquisition does not change the nature of the contingent consideration arrangement.

The fair value of a contingent consideration arrangement of an acquiree should be determinable because (1) the existing contingent consideration arrangement is inherently part of the economic consideration in the negotiations between the buyer and the seller and (2) most contingent consideration obligations are financial instruments for which fair value can be determined using current valuation techniques.

2.6.4.6 *Existing contingent consideration arrangement of an acquiree—IFRS*

Existing contingent payment arrangements of the acquiree are contingent consideration under IFRS 3. Contingent consideration arrangements of the acquiree would be liabilities (or in some instances, assets) of the acquired business. These arrangements would almost always be established by contract and fall within the scope of IAS 39 and be recognised at fair value on the acquisition date. The subsequent accounting would be driven by the classification of the asset or liability under IAS 39.

2.6.4.7 *Effect of contingent equity issued in a business combination on earnings per share*

When contingent consideration arrangements are in the form of common shares [ordinary shares], the shares are considered contingently issuable shares and may need to be included in the computation of basic and diluted **earnings per share (EPS)** of the combined entity. The EPS guidance for contingently issuable shares is included in ASC 260, *Earnings per Share* (ASC 260), paragraphs ASC 260-10-45-13 and ASC 260-10-45-48 through 45-57, and paragraphs 52–57 of IAS 33, *Earnings Per Share* (IAS 33). Contingently issuable shares (including shares placed in escrow) are shares whose issuance is contingent upon the satisfaction of certain conditions, and are considered outstanding and included in the computation of EPS as follows:

- If all necessary conditions have been satisfied by the end of the period (the events have occurred), those shares must be included in basic and diluted EPS as of the date that such conditions were satisfied.

- If all necessary conditions have not been satisfied by the end of the period, the number of contingently issuable shares is excluded from basic EPS but may be included in the calculation of diluted EPS. The number of contingently issuable shares included in diluted EPS is based on the number of shares, if any, that would be issuable if the end of the reporting period was the end of the contingency period (e.g., the number of shares that would be issuable based on current period earnings [profit or loss] or period-end market price), assuming the effect is dilutive. These contingently issuable shares are included in the denominator of diluted EPS as of the beginning of the period or as of the acquisition date, if later [ASC 260-10-45-48 through 45-50; IAS 33.52].

Figure 2-2 provides guidance on the effect of certain types of contingencies on EPS if all necessary conditions have not been satisfied by the end of the reporting period.

Figure 2-2
EPS guidance for specific types of contingencies

Earnings [profit] contingency	The number of contingently issuable shares depends upon meeting or maintaining a specified amount of earnings [profit or loss]. The diluted EPS computation should include those shares that would be issued under the conditions of the contract based on the actual earnings [profit], if the end of the reporting period was the end of the contingency period and their effect is dilutive. Because the amount of earnings [profit] may change in a future period, basic EPS should not include such contingently issuable shares, because all necessary conditions (i.e., end of the contingency period) have not been satisfied [ASC 260-10-45-51; IAS 33.53].
Market price contingency	The number of contingently issuable shares depends upon the market price of the shares at a future date. The computation of diluted EPS should reflect the number of shares that would be

	issued based on the current market price at the end of the period being reported, if the end of the reporting period were the end of the contingency period and their effect is dilutive. If the condition is based on an average of market prices over some period of time, the average should be used. Because the market price may change in a future period, basic EPS should not include such contingently issuable shares since all necessary conditions (i.e., end of the contingency period) have not been satisfied [ASC 260-10-45-52; IAS 33.54].
Both earnings [profit] and market price contingency	If the number of shares contingently issuable depends on both future earnings [profit] and future market prices of the shares, the determination of the number of shares included in diluted EPS must be based upon both conditions—that is, earnings [profit] to date and current market price—as they exist at the end of the reporting period. Contingently issuable shares should be included in diluted EPS if both conditions are met at the end of the reporting period and the effect is dilutive. Because the amount of earnings [profit] and the market price may change in a future period, basic EPS should not include such contingently issuable shares because all necessary conditions (i.e., end of the contingency period) have not been satisfied [ASC 260-10-45-53; IAS 33.55].
Other performance contingency	If the contingency is based on a condition other than earnings [profit] or market price (e.g., opening a certain number of retail stores), the contingent shares should be included in the computation of diluted EPS, based on the current status of the condition and the assumption that the current status will remain unchanged until the end of the contingency period. Until the condition has been satisfied and the number of shares to be issued is no longer contingent, basic EPS should not include such contingently issuable shares [ASC 260-10-45-54; IAS 33.56].

2.6.4.8 Contingent consideration—seller accounting

Entities may sell a business in a transaction that includes a contingent consideration arrangement.

The seller should determine whether the arrangement meets the definition of a derivative under U.S. GAAP. ASC 815-10-15-83 defines a derivative instrument as a financial instrument or other contract with all of the following characteristics:

ASC 815-10-15-83

A derivative instrument is a financial instrument or other contract with all of the following characteristics:

a. Underlying, notional amount, payment provision. The contract has both of the following terms, which determine the amount of the settlement or settlements, and, in some cases, whether or not a settlement is required:

    1. One or more underlyings

    2. One or more notional amounts or payment provisions or both.

b. Initial net investment. The contract requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.

c. Net settlement. The contract can be settled net by any of the following means:

    1. Its terms implicitly or explicitly require or permit net settlement.

    2. It can readily be settled net by a means outside the contract.

    3. It provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.

If the arrangement meets the definition of a derivative and does not qualify for a scope exception in ASC 815-10-15, it should be recorded at fair value on the acquisition date and subsequently adjusted to fair value each reporting period. It is important to note that the FASB has acknowledged that most contingent consideration arrangements are financial instruments and that many meet the definition of a derivative [FAS 141(R).B349]. However, in practice, contingent consideration arrangements where the underlying is revenue, net income or EBITDA do qualify for the scope exception in ASC 815-10-15-59 (unless the income measure is due predominantly to the movement of the fair value of a portfolio of assets) and would therefore not be accounted for as derivatives.

If the arrangement meets the definition of a derivative but qualifies for a scope exception in ASC 815-10-15 or it does not meet the definition of a derivative, then the seller should make an accounting policy election to either record the contingent consideration portion of the arrangement at fair value at the transaction date, or record the contingent consideration portion of the arrangement when the consideration is determined to be realisable. If the seller elects to record the contingent consideration portion of the arrangement at fair value at the transaction date, the seller must also make an election with respect to the subsequent accounting. The seller may elect the fair value option or account for it as an interest bearing financial instrument.

Under IFRS, a contract to receive contingent consideration that gives the seller the right to receive cash or other financial assets when the contingency is resolved meets the definition of a financial asset. When the contingent consideration arrangement meets the definition of a financial asset, it should be included as part of consideration received and should be measured using one of the four measurement categories specified in IAS 39 [IAS 32.11]. Determining the contingent consideration arrangement's classification will require judgment and will be based on the specific facts and circumstances of each arrangement.

Example 2-19 provides an example of how to account for a contingent consideration arrangement from a seller perspective.

EXAMPLE 2-19

Contingent consideration—seller accounting

Company A sells its entire controlling stake in wholly owned Subsidiary B. The proceeds of the sale include CU150 million in cash paid up front plus contingent payments of 5% of revenue for the next 3 years. Net assets of Subsidiary B were CU100 million. Company A has accounted for the contingent consideration arrangement based on the following information:

- The contingent consideration arrangement does not meet the criteria to be accounted for as a derivative under ASC 815 or IAS 39.
- For U.S. GAAP, the seller can make an accounting policy election to either record the contingent consideration portion of the arrangement at fair value at the transaction date or when the consideration is determined to be realisable. In this example, Company A will account for the contingent consideration arrangement at fair value at the transaction date.
- The fair value of the contingent consideration proceeds as of the disposal date is CU10 million (assessed based on expected sales over the next 3 years of CU70 million in year 1 with a 15% annual growth rate for years 2 and 3 and using a 10% discount rate that does not change over the period of the arrangement).
- At the end of year one, while revenue was equal to the projections for the year, it was determined that the years two and three revenue growth rate would increase to 30%.
- For U.S. GAAP, Company A elects the fair value option for subsequent accounting.
- For IFRS, the contingent consideration arrangement is considered an available for sale debt asset.
- Interest income is recognised using the effective interest method.

Analysis

The following analysis evaluates how Company A should account for the contingent proceeds (excluding the accounting for any tax effects of the transaction).

The journal entry to record the sale of Subsidiary B at the disposal date is as follows (in millions):

Cash	CU150	
Contingent consideration—asset	CU10	
Net assets		CU100
Gain on sale		CU60

Company A records the following journal entries at the end of year one. Similar journal entries would be recorded for years two and three. For ease of illustration, this example assumes that there is a 100% probability of the annual growth rates noted above will be achieved (companies would have to consider multiple scenarios and probability weight each scenario to determine the fair value).

The journal entry to record cash received from the contingent consideration arrangement after year one is as follows (in millions):

Cash (A)	CU3.5	
Contingent consideration—asset		CU3.5

Under U.S. GAAP, the journal entry to record interest income and the remeasurement of contingent consideration due to the change in growth rate expectation for year one is as follows (in millions):

Contingent consideration—asset	CU2.5	
P&L—changes in fair value (B)		CU2.5

Under IFRS, the journal entries to record interest income and the remeasurement of contingent consideration due to the change in growth rate expectation are as follows (in millions):

Contingent consideration—asset	CU1.0	
Interest income (C)		CU1.0
Contingent consideration—asset	CU1.5	
Gain (D)		CU1.5

Expected revenues at sale date (15% growth rate and 10% discount rate):

	Revenue	5% of revenue	Present value
Year 1	CU70.0	CU3.5	CU3.2
Year 2	80.5	4.0	3.3
Year 3	92.6	4.6	3.5
Total		**CU12.1**	**CU10.0**

Expected revenues after year 1 (30% growth rate and 10% discount rate):

	Revenue	5% of revenue	Present value
Year 2	CU91.0	CU4.6	CU4.1
Year 3	118.3	5.9	4.9
Total		**CU10.5**	**CU9.0**

A = CU70 x 5%

B = (CU10 x 10%) + (CU9 – (10 – 3.5 + (CU10 x 10%)))

C = CU10 x 10%

D = CU9 – (10 – 3.5 + 1.0)

If Company A had elected to record the contingent consideration portion of the arrangement when the consideration is determined to be realisable under U.S. GAAP, then Company A would not have recorded a contingent consideration asset at the transaction date and any subsequent proceeds would not be recognised until the contingent consideration asset was realisable.

Under IFRS, since the contingent consideration asset was classified as an available-for-sale debt asset and there are no changes in the market discount rate during the three years, fair value would not differ from amortised cost and therefore there is nothing to recognise in OCI.

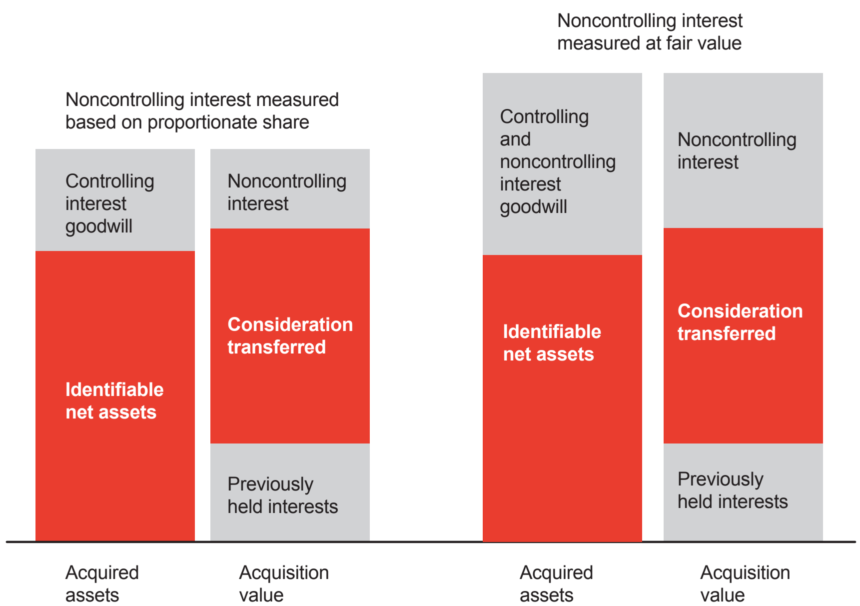
2.6.5 Noncontrolling interest

The noncontrolling interest is the portion of equity (net assets) in a subsidiary not attributable, directly or indirectly, to a **parent** [ASC 810-10-45-15; IFRS 10, Appendix A]. Only financial instruments issued by a subsidiary that are classified as equity in the subsidiary's financial statements for financial reporting purposes can be classified as noncontrolling interest in the **consolidated financial statements** [ASC 810-10-45-17]. A financial instrument that a subsidiary classifies as a liability is not a noncontrolling interest in the consolidated financial statements. However, not all financial instruments that are issued by a subsidiary and classified as equity will be recognised as a noncontrolling interest within equity in consolidation. Certain preferred shares, warrants, puts, calls, and options may not form part of noncontrolling interest within equity in consolidation by the parent company. For example, instruments indexed to a subsidiary's shares issued to investors do not create NCI if those instruments do not meet the requirements for equity classification. See PwC's accounting and financial reporting guide for *Financing transactions* (FG) 2.1 for the analysis of equity-linked instruments. See BCG 6.2 for further information on the guidance to determine whether such instruments are considered noncontrolling interests in consolidation.

For all U.S. GAAP companies, the noncontrolling interest is recognised and measured at fair value on the acquisition date [ASC 805-20-30-1]. IFRS companies, on the other hand, have the option of measuring the noncontrolling interest at fair value or at its proportionate share of the recognised amount of the acquiree's identifiable net assets [IFRS 3.19]. This accounting choice may be made on a transaction-by-transaction basis and does not require a company to make an accounting policy election. See Chapter 6 for additional guidance on the accounting for the noncontrolling interest and Chapter 7 for guidance on measuring the noncontrolling interest at fair value.

The accounting election related to the measurement of the noncontrolling interest in a **partial acquisition** can impact the amount of goodwill recognised under IFRS. However, goodwill is the same for a full or partial acquisition under U.S. GAAP. Figure 2-3 provides a diagram showing the impact of the accounting election on the measurement of goodwill.

Figure 2-3
Measurement of goodwill based on accounting election for the noncontrolling interest under IFRS



2.6.5.1 *Redeemable noncontrolling interest—U.S. GAAP*

U.S. GAAP public companies with securities that are redeemable upon the occurrence of an event that is not solely within the control of the issuer are subject to the guidance issued in ASC 480-10-S99-3A. U.S. GAAP public companies would continue to classify these securities as mezzanine equity in the consolidated financial statements but still consider these securities a noncontrolling interest. As a result, these securities would be subject to the accretion requirements in ASC 480-10-S99-3A in addition to the accounting guidance in ASC 810-10. However, companies should consider the SEC staff's views in ASC 480-10-S99-3A regarding the interaction between that guidance and ASC 810-10. The staff's views:

- Clarify that ASC 480-10-S99-3A applies to the noncontrolling interests that are redeemable or may become redeemable 1) at a fixed or determinable price on a fixed or determinable date, 2) at the option of the holder, or 3) upon occurrence of an event that is not solely within the control of the issuer. This may be a change in practice for certain companies that previously did not accrete noncontrolling interests that meet these criteria.

- Provide guidance for the reclassification of securities to permanent equity if they are no longer required to be classified as mezzanine equity under ASC 480-10-S99-3A.

- Require the measurement of any gains and losses in the deconsolidation of a subsidiary to exclude any accretion included in the carrying amount of the noncontrolling interest.

- Provide guidance for the calculation of EPS if:

  a. **Preferred shares issued or guaranteed by the parent:** Increases or decreases in the carrying amount of the preferred shares should be treated in the same manner as dividends on nonredeemable shares and should be effected by charges against retained earnings or, in the absence of retained earnings, by charges against additional paid-in capital. Increases or decreases in the carrying amount of the preferred shares should reduce or increase income available to common shareholders of the parent.

  b. **Preferred shares issued by the subsidiary:** Increases or decreases in the carrying amount of the preferred shares should be treated in the same manner as dividends on nonredeemable shares and should be effected by charges against retained earnings or, in the absence of retained earnings, by charges against additional paid-in capital. Increases or decreases in the carrying amount of the preferred shares should be attributed to the parent and the noncontrolling interest in accordance with ASC 260-10-55-20 (i.e., attributed to the parent based on its holdings in the subsidiary).

  c. **Common shares:** Increases or decreases in the carrying amount of the common shares should be treated in the same manner as dividends on nonredeemable shares and should be effected by charges against retained earnings or, in the absence of retained earnings, by charges against additional paid-in capital. If the adjustment to the carrying value of the common shares is not fully considered in the attribution of net income to the parent and noncontrolling interest under ASC 810-10-45, application of the two-class method described in ASC 260-10-45-59A at the subsidiary level is necessary to determine net income available to common shareholders of the parent. If the adjustment to the carrying value of the common shares is fully considered in the attribution of net income to the parent and noncontrolling interest under ASC 810-10-45, application of the two-class method is unnecessary.

Generally the guidance in ASC 480-10-S99-3A was effective upon the adoption of ASC 810-10. Although technically not required for non-public entities, mezzanine equity presentation of a redeemable noncontrolling interest is strongly encouraged. For further discussion refer to PwC's accounting and financial reporting guide for *Financial statement presentation* (FSP) 5.

Initial measurement

Upon issuance, redeemable equity securities are generally recorded at fair value. If the securities are issued in conjunction with other non-derivative financial instruments, such as debt or equity instruments, the sales proceeds from the issuance should be allocated to each instrument based on their relative fair values.

Subsequent measurement

The objective in accounting for redeemable equity securities subsequent to issuance is to report the securities at their redemption value no later than the date they become redeemable by the holder.

A discount may arise from a redeemable equity security when it is issued:

- On a stand-alone basis with a fair value less than its redemption value.

- In conjunction with other securities, and the proceeds are allocated between the redeemable equity security and the other securities issued.

A redeemable equity security recorded at an amount less than its redemption value should be accreted to its redemption value in some cases. Accretion of a redeemable equity security is recorded as a deemed dividend, which reduces retained earnings and earnings available to common shareholders in calculating basic and diluted EPS.

- If the equity security is currently redeemable (e.g., at the option of the holder), it should be adjusted to its maximum redemption amount as of each reporting period.

- If the equity security is not currently redeemable and it is probable the instrument will become redeemable, then it should be either (1) accreted to its redemption value over the period from the date of issuance to the earliest redemption date or (2) recognised immediately at its redemption value.

- If the equity security is not currently redeemable (e.g., the contingency that triggers the holder's redemption right has not been met) and it is not probable that it will become redeemable, subsequent adjustment is not necessary until redemption is probable. The parent company should disclose why redemption of the equity security is not probable.

A reduction in the carrying value of a redeemable equity security is appropriate only to the extent the carrying value had previously been increased. Thus, if the redemption price of an instrument decreases, it should not be adjusted below its initial carrying value. An exception to this rule exists for redeemable securities that participate in the earnings of the subsidiary. In that case, the adjustment to the carrying value is determined after the attribution of net income or loss of the subsidiary pursuant to the consolidation procedures in ASC 810.

EXAMPLE 2-20

Adjustment to the carrying value of redeemable equity securities

- Parent Company A acquires 80% of the common shares of Subsidiary B from Company Z. Company Z retains the remaining common shares (20%) in Subsidiary B. As part of the acquisition, Parent Company A and Company Z enter into an agreement that allows Company Z to put its equity interest in Subsidiary B, in its entirety, to Parent Company A for CU100 million.

- The fair value of the noncontrolling interest at the acquisition date is CU100 million.

- Parent Company A concludes that the put option is embedded in the noncontrolling interest (i.e., it is a puttable noncontrolling interest). As a result, the noncontrolling interest is recorded as mezzanine equity because the interest is redeemable at the option of the minority shareholder.

- The put option is immediately exercisable.

- At the end of the first year, Subsidiary B records a net loss of CU50 million. The amount of the net loss attributable to the noncontrolling interest shares is CU50 million x 20% = CU10 million.

- The redemption value of CU100 million does not change as a result of Subsidiary B generating a net loss.

Analysis

Since the redemption value of the noncontrolling interest remains unchanged, the CU10 million net loss attributable to the noncontrolling interest shares should be offset by a deemed dividend to the noncontrolling interest holder. The dividend is deducted from earnings available to common shareholders in calculating Parent Company A's basic and diluted earnings per share.

2.6.6 Calls and puts related to the noncontrolling interest

The entity may have the right to purchase the noncontrolling interest (i.e., a call right) or the noncontrolling interest holder may have the right to sell its interest (i.e., a put right) to the entity. These rights to purchase or sell the noncontrolling interest may be at a fixed or variable price, or at fair value, and may be exercisable on a fixed date or any time at some point in the future. The existence of these rights impacts (1) whether separate assets or liabilities should be recognised for these rights, (2) the classification of any minority ownership as a liability or equity (including mezzanine equity under U.S. GAAP), and (3) the amount of earnings [profit or loss] recognised in the financial statements.

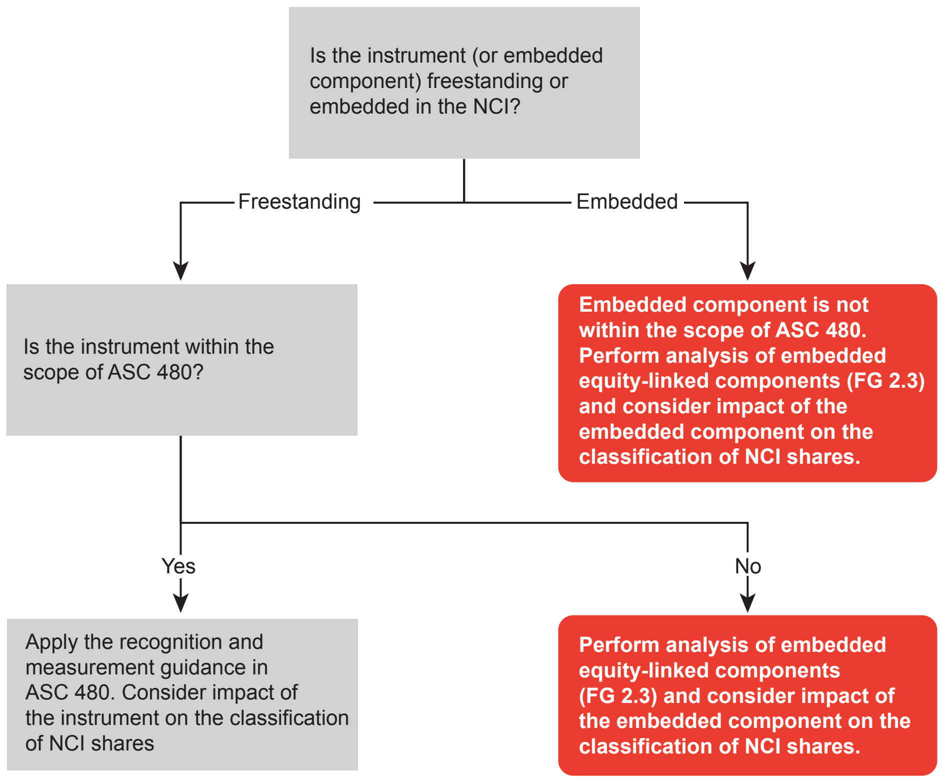
The complexity surrounding the accounting for call and put rights is due to the difficulty in determining whether these rights are accounted for separately or as part of the noncontrolling interest. An in-depth analysis of equity-linked instruments as well as share repurchase contracts can be found in PwC's accounting and financial reporting guide for *Financing transactions* (FG). This section provides an overview of the accounting for options related to the noncontrolling interest with specific references to relevant FG sections.

2.6.6.1 Calls and puts related to the noncontrolling interest—U.S. GAAP

An instrument indexed to the stock of a consolidated subsidiary should be considered indexed to its own stock (provided the subsidiary is a substantive entity) based on the guidance in ASC 815-40-15-5C. This is the case whether an instrument that is executed with a noncontrolling interest holder is entered into by the parent or by the subsidiary. Therefore, the analysis to determine the appropriate accounting treatment for an instrument issued by a parent indexed to the stock of a consolidated subsidiary is similar to the analysis to determine the accounting treatment for an equity-linked instrument on a company's own stock. FG 7 provides an overview of equity-linked instruments.

Figure 2-4 illustrates the steps used to assess whether an instrument indexed to a subsidiary's shares and executed with noncontrolling interest holders is embedded in the noncontrolling interest or is a freestanding instrument.

Figure 2-4
Analysis of instruments indexed to a subsidiary's shares executed with noncontrolling interest holders



Freestanding vs. embedded

To determine the appropriate accounting treatment of an instrument indexed to a subsidiary's shares executed with a noncontrolling interest holder, it is necessary to first determine whether the instrument is freestanding or embedded in the noncontrolling interest. A freestanding financial instrument is defined as:

A financial instrument that meets either of the following conditions:

- It is entered into separately and apart from any of the entity's other financial instruments or equity transactions.
- It is entered into in conjunction with some other transaction and is legally detachable and separately exercisable.

Separately and apart

Factors to consider in determining whether an instrument is entered into separately and apart from the transaction that created the noncontrolling interest include:

- Whether the counterparty to the instrument is unrelated to the noncontrolling interest holder—a counterparty that is unrelated to the noncontrolling interest holder would be an indicator that the instrument was entered into separately and apart from the noncontrolling interest.

- When the counterparty to the instrument is the noncontrolling interest holder, (1) whether the instrument is documented separately from the transaction that gave rise to the noncontrolling interest, and (2) the length of time between the creation of the noncontrolling interest and the execution of the instrument—execution with the noncontrolling interest holder may occur separately and apart from the noncontrolling interest if the instrument is separately documented (and there is no linkage between the two instruments) and there is a reasonable period of time between the transaction that created the noncontrolling interest and the execution of the instrument.

Legally detachable and separately exercisable

Oftentimes an instrument indexed to a subsidiary's shares will be executed in connection with the transaction that created the noncontrolling interest. Thus, in determining whether the instrument is freestanding or embedded, the analysis generally hinges on whether the instrument is legally detachable and separately exercisable.

Figure 2-5 highlights indicators and considerations when determining whether an instrument is legally detachable and separately exercisable from the noncontrolling interest.

Figure 2-5
Embedded vs. freestanding indicators

Indicator	Indicates freestanding	Indicates embedded	Considerations
Transferability of either (1) the shares that represent the NCI or (2) the instrument	Shareholder and/or purchase agreements do *not* limit the transfer of either instrument (i.e., the instrument can be transferred while the underlying shares are retained)	Shareholder and/or purchase agreements *do* limit the transfer of either instrument (i.e., the instrument cannot be transferred without the underlying shares)	Significant indicator if separately transferable; however, not a significant indicator if shares/instrument cannot be separately transferred as stapled/attached securities can still be freestanding
Continued existence of the NCI after the instrument is settled	Instrument can be settled while the NCI remains outstanding	Once the instrument is settled, the NCI is subject to redemption or is no longer outstanding	Significant indicator
Settlement	Instrument can be or is required to be net settled	Instrument can only be settled on a gross physical basis	Significant indicator
Counterparty	If the parent is the counterparty, then from the perspective of the NCI holder the instrument could be viewed as separate from or attached to the NCI	If the subsidiary is the counterparty, then the equity comprising the NCI and the instrument are with the same counterparty. From a consolidated perspective, a subsidiary's equity is also the parent's equity	Not a significant freestanding indicator

Indicator	Indicates freestanding	Indicates embedded	Considerations
Specific shares	The shares that represent the NCI to be delivered upon settlement of the instrument are *not* specifically identified	The shares that represent the NCI to be delivered upon settlement of the instrument are specifically identified	If the shares issued by the subsidiary are not publicly traded, this indicator is less significant because it may not be possible for the NCI holder to obtain the issuer's shares in the open market

Example 2-21 illustrates an example of an embedded put option.

EXAMPLE 2-21

Analysis of put right

Parent Company A acquires 80% of the common shares of Subsidiary B from Company Z. Company Z retains the remaining common shares (20%) in Subsidiary B.

As part of the acquisition, Parent Company A and Company Z enter into an agreement that allows Company Z to put its equity interest in Subsidiary B, in its entirety, to Parent Company A at a fixed price on a specified date. The put option is non-transferrable and terminates if Company Z sells its Subsidiary B shares to a third party.

Analysis

The put option is embedded in the noncontrolling interest recorded in Parent Company A's financial statements because it does not meet either of the conditions of a freestanding financial instrument.

- The put option was executed as part of the acquisition, therefore it was not entered into separately and apart from the transaction that created the noncontrolling interest.
- The put option is not legally detachable and separately exercisable as it is non-transferrable and terminates if Company Z sells its shares.

Accounting for a freestanding instrument executed with noncontrolling interest holders

A freestanding instrument should be accounted for on a separate basis. The appropriate accounting treatment will be determined by the type of instrument and its terms. The issuer should also consider what impact, if any, the freestanding instrument has on the parent company's accounting for the noncontrolling interest. In many cases, the noncontrolling interest continues to be reported in the parent company's financial statements based on the contractual terms of the shares that represent the noncontrolling interest. In other cases, the noncontrolling interest is derecognised and a liability is recognised even though the instrument indexed to the subsidiary's shares is considered freestanding from the noncontrolling interest.

Figure 2-6 summarizes the parent company's accounting treatment for (1) various instruments indexed to a subsidiary's shares and (2) noncontrolling interest.

Figure 2-6
Accounting impacts of freestanding derivatives on NCI shares

Freestanding derivative on NCI shares	Accounting for the instrument(s)	Accounting for NCI
Written put option	Generally, a written put option is recorded at fair value with changes in fair value recorded in earnings.	Recorded as a separate component of equity.
Purchased call option	A purchased call option is recorded at fair value with no subsequent remeasurement if the option meets the requirements for equity classification. A purchased call option is recorded at fair value with subsequent remeasurement in earnings if the option does not meet the requirement for equity classification.	Recorded as a separate component of equity.
Forward-purchase for a fixed number of shares for cash	Generally, physically settled forward-purchase contracts are initially recorded at fair value. If the amount to be paid and the settlement date are fixed, the liability should be accreted to the settlement date payment amount. If the amount to be paid or the settlement date vary, ASC 480 requires the instrument to be remeasured each reporting date. Subsequent remeasurement should be recognised in interest cost.	The NCI is derecognised and a liability is recognised because it is certain that the parent will purchase the remaining shares.
Collar comprised of a purchased call option and a written put option	Generally, a collar is recorded at fair value with changes in fair value recorded in earnings based on the guidance in ASC 480.	Recorded as a separate component of equity.

Freestanding derivative on NCI shares	Accounting for the instrument(s)	Accounting for NCI
Freestanding written put and purchased call	Generally, a written put option and a purchased call option are accounted for separately unless they are economically equivalent to a forward-purchase contract.	Recorded as a separate component of equity.

See FG 2.4, 2.5, 10.2 and 10.3 for further discussion of the accounting treatment for these instruments.

Combination of written put and purchased call options freestanding from the noncontrolling interest

Generally, a written put option and a purchased call option are accounted for separately; however, a written put option and a purchased call option with the same exercise price and exercise dates are economically equivalent to a forward-purchase contract. The accounting treatment of both (1) the instrument and (2) the corresponding noncontrolling interest differ based on whether the options are accounted for separately (i.e., as a written put option and a purchased call option) or in combination (i.e., as a forward-purchase contract). Thus, a parent company should determine whether a written put option and a purchased call option that are freestanding from a noncontrolling interest are also freestanding from each other.

If the written put option and purchased call option with the same exercise price and exercise dates are issued as a single instrument and are freestanding from the noncontrolling interest, the single instrument is economically equivalent to a forward-purchase contract and is recorded as an asset or liability at fair value with changes in fair value recorded in earnings based on the guidance in ASC 480.

As discussed in ASC 480-10-25-15, a freestanding written put option that is accounted for as a liability within the scope of ASC 480 should not be combined with a freestanding purchased call option that is outside the scope of ASC 480. A written put option is recorded as a liability at fair value with changes in fair value recorded in earnings based on the guidance in ASC 480. A purchased call option may be recorded as (1) equity, which is not remeasured, or (2) an asset recorded at fair value with changes in fair value recorded in earnings depending on its terms (see FG 2.4 and 2.5).

Classification of an instrument embedded in a noncontrolling interest

Once the parent company determines that an instrument is embedded in a noncontrolling interest, it should assess whether the agreement meets the requirements to be accounted for separately from the host noncontrolling interest. FG 2.3 provides an analysis of embedded equity-linked components. Frequently, embedded components in a noncontrolling interest are not required to be accounted for as derivatives and thus are not accounted for separately.

If a parent company determines that an embedded component should not be accounted for separately, it should assess whether the embedded component has an impact on the classification of and accounting for the noncontrolling interest shares.

Figure 2-7 summarizes the potential effect that various embedded components may have on the classification of noncontrolling interest shares.

Figure 2-7
Impacts of embedded components on the classification of NCI

Embedded component	Impact on classification of NCI
Written put option	Typically, for public companies, the puttable shares will result in classification as mezzanine equity. See BCG 2.6.5.1 for a discussion of redeemable NCI.
Purchased call option	A purchased call option typically will not affect the classification of the NCI shares.
Forward-purchase	A forward contract embedded in a NCI results in mandatorily redeemable NCI shares. The parent company should eliminate the NCI shares from equity and recognize a liability for the mandatorily redeemable shares. See FG 4 for a discussion of mandatorily redeemable shares.
Collar	The impact of a collar is generally determined by the terms of the options. See written put option and purchased call option discussions above.
Written put and purchased call with the same fixed exercise price and exercise date	Based on the guidance in ASC 480-10-55-59 and 55-60, the written put option and purchased call option should be viewed on a combined basis with the NCI and accounted for as a financing of the parent's purchase of the NCI. The parent consolidates 100% of the subsidiary. The instrument is recorded as a liability and accreted, through interest cost, to the exercise price over the period until settlement.
Written put and purchased call with floating exercise prices	A NCI with an embedded put and purchased call with a floating exercise price is not considered a mandatorily redeemable instrument under ASC 480. Therefore, the NCI shares are contingently redeemable rather than mandatorily redeemable and typically, for public companies, the puttable shares will result in classification as mezzanine equity. See FG 4 for a discussion of contingently redeemable securities.

2.6.6.2 *Calls and puts related to the noncontrolling interest—IFRS*

An acquirer may purchase a call option and/or write a put over a noncontrolling interest in connection with the acquisition of a controlling interest in a business combination. IFRS 3 does not provide guidance on how such contracts should be accounted for in a business combination and there is also a lack of guidance when such contracts are entered into by a parent subsequent to the business combination. In determining the appropriate accounting treatment, IFRS 10, IAS 32 and IAS 39 need to be considered. The main accounting principles are as follows:

- The ownership risks and rewards of the shares relating to the forward or option should be analysed to determine whether they remain with the noncontrolling interest or have transferred to the parent. The noncontrolling interest is recognised to the extent the risks and rewards of ownership of those shares remain with them.

- Irrespective of whether the noncontrolling interest is recognised, a financial liability (redemption liability) is recorded to reflect the forward or put option. All subsequent changes to the liability are recognised in profit or loss. Where the risks and rewards of ownership remain with the noncontrolling interest, the financial liability recognised reduces the controlling interest equity. The noncontrolling interest continues to be recognised and is allocated its share of profits and losses in the normal way. Where significant risks and rewards of ownership reside with the controlling interest, the financial liability recognised is offset against the noncontrolling interest balance:

    - If the liability is greater than the noncontrolling interest (which will generally be the case) the difference is debited to controlling interest equity. This is to avoid the noncontrolling interest becoming negative.

    - If the liability is less than the noncontrolling interest, it is likely that the noncontrolling interest has retained some residual rights, which might be, for example, to future dividends. In this situation, the balance is shown as a noncontrolling interest.

    - Dividends paid to the noncontrolling interest that do not reduce the contracted future purchase price are deducted from the noncontrolling interest carrying value. Profits and losses are allocated to the noncontrolling interest to the extent it is necessary to cover the dividend payment so that the noncontrolling interest does not become negative.

    - If the forward or put option states that dividend payments reduce the contracted future purchase price, then the dividend amount should be deducted from the redemption liability.

Analysis of contract terms

The terms of the forward and option contracts should be analysed to assess whether they provide the parent with access to the economic benefits and risks associated with the actual ownership of the shares during the contract period. The noncontrolling shareholder may have substantially retained the risks and rewards associated with the continued ownership until such time as the contract is settled. Factors to consider in making this assessment include, for example, the pricing of the forward contract or options and whether share price movements during the contract period result in benefits and losses being borne by the parent or by the noncontrolling shareholder.

Typically, forwards or options that will be settled with a transfer of the noncontrolling interest's shares for a fair value price do not result in a transfer of the risks and rewards or ownership to the parent until the contract is settled. However, fixed price forwards do result in a transfer of risks and rewards of ownership of the shares to the parent from the date the contract is written. Written put options with a fixed exercise price that are accompanied by a similarly priced call option, exercisable at the same future date, are similar, in substance, to a fixed price forward. If symmetrical put and call options exist, it is often virtually certain that either the parent or the noncontrolling shareholder will exercise the option given it will be in one of their economic interests to do so. If the share price falls below the fixed exercise price, the noncontrolling shareholder will exercise the put option and sell the shares (that is, the parent has retained the risks of decline in value during the option period). If the share price increases above the fixed exercise price, the parent will exercise the call option and buy the shares (that is, the parent has retained access to the benefits from increases in value during the option period).

Accounting for option and forward contracts related to noncontrolling interests

A noncontrolling interest is recognised in equity to the extent that the risks and rewards of ownership substantially remain with the noncontrolling interest during the contract period. Where all the risks and rewards of ownership have transferred to the parent, a noncontrolling interest is not recognised. If the forward or symmetrical put and call options are entered into at the same time as the business combination and an amount is recognised for noncontrolling interest, in accordance with IFRS 3, it is recorded either at fair value or at its proportionate share of the fair value of identifiable net assets of the subsidiary. If the contracts are entered into subsequent to the date of the business combination, then the noncontrolling interest is derecognised to the extent the risks and rewards of ownership have transferred to the parent.

Evaluating whether the risk and rewards of ownership transfer to the parent or remain with the noncontrolling interest is judgemental and requires consideration of all contracts' terms and conditions. There may also be circumstances when the exercise price of the forward or symmetrical put and call options to acquire the noncontrolling interest is based on a formula that is not akin to a fair value price. These are complex situations, and determining where the risks and rewards of ownership lie depends on the facts and circumstances.

An entity that enters into a contract that contains an obligation for the entity to deliver cash or another financial asset in exchange for its own equity shares is a financial liability [IAS 32.23]. This liability is recorded irrespective of whether that contract meets the definition of an equity instrument. Under a forward contract, the entity has an obligation to deliver cash or a financial asset, but an issue arises as to whether an obligation exists for an entity that enters into a written put option over its own shares.

The financial liability is recognised at the present value of the redemption amount and accreted through finance charges in the income statement over the contract period up to the final redemption amount. Any adjustments to the redemption amount are recognised as finance charges in the income statement in accordance with IAS 39.AG8. The initial redemption liability is a reduction of parent's equity if the risks and rewards of ownership remain with the noncontrolling interest or a reduction of noncontrolling interest equity if the risks and rewards of ownership transfer to the parent. If the present value of the redemption amount exceeds the carrying value of the noncontrolling interest, any excess is recorded against parent's equity.

A noncontrolling interest may receive dividends during the period of the contract. Dividends are deducted from the noncontrolling interest; however, if the dividend amount exceeds the carrying value of the noncontrolling interest, then an allocation of the entity's profits is made to bring the noncontrolling interest to zero. Dividends paid should only reduce the redemption liability if the forward or put and call options stipulate that such payments reduce the exercise price. Profits should be allocated to the noncontrolling interest to the extent they retain risks and rewards of ownership.

If the contract is exercised, any noncontrolling interest equity is allocated to parent equity. No adjustments are made to goodwill upon settlement of the contract. The redemption liability is offset by the cash payment.

If the contract lapses unexercised where the risks and rewards of ownership have transferred to the parent, a noncontrolling interest equity is reinstated. In substance, the parent has sold those shares back to the noncontrolling interest and it is a transaction with a noncontrolling interest. The noncontrolling interest equity amount is reinstated at an amount equal to its share of the carrying values of the subsidiary's net assets at the date of lapse plus the goodwill from the subsidiary's initial acquisition. Any difference between the redemption liability and the noncontrolling interest equity adjustment is recognised against the parent's equity. No adjustments are made to goodwill.

If the contract lapses unexercised where the risks and rewards of ownership remain with the noncontrolling interest, then no adjustment is made to the carrying value of the noncontrolling interest and the redemption liability is derecognised against the parent's equity.

2.6.7 Treatment of a previously held equity interest in an acquiree

The acquirer may hold an equity interest in the acquiree prior to a business combination. The Boards concluded that, on the acquisition date, the acquirer exchanges its status as an owner of an investment in the acquiree for a controlling financial interest of the acquiree and the right to direct and manage its assets and operations [FAS 141(R).B384; IFRS 3.BC384]. The Boards believe this change in control of the previously held equity interest in the acquiree is an economic event that triggers the remeasurement of the investment to fair value.

On the acquisition date, the acquirer recognises a gain or loss in earnings [profit or loss] based on the remeasurement of any previously held equity interest in the acquiree to fair value. If a previously held equity interest had been classified as an available-for-sale security under ASC 320 or IAS 39, prior adjustments to its fair value would have been recognised in other comprehensive income [directly in equity]. In these situations, the amount recognised in other comprehensive income [directly in equity] should be reclassified and included in the calculation of any gain or loss for U.S. GAAP, or recognised on the same basis that would be required if the acquirer had directly disposed of the previously held equity interest for IFRS [ASC 805-10-25-10; IFRS 3.42].

The remeasurement of a previously held equity interest is more likely to result in the recognition of gains, since companies are required to periodically evaluate their investments for impairment. Example 2-22 illustrates the recognition and measurement of a gain on a previously held equity interest in the acquiree in a business combination.

EXAMPLE 2-22

Gain on a previously held equity interest in an acquiree

Company T (acquirer) previously held a 10% equity interest in Company U (acquiree) with an original investment of CU6 million. Company T pays CU90 million in cash for the remaining 90% interest outstanding. The 10% equity interest held in the acquiree is classified as an available-for-sale security. On the acquisition date, the identifiable net assets of the acquiree have a fair value of CU80 million, the 10% equity interest of the acquiree has a fair value of CU10 million, and CU4 million of unrecognised gains related to the previously held equity interest was recorded in other comprehensive income [directly in equity].

Analysis

Excluding any income tax effects, Company T would record the following entry to recognise a gain and the acquisition of Company U (in millions):

Identifiable net assets	CU80	
Goodwill	CU20[1]	
Equity—unrecognised gains	CU4	
Cash		CU90
10% equity interest in acquiree		CU10
Gain		CU4[2]

[1] Goodwill: Fair value of consideration transferred, plus the fair value of the previously held equity interest in acquiree, less identifiable net assets = (CU90 + CU10) – CU80.
[2] Gain: Fair value of previously held equity interest in acquiree, less carrying value of previously held equity interest in acquiree, plus / less amount recognised in other comprehensive income [directly to equity] = CU10 – CU10 + CU4.

2.6.8 *Business combinations achieved without consideration transferred*

Business combinations achieved without consideration transferred should also apply the acquisition method. Business combinations can occur without the transfer of consideration, as control may be obtained through means other than the purchase of equity interests or net assets. As discussed in Chapter 1, business combinations that do not involve a transfer of consideration include a share repurchase by an investee, combinations by contract, and the lapse of minority veto rights.

In a business combination achieved by contract alone, the equity interests in the acquiree held by parties other than the acquirer are the noncontrolling interest in the acquirer's financial statements. This could result in the noncontrolling interest being equal to 100 percent of the acquiree's equity if the acquirer holds no equity interests in the acquiree after the business combination [ASC 805-10-25-12; IFRS 3.44].

2.7 *Assessing what is part of a business combination transaction*

The Standards provide the following principle for determining what is part of a business combination transaction:

Excerpts from ASC 805-10-25-20 and IFRS 3.51

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

The transfer of consideration may be accompanied by other transactions in a business combination. A transaction is likely to be recognised and accounted for separately from a business combination if it is entered into by or on behalf of the acquirer and is primarily for the benefit of the acquirer or the combined entity rather than that of the acquiree or its former owners [ASC 805-10-25-21 through 25-22; IFRS 3.51].

Identifying those transactions that should be accounted for separately from the acquisition can require significant judgment and analysis. The Standards provide three factors to consider that are neither mutually exclusive nor individually conclusive. Those factors are:

Excerpts from ASC 805-10-55-18 and IFRS 3.B50

a. The reasons for the transaction—Understanding the reasons why the parties to the combination (the acquirer, the acquiree, and their owners, directors, managers, and their agents) entered into a particular transaction or arrangement may provide insight into whether it is part of the consideration transferred and the assets acquired or liabilities assumed. For example, if a transaction is arranged primarily for the benefit of the acquirer or the combined entity rather than primarily for the benefit of the acquiree or its former owners before the combination, that portion of the transaction price paid (and any related assets or liabilities) is less likely to be part of the exchange for the acquiree. Accordingly, the acquirer would account for that portion separately from the business combination.

b. Who initiated the transaction—Understanding who initiated the transaction may also provide insight into whether it is part of the exchange for the acquiree. For example, a transaction or other event that is initiated by the acquirer may be entered into for the purpose of providing future economic benefits to the acquirer or combined entity with little or no benefit received by the acquiree or its former owners before the combination. On the other hand, a transaction or arrangement initiated by the acquiree or its former owners is less likely to be for the benefit of the acquirer or combined entity and more likely to be part of the business combination transaction.

c. The timing of the transaction—The timing of the transaction may also provide insight into whether it is part of the exchange for the acquiree. For example, a transaction between the acquirer and the acquiree that takes place during the negotiations of the terms of a business combination may have been entered into in contemplation of the business combination to provide future economic benefits to the acquirer or the combined entity. If so, the acquiree or its former owners before the business combination are likely to receive little or no benefit from the transaction except for benefits they receive as part of the combined entity.

Transactions that are recognised separately from the business combination are accounted for based on the applicable guidance in U.S. GAAP or IFRS. Specific guidance is provided for the following transactions in connection with a business combination:

- Employee compensation arrangements
- Reimbursement provided to the acquiree or former owners for paying the acquirer’s acquisition costs
- Settlement of preexisting relationships between the acquirer and acquiree [ASC 805-10-25-21; IFRS 3.52]

These types of transactions are discussed in the next sections of this chapter.

2.7.1 *Employee compensation arrangements*

Employees of the acquiree may receive **replacement awards** or be provided with other agreements that represent compensation for past services to the acquiree or future services to the combined entity, or both. Employee compensation arrangements should be reviewed to determine what amount, if any, is considered part of the business combination and recognised as a component of consideration transferred. Amounts that are not part of the consideration transferred are recognised separately from a business combination and accounted for in accordance with the applicable U.S. GAAP or IFRS. Additional guidance on the accounting for employee compensation arrangements can be found in Chapter 3.

Examples 2-23 and 2-24 illustrate the accounting treatment for certain employee compensation arrangements that are not recognised as a component of the consideration transferred in a business combination.

EXAMPLE 2-23

Employee compensation arrangements—prefunded retention agreement

Company A acquires Subsidiary B from Company C for CU200 million. As part of the transaction, Company A hires five employees of Subsidiary B who were deemed critical to Subsidiary B's business due to their knowledge and expertise. Also as part of the transaction, Company C agreed to fund an escrow arrangement under which these five individuals would receive a retention bonus aggregating CU15 million if they remain employed by Company A for the three years following the acquisition. If any of the five individuals terminate employment, they forfeit their bonus and these amounts will revert to Company C.

Analysis

The retention arrangement represents compensation for postcombination services rendered to Subsidiary B, even though it is funded by Company C. Accordingly, the retention arrangement is a separate transaction from the business combination and should be reflected as expense in Company A's consolidated financial statements during the three-year employment period to the extent paid to the employees in accordance with ASC 805-10-25-20 [IFRS 3.51]. Therefore, Company A would allocate the amount paid of CU200 million between prepaid compensation and consideration transferred to acquire Subsidiary B.

EXAMPLE 2-24

Agreement conditioned upon a dual trigger consisting of change in control and termination

Company D acquires Company E in a business combination. Company E has an existing employment agreement in place with one of its key employees that states that the employee will be paid CU1 million upon a change of control and termination of employment within 18 months following the acquisition date (sometimes referred to as a "dual trigger"). The employee receives the stated amount only if the employee is subsequently terminated without cause or leaves for good reason as defined in the employment contract. At the date of the business combination, Company D had determined it would not offer employment to the key employee of Company E, effectively terminating employment on the acquisition date, and would pay CU1 million to the former employee of Company E.

Analysis

The termination payment to the employee is only incurred when both of the two conditions outlined in the employment agreement are met (i.e., a change of control and termination of employment). Since the decision to terminate the employee is out of Company E's control, only one of the two conditions is met by Company E at the acquisition date. Therefore, it would not be appropriate for Company E to record a liability in connection with the effective termination of the key employee.

Company D should recognise CU1 million of expense in its postcombination period as a transaction separate from the business combination. As noted above, the payment to the employee is conditioned upon both a change in control of the acquiree and a termination of employment by the acquirer. At the acquisition date, both conditions were triggered. The decision by Company D was made for its own benefit and should be recorded separately from the business combination [ASC 805-10-55-18; IFRS 3.B50]. Therefore, Company D would not record a liability in acquisition accounting but instead would recognise the expense in the period after the business combination.

2.7.2 Reimbursement arrangements between the acquiree and the acquirer for transaction costs incurred

Consistent with the guidance for acquisition costs (see BCG 2.7.5), acquisition costs embedded in the consideration transferred should be accounted for separately from the business combination. For example, consideration transferred by the acquirer that includes amounts to reimburse the acquiree or its former owners for payments made on behalf of the acquirer for its acquisition-related costs should be recognised separately from the business combination. In contrast, costs incurred by an acquiree to sell a business are not acquisition-related costs. Consideration transferred by the acquirer that includes amounts to reimburse the acquiree for the acquiree's costs incurred to sell the business generally would be accounted for by the acquirer as part of the consideration transferred.

2.7.3 Settlement of preexisting relationships between the acquirer and acquiree

A preexisting relationship can be contractual (e.g., vendor and customer, licensor and licensee) or it can be noncontractual (e.g., plaintiff and defendant) [ASC 805-10-55-20; IFRS 3.B51]. The acquirer should identify any preexisting relationships to determine which ones have been effectively settled. Typically, a preexisting relationship will be effectively settled, since such a relationship becomes an "intercompany" relationship upon the acquisition and is eliminated in the postcombination financial statements. Reacquired rights, which also arise from preexisting relationships, are discussed at BCG 2.5.6. The acquirer should recognise a gain or loss if there is an effective settlement of a preexisting relationship [ASC 805-

10-55-21; IFRS 3.B52]. When there is more than one contract or agreement between the parties with a preexisting relationship or more than one preexisting relationship, the settlement of each contract and each preexisting relationship should be assessed separately.

Example 2-25 illustrates the settlement of a preexisting debtor/creditor relationship between an acquirer and acquiree.

EXAMPLE 2-25

Settlement of a preexisting relationship recorded at current market rates

Company A has accounts payable of CU100 to Company B and Company B has accounts receivable of CU100 from Company A. Both the recorded payable and corresponding receivable approximate fair value. Company A acquires Company B for CU2,000 in a business combination.

Analysis

As a result of the business combination, the preexisting relationship between Company A and Company B is effectively settled. No gain or loss was recognised on the settlement as the payable was effectively settled at the recorded amount. Company A should reduce the consideration transferred for the acquisition by CU100 to account for the effective settlement of the payable to Company B.

2.7.3.1 Calculating the gain or loss on settlement of preexisting relationships

The acquirer should recognise a gain or loss for the effective settlement of a preexisting relationship. Settlement gains and losses from noncontractual relationships should be measured at fair value on the acquisition date [ASC 805-10-55-21; IFRS 3.B52].

Settlement gains and losses from contractual relationships should be measured as the lesser of:

a. The amount the contract terms are favourable or unfavourable (from the acquirer's perspective) compared to pricing for current market transactions for the same or similar items. If the contract terms are favourable compared to current market transactions, a settlement gain should be recognised. If the contract terms are unfavourable compared to current market transactions, a settlement loss should be recognised.

b. The amount of any stated settlement provisions in the contract available to the counterparty to whom the contract is unfavourable [ASC 805-10-55-21; IFRS 3.B52]. The amount of any stated settlement provision (e.g., voluntary termination) should be used to determine the settlement gain or loss. Provisions that provide a remedy for events not within the control of the counterparty, such as a change in control, bankruptcy, or liquidation, would generally not be considered a settlement provision in determining settlement gains or losses.

If (b) is less than (a), the difference is included as part of the business combination [ASC 805-10-55-21; IFRS 3.B52]. If there is no stated settlement provision in the contract, the settlement gain or loss is determined from the acquirer's perspective based on the favourable or unfavourable element of the contract.

If the acquirer has previously recognised an amount in the financial statements related to a preexisting relationship, the settlement gain or loss related to the preexisting relationship should be adjusted (i.e., increasing or decreasing any gain or loss) for the amount previously recognised [ASC 805-10-55-21; IFRS 3.B52].

Examples 2-26 through 2-28 reflect the settlement accounting for certain preexisting relationships in a business combination. The examples illustrate the accounting for settlement of a noncontractual relationship, settlement of a contractual relationship that includes a settlement provision, and settlement of a contractual relationship that does not include a settlement provision. Additional examples are provided in the Standards [ASC 805-10-55-30 through 55-33; IFRS 3.IE54-IE57].

EXAMPLE 2-26

Settlement loss with a liability previously recorded on a noncontractual relationship

Company A is a defendant in litigation relating to a patent infringement claim brought by Company B. Company A pays CU50 million to acquire Company B and effectively settles the lawsuit. The fair value of the settlement of the lawsuit is estimated to be CU5 million, and Company A had previously recorded a CU3 million litigation liability in its financial statements before the acquisition.

Analysis

Company A would record a settlement loss related to the litigation of CU2 million, excluding the effect of income taxes. This represents the CU5 million fair value of the settlement after adjusting for the CU3 million litigation liability previously recorded by Company A. The acquisition of Company B and the effective settlement of the litigation are recorded as separate transactions (in millions):

Litigation liability	CU3	
Loss on settlement of lawsuit with Company B	CU2	
Acquired net assets of Company B	CU45	
Cash		CU50

If, however, Company A had previously recorded a liability greater than CU5 million, then a settlement gain would be recognised for the difference between the liability previously recorded and the fair value of the settlement.

EXAMPLE 2-27

Settlement loss on a contractual relationship

Company C provides services to Company D. Since the inception of the contract, the market price for these services has increased. The terms in the contract are unfavourable compared to current market transactions for Company C in the amount of CU10 million. The contract contains a settlement provision that allows Company C to terminate the contract at any time for CU6 million. Company C acquires Company D for CU100 million.

Analysis

Company C would recognise a settlement loss of CU6 million, excluding the effect of income taxes.

A settlement loss of CU6 million is recognised because it is the lesser of the fair value of the unfavourable contract terms (CU10 million) and the contractual settlement provision (CU6 million). The CU100 million in cash paid by Company C is attributed as CU6 million to settle the services contract and CU94 million to acquire Company D. The CU4 million difference between the fair value of the unfavourable contract terms and the contractual settlement provision is included as part of consideration transferred for the business combination. The acquisition of Company D and the effective settlement of the services contract would be recorded as follows (in millions):

Loss on settlement of services contract with Company D	CU6	
Acquired net assets of Company D	CU94	
Cash		CU100

EXAMPLE 2-28

Settlement loss on a contractual relationship when the contract is silent on the amount of the settlement provision

Company E acquires Company F for CU100 million. Company E provides services to Company F. Since the inception of the services contract, the market price for these services has increased. The terms in the contract are unfavourable compared to current market transactions for Company E in the amount of CU10 million. The services contract is silent on a settlement provision in the event that either party terminates the contract.

Analysis

Company E would recognise a CU10 million settlement loss, excluding the effect of income taxes, for the unfavourable amount of the contract. The CU100 million that Company E pays Company F's shareholders is attributed CU10 million to settle the preexisting relationship and CU90 million to acquire Company F. The acquisition of

Company F and the effective settlement of the services contract would be recorded by Company E as follows (in millions):

Loss on settlement of services contract with Company F	CU10	
Acquired net assets of Company F	CU90	
Cash		CU100

2.7.4 *Settlement of debt*

If the preexisting relationship effectively settled is a debt financing issued by the acquirer to the acquiree, the guidance in ASC 470, *Debt* (ASC 470), and IAS 39 should be applied. If debt is settled (extinguished) prior to maturity, the amount paid upon reacquisition of debt may differ from the carrying amount of the debt at that time. An extinguishment gain or loss is recognised in earnings [profit or loss] for the difference between the reacquisition price (fair value or stated settlement amount) and the carrying amount of the debt [ASC 470-50-40-2; IAS 39.41]. For example, if the acquiree has an investment in debt securities of the acquirer with a fair value of CU110 million and the carrying amount of the acquirer's debt is CU100 million, the acquirer would recognise a settlement loss of CU10 million on the acquisition date (based on the assumption that the debt was settled at CU110 million).

If the preexisting relationship effectively settled is a debt financing issued by the acquiree to the acquirer, the acquirer effectively is settling a receivable and would apply the Standards' guidance for settling a preexisting relationship. See BCG 2.7.3.1 for further information.

2.7.5 *Acquisition-related costs*

An acquirer in a business combination typically incurs acquisition-related costs, such as finder's fees; advisory, legal, accounting, valuation, other professional or consulting fees; and general and administrative costs. Acquisition-related costs are considered separate transactions and should not be included as part of the consideration transferred but, rather, expensed as incurred or when the service is received [ASC 805-10-25-23; IFRS 3.53]. These costs are not considered part of the fair value of a business and, by themselves, do not represent an asset. Acquisition-related costs represent services that have been rendered to and consumed by the acquirer.

Costs related to the issuance of debt are capitalised and amortised into earnings [profit or loss] over the term of the debt [ASC 835-30-45-1 through 45-4; IAS 39R.43; IAS 39R.47]. Costs related to the issuance of equity reduce the proceeds received from the issuance.

Question 2-8

Are fees paid to an investment banker to handle the financing of the business combination considered acquisition-related costs?

PwC response

Fees paid to an investment banker in connection with a business combination, when the investment banker is also providing interim financing or underwriting services, must be allocated between direct costs of the acquisition and those related to financing or underwriting the business combination. For example, assume Company A acquired Company B for 70 percent cash and the balance in preferred shares and debt and Company A hired an investment banker to handle the financing and underwriting services. The costs paid to the investment banker should be allocated between those that related to financing or underwriting the business combination (generally recorded as part of the cost of the debt or equity issuance) and all other services that should be expensed as incurred.

Question 2-9

Should transaction costs incurred by the acquirer be reflected in the separate financial statements of the acquiree in a business combination accounted for under ASC 805 ?

PwC response

Under U.S. GAAP, generally no. SAB Topic 1B (Questions 1-2) indicates that the separate financial statements of a subsidiary should reflect any costs of its operations that are incurred by the parent on its behalf. Acquisition-related costs incurred by the acquirer in acquiring the acquiree (e.g., acquisition due diligence fees to assist in determining the purchase price) generally would not benefit the acquiree nor represent part of the acquiree's operations and, therefore, would not be reflected as expense in the separate financial statements of the acquiree.

2.7.6 Financial instruments entered into by the acquirer in contemplation of a business combination

Financial instruments entered into by the acquirer to hedge certain risks in contemplation of a business combination generally should be accounted for as separate transactions apart from the business combination. These contracts are generally not eligible for hedge accounting under U.S. GAAP and IFRS, even though these contracts may effectively hedge various economic risks and exposures related to the transaction. Hedge accounting for a firm commitment to acquire a business is prohibited under ASC 815 and IAS 39, with the exception that IAS 39 does allow companies to achieve hedge accounting for the foreign currency exchange risk embedded in a firm commitment [ASC 815-20-25-12, ASC 815-20-25-43); IAS 39.AG98].

Hedges of other items in contemplation of a business combination (e.g., the forecasted interest expense associated with debt to be issued to fund an acquisition or the forecasted sales associated with the potential acquiree) generally do not qualify for hedge accounting and should be accounted for separately from the business combination. While it may be argued that hedge accounting should be acceptable theoretically, practically it may not be possible to achieve because a forecasted transaction can qualify for hedge accounting under ASC 815 and IAS 39 only if it is probable of occurrence. The ability to support an assertion that a business combination is probable of occurrence and achieve hedge accounting for these types of hedges will be rare given the number of conditions that typically must be met before an acquisition can be consummated (e.g., satisfactory due diligence, no material adverse changes/developments, shareholder votes, regulatory approval). Accordingly, an evaluation of the specific facts and circumstances would be necessary if an entity asserts that a forecasted acquisition is probable of occurrence.

2.8 Example of applying the acquisition method

Example 2-29 provides an example of the general application of the acquisition method in a business combination.

EXAMPLE 2-29

Applying the acquisition method

Company A acquires all of the equity of Company B in a business combination. The company applied the acquisition method based on the following information on the acquisition date:

- Company A pays CU100 million in cash to acquire all outstanding equity of Company B.
- Company A incurs CU15 million of expenses related to the acquisition. The expenses incurred include legal, accounting, and other professional fees.
- Company A agreed to pay CU6 million in cash if the acquiree's first year's postcombination revenues are more than CU200 million. The fair value of this contingent consideration arrangement at the acquisition date is CU2 million.
- The fair value of tangible assets and assumed liabilities on the acquisition date is CU70 million and CU35 million, respectively.
- The fair value of identifiable intangible assets is CU25 million.
- Company A intends to incur CU18 million of restructuring costs by severing employees and closing various facilities of Company B shortly after the acquisition.
- There are no measurement period adjustments.
- Company A obtains control of Company B on the closing date.

Analysis

The following analysis excludes the accounting for any tax effects of the transaction.

Identifying the acquirer (BCG 2.3)

Company A is identified as the acquirer because it acquired all of Company B's equity interests for cash. The acquirer can be identified based on the guidance in ASC 810-10 and IFRS 10.

Determining the acquisition date (BCG 2.4)

The acquisition date is the closing date.

Recognising and measuring the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree (BCG 2.5)

Company A recognises and measures all identifiable assets acquired and liabilities assumed at the acquisition date. There is no noncontrolling interest because Company A acquired all of the equity of Company B. Company A would record the acquired net assets of Company B in the amount of CU60 million (CU95 million of assets less CU35 million of liabilities), excluding goodwill as follows (in millions):

Tangible assets	CU70	
Intangible assets	CU25	
Liabilities		CU35

Company A does not record any amounts related to its expected restructuring activities as of the acquisition date because Company A did not meet the relevant U.S. GAAP or IFRS criteria. The recognition of exit/restructuring costs is recognised in postcombination periods.

Recognising and measuring goodwill or a gain from a bargain purchase (BCG 2.6)

Acquisition costs are not part of the business combination and will be expensed as incurred. Company A would make the following entry to expense acquisition cost as incurred, excluding income tax effects (in millions):

Acquisition costs	CU15	
Cash		CU15

The consideration transferred is CU102 million, which is calculated as follows (in millions):

Cash	CU100
Contingent consideration—liability	2[1]
	CU102

[1] The contingent consideration liability will continue to be measured at fair value in the postcombination period with changes in its value reflected in earnings [profit or loss].

The acquisition results in goodwill because the CU102 million consideration transferred is in excess of the CU60 million identifiable net assets acquired, excluding goodwill, of Company B. Goodwill resulting from the acquisition of Company B is CU42 million and is measured, as follows (in millions):

Total consideration transferred	CU102
Less: acquired net assets of Company B	(60)
Goodwill to be recognised	CU42

2.9 Measurement period adjustments

The Standards provide the following principle for measurement period adjustments:

Excerpts from ASC 805-10-25-13, ASC 805-10-25-14 and IFRS 3.45

If the initial accounting for a business combination is incomplete by the end of the reporting period in which the combination occurs, the acquirer shall report in its financial statements provisional amounts for the items for which the accounting is incomplete. During the measurement period, the acquirer shall retrospectively adjust the provisional amounts recognised at the acquisition date to reflect new information obtained about facts and circumstances that existed as of the acquisition date that, if known, would have affected the measurement of the amounts recognised as of that date.

During the measurement period, the acquirer also shall [shall also] recognise additional assets or liabilities if new information is obtained about facts and circumstances that existed as of the acquisition date that, if known, would have resulted in the recognition of those assets and liabilities as of that date. The measurement period ends as soon as the acquirer receives the information it was seeking about facts and circumstances that existed as of the acquisition date or learns that more information is not obtainable. However, the measurement period shall not exceed a year from the acquisition date.

The acquirer has a period of time, referred to as the measurement period, to finalise the accounting for a business combination. The measurement period provides companies with a reasonable period of time to determine the value of:

- The identifiable assets acquired, liabilities assumed, and any noncontrolling interest in the acquiree.
- The consideration transferred for the acquiree or other amount used in measuring goodwill (e.g., a business combination achieved without consideration transferred).
- The equity interest in the acquiree previously held by the acquirer.
- The goodwill recognised or a bargain purchase gain [ASC 805-10-25-15; IFRS 3.46].

New information that gives rise to a measurement period adjustment should relate to events or circumstances existing at the acquisition date. Factors to consider in determining whether new information obtained gives rise to a measurement period adjustment includes the timing of the receipt of new information and whether the acquirer can identify a reason for the measurement period adjustment. Information obtained shortly after the acquisition date is more likely to reflect facts and circumstances existing at the acquisition date, as opposed to information received several months later [ASC 805-10-30-2 through 30-3; IFRS 3.47].

If a measurement period adjustment is identified, the acquirer is required to recognise the adjustment as part of its acquisition accounting. An acquirer increases or decreases the provisional amounts of identifiable assets or liabilities by means of increases or decreases in goodwill for measurement period adjustments. However, new information obtained during the measurement period sometimes may result in an adjustment to the provisional amounts of more than one asset or liability. In these situations, an adjustment to goodwill resulting from a change to a provisional amount may be offset, in whole or part, by another adjustment to goodwill from a corresponding adjustment to a provisional amount of the other asset or liability [ASC 805-10-25-16; IFRS 3.48].

For example, the acquirer might have assumed a liability to pay damages related to an accident in one of the acquiree's facilities, part or all of which are covered by the acquiree's insurance policy. If the acquirer obtains new information during the measurement period about the acquisition date fair value of that liability, the adjustment to goodwill resulting from a change in the provisional amount recognised for the liability would be offset,in whole or in part, by a corresponding adjustment to goodwill resulting from a change in the provisional amount recognised for the claim receivable from the insurer [ASC 805-10-25-16; IFRS 3.48].

Comparative prior period information included in subsequent financial statements is revised to include the effect of the measurement period adjustment as if the accounting for the business combination had been completed on the acquisition date. The effects of a measurement period adjustment may cause changes in depreciation, amortisation, or other income or expense recognised in prior periods [ASC 805-10-25-17; IFRS 3.49].

All changes that do not qualify as measurement period adjustments are included in current period earnings [profit or loss].

After the measurement period ends, an acquirer should revise its accounting for the business combination only to correct an error in accordance with ASC 250, *Accounting Changes and Error Corrections* (ASC 250), for U.S. GAAP, and IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors* (IAS 8), for IFRS [ASC 805-10-25-19; IFRS 3.50].

Paragraphs ASC 805-10-55-27 through 55-29 and paragraphs IE51–IE53 of IFRS 3 provide an example that illustrates the application of the measurement period guidance where an appraisal is completed after the initial acquisition. Example 2-30 provides an example of the assessment of whether new information gives rise to a measurement period adjustment.

EXAMPLE 2-30

Identifying measurement period adjustments

On 1 January 20X0, Company C acquires Company D. As part of the initial acquisition accounting, Company C recognises CU50 million of goodwill and a CU5 million intangible asset for the customer relationship related to Company D's largest customer. The useful life of the customer relationship is deemed to be four years. On 30 June 20X0, Company D obtains an independent appraisal of the acquisition date fair value of the customer relationship intangible asset. Based on the appraisal, the value of the customer relationship of Company D's largest customer is determined to be CU7 million, with a useful life of four years.

Analysis

The appraisal obtained by Company C in the postcombination period is new information about facts and circumstances existing at the acquisition date. Company C should recognise any difference between the appraisal and the initial acquisition accounting as a measurement period adjustment. In the 30 June 20X0 financial statements, Company D makes the following measurement period adjustments to adjust the year-to-date financial information, excluding income tax effects (in millions):

Customer relationship	CU2	
Goodwill		CU2
To adjust for the increase in value of the customer relationship		
Amortisation expense	CU0.25[1]	
Customer relationship		CU0.25

[1] Incremental amortisation expense: amortisation expense based on appraised value, less amortisation expense based on initial value = CU0.875 or 6 months / 48 total months x CU7 less CU0.625 or 6 months / 48 total months x CU5.

To adjust the six-month amortisation expense to reflect the incremental value assigned to the customer relationship

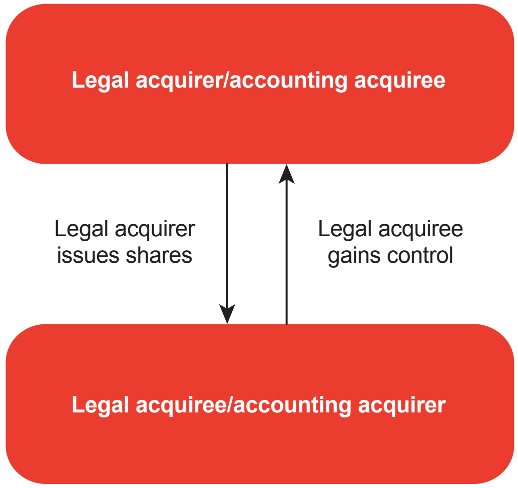
When subsequently presented, the financial statements for the quarter ended 31 March 20X0 should be adjusted to include the impact of the measurement period adjustment. The results of operations would reflect the amortisation expense of the intangible asset as if the adjustment had been recorded on the acquisition date.

2.10 Reverse acquisitions

Reverse acquisitions (reverse mergers) present unique accounting and reporting considerations. Depending on the facts and circumstances, these transactions can be **asset acquisitions**, capital transactions, or business combinations. See BCG 8.2.1.1 for further information on the accounting for when a new parent is created for an existing entity or group of entities. A reverse acquisition that is a business combination can occur only if the accounting acquiree meets the definition of a business under the Standards. An entity that is a reporting entity, but not a legal entity, could be considered the accounting acquirer in a reverse acquisition. Like other business combinations, reverse acquisitions must be accounted for using the acquisition method.

A reverse acquisition occurs if the entity that issues securities (the legal acquirer) is identified as the acquiree for accounting purposes and the entity whose equity interests are acquired (legal acquiree) is the acquirer for accounting purposes. For example, a private company wishes to go public but wants to avoid the costs and time associated with a public offering. The private company arranges to be legally acquired by a publicly listed company that is a business. However, after the transaction, the owners of the private company will have obtained control of the public company and would be identified as the accounting acquirer under the Standards [ASC 805-40-05-2, ASC 805-40-25-1 and ASC 805-40-30-1; IFRS 3.B19]. In this case, the public company would be the legal acquirer, but the private company would be the accounting acquirer. The evaluation of the accounting acquirer should include a qualitative and quantitative analysis of the factors. See BCG 2.3 for further information. Figure 2-8 provides a diagram of a reverse acquisition.

Figure 2-8
Diagram of a reverse acquisition



The legal acquirer is the surviving legal entity in a reverse acquisition and continues to issue financial statements. The financial statements are generally in the name of the legal acquiree because the legal acquirer often adopts the name of the legal acquiree. In the absence of a change in name, the financial statements remain labelled as those of the surviving legal entity. Although the surviving legal entity may continue, the financial reporting will reflect the accounting from the perspective of the accounting acquirer, except for the legal capital, which is retroactively adjusted to reflect the capital of the legal acquirer (accounting acquiree) [ASC 805-40-45-1; IFRS 3.B21].

2.10.1 *Reverse acquisition (merger) involving a nonoperating public shell and a private operating entity*

The merger of a private operating entity into a nonoperating public shell corporation with nominal net assets typically results in (1) the owners of the private entity gaining control over the combined entity after the transaction, and (2) the shareholders of the former public shell corporation continuing only as passive investors. This transaction is usually not considered a business combination because the accounting acquiree, the nonoperating public shell corporation, does not meet the definition of a business under the Standards. Instead, these types of transactions are considered to be capital transactions of the legal acquiree and are equivalent to the issuance of shares by the private entity for the net monetary assets of the public shell corporation accompanied by a recapitalisation.

Under U.S. GAAP, any excess of the fair value of the shares issued by the private entity over the value of the net monetary assets of the public shell corporation is recognised as a reduction to equity.

Under IFRS, any difference in the fair value of the shares issued by the private entity over the value of the net monetary assets of the public shell corporation represents a service, and the cost of the service should be recognised as an expense by the acquirer.

2.10.2 Consideration transferred in a reverse acquisition

In a reverse acquisition, the accounting acquirer usually issues no consideration for the acquiree. Instead, the accounting acquiree usually issues its equity shares to the owners of the accounting acquirer. Accordingly, the acquisition date fair value of the consideration transferred by the accounting acquirer for its interest in the accounting acquiree is based on the number of equity interests the legal subsidiary would have had to issue to give the owners of the legal parent the same percentage equity interest in the combined entity that results from the reverse acquisition [ASC 805-40-30-2; IFRS 3.B20].

In a reverse acquisition involving only the exchange of equity, the fair value of the equity of the accounting acquiree may be used to measure consideration transferred if the value of the accounting acquiree's equity interests are more reliably measurable than the value of the accounting acquirer's equity interest. This may occur if a private company acquires a public company with a quoted and reliable market price. If so, the acquirer should determine the amount of goodwill by using the acquisition date fair value of the accounting acquiree's equity interests [ASC 805-30-30-2 through 30-3; IFRS 3.33].

Example 2-31 illustrates the measurement of the consideration transferred in a reverse acquisition.

EXAMPLE 2-31

Valuing consideration transferred in a reverse acquisition (adapted from ASC 805-40-55-10 and IFRS 3.IE5)

Company B, a private company, acquires Company A, a public company, in a reverse acquisition.

Immediately before the acquisition date:

- Company A has 100 shares outstanding
- Company B has 60 shares outstanding

On the acquisition date:

- Company A issues 150 shares in exchange for Company B's 60 shares
- The shareholders of Company B own 60% (150/250) of the new combined entity
- The shareholders of Company A own 40% (100/250) of the new combined entity
- Market price of a share of Company A is CU16
- Estimated fair value of a share of Company B is CU40

Analysis

The fair value of the consideration effectively transferred should be measured based on the most reliable measure. Because Company B is a private company, the fair value of Company A's shares is likely more reliably measurable. The consideration effectively transferred of CU1600 is measured using the market price of Company A's shares (100 shares times CU16).

Otherwise, the fair value of the consideration effectively transferred would be calculated using the amount of Company B's shares that would have been issued to the owners of Company A on the acquisition date to give Company A an equivalent ownership interest in Company B as it has in the combined company. Company B would have had to issue 40 shares[1] to Company A shareholders, increasing Company B's outstanding shares to 100 shares. Consideration effectively transferred would be CU1,600 (40 shares times the fair value of Company B's shares of CU40).

[1] Number of shares on which the consideration transferred is based: number of shares to be issued that will give owners of accounting acquiree a percentage ownership interest equal to their ownership interest in the combined entity = (60 shares / 60%) x 40%, or 40 shares.

2.10.3 *Presentation of consolidated financial statements*

The presentation of the financial statements represents the continuation of the legal acquiree, except for the legal capital structure in a reverse acquisition [ASC 805-40-45-1; IFRS 3.B21].Historical shareholders' equity of the accounting acquirer (legal acquiree) prior to the reverse acquisition is retrospectively adjusted (a recapitalisation) for the equivalent number of shares received by the accounting acquirer after giving effect to any difference in par value of the issuer's and acquirer's stock with any such difference recognised in equity. Retained earnings (deficiency) of the accounting acquirer are carried forward after the acquisition. Operations prior to the merger are those of the accounting acquirer. Earnings per share for periods prior to the merger are retrospectively adjusted to reflect the number of equivalent shares received by the acquiring company.

The Standards provide the following financial statement presentation guidance for reverse acquisitions:

Excerpts from ASC 805-40-45-2 and IFRS 3.B22

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

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

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

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

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

e. The noncontrolling interest's proportionate share of the legal subsidiary's (accounting acquirer's) precombination carrying amounts of retained earnings and other equity interests as discussed in paragraphs 805-40-25-2 and 805-40-30-3 [IFRS3.B23 and B24] and illustrated in Example 1, Case B (see paragraph 805-40-55-18).

Examples 2-32 and 2-33 illustrate the presentation of shareholders' equity following a reverse acquisition.

EXAMPLE 2-32

Presentation of shareholders' equity immediately following a reverse acquisition (adapted from ASC 805-40-55-13 and IFRS 3.IE7)

Company B, a private company, acquires Company A, a public company, in a reverse acquisition.

Shareholders' equity immediately before the acquisition date:

	Company A (accounting acquiree)	Company B (accounting acquirer)
Shareholders' equity		
Retained earnings	CU800	CU1,400
Issued equity		
100 common shares	300	
60 common shares		600
Total shareholders' equity	CU1,100	CU2,000

On the acquisition date:

- Company A issues 150 shares in exchange for Company B's 60 shares
- Fair value of consideration transferred is CU1,600
- The shareholders of Company B own 60% (150/250) of the new combined entity

Analysis

The presentation of shareholders' equity of the combined company on the acquisition date is:

	Combined company
Shareholders' equity	
Retained earnings[1]	CU1,400
Issued equity	
250 common shares[2]	2,200
Total shareholders' equity	**CU3,600**

[1] Retained earnings is based on the retained earnings of Company B, which is the accounting acquirer.

[2] The amount recognised for issued equity (i.e., common shares outstanding) is the sum of the value recognised for issued equity interests of Company B immediately before the acquisition, plus the value of the consideration transferred. CU2,200 = CU600 + CU1,600.

EXAMPLE 2-33

Restated presentation of shareholders' equity following a reverse acquisition

Company B, a private company, acquires Company A, a public company, in a reverse acquisition. The transaction was consummated on 4/1/X2.

Immediately before the acquisition date:

- Company A has 100 shares outstanding (CU1 par)
- Company A has total shareholders' equity of CU125
- Company B has 100 shares outstanding (CU2 par)
- Company B has total shareholders' equity of CU1,850

On the acquisition date:

- Company A issues 400 shares in exchange for 100% of Company B

After the acquisition date:

- The recapitalized entity has net income of CU300 for the period 4/1/X2 to 12/31/X2

Analysis

Shareholders' equity (Company B) immediately before the acquisition date:

	Shares at par (CU2)	APIC[1]	Retained earnings	Total shareholders' equity
1/1/X1	120	600	300	1,020
Shares issued 7/1/X1	40	110		150
Net income			250	250
12/31/X1	160	710	550	1,420
Shares issued 2/1/X2	40	190		230
Net income			200	200
3/31/X2	200	900	750	1,850

[1] APIC-Additional Paid in Capital

Restated shareholders' at 12/31/X2:

	Shares at par (CU1)	APIC	Retained earnings	Total shareholders' equity
1/1/X1	240	480	300	1,020
Shares issued 7/1/X1	80	70		150
Net income			250	250
12/31/X1	320	550	550	1,420
Shares issued 2/1/X2	80	150		230
Net income			200	200
3/31/X2	400	700	750	1,850
Recapitalization 4/1/X2	100	25		125
Net income			300	300

	Shares at par (CU1)	APIC	Retained earnings	Total shareholders' equity
12/31/X2	500	725	1,050	2,275

2.10.4 *Noncontrolling interest in a reverse acquisition*

Some shareholders of the legal acquiree (accounting acquirer) may not participate in the exchange transaction in a reverse acquisition. These shareholders will continue to hold shares in the legal acquiree and will not exchange their shares for shares in the legal acquirer (accounting acquiree). Because these shareholders hold an interest only in the legal acquiree, they participate in the earnings [profit or loss] of only the legal acquiree and not the earnings [profit or loss] of the combined entity [ASC 805-40-25-2; IFRS 3.B23]. As mentioned in the previous section, the legal acquiree's assets and liabilities are recognised at their precombination carrying values (i.e., not recognised at fair value) on the acquisition date. These shareholders that will now become noncontrolling interest holders were not owners of the accounting acquiree and do not participate in earnings [profit or loss] generated in the accounting acquiree. Therefore, in a reverse acquisition, the value of the noncontrolling interest is recognised at its proportionate interest in the precombination carrying amounts of the accounting acquirer [ASC 805-40-30-3; IFRS 3.B24].

Example 2-34 illustrates the measurement of a noncontrolling interest in a reverse acquisition.

EXAMPLE 2-34

Measurement of noncontrolling interest (adapted from ASC 805-40-55-18 through 55-21 and IFRS 3.IE12)

Company B, a private company, acquires Company A, a public company, in a reverse acquisition.

Immediately before the acquisition date:

- Company A has 100 shares outstanding.
- Company B has 60 shares outstanding.

Company B's recognised net assets are CU2,000

On the acquisition date:

- Company A issues 140 shares in exchange for 56 shares of Company B.
- The shareholders of Company B own 58.3% (140/240) of the new combined entity.
- Four shares of Company B remain outstanding.

Analysis

The combined entity would recognise a noncontrolling interest related to the four remaining outstanding shares of Company B. The value of the noncontrolling interest should reflect the noncontrolling interest's proportionate share in the precombination carrying amounts of the net assets of Company B, or CU134. This is based on a 6.7% ownership (4 shares / 60 issued shares) in Company B and Company B's net assets of CU2,000.

2.10.5 *Computation of earnings per share in a reverse acquisition*

In a reverse acquisition, the financial statements of the combined entity reflect the capital structure (i.e., share capital, share premium and treasury capital) of the legal acquirer (accounting acquiree), including the equity interests issued in connection with the reverse acquisition. Consistent with this financial statement presentation, the computation of EPS is also based on the capital structure of the legal acquirer.

The Standards provide the following guidance on EPS:

Excerpts from ASC 805-40-45-4, ASC 805-40-45-5 and IFRS 3.B26, B27

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

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

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

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

a. The income [profit or loss] of the legal acquiree attributable to common [ordinary] shareholders in each of those periods

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

Example 2-35 illustrates the computation of EPS in a reverse acquisition.

EXAMPLE 2-35

Computation of EPS (adapted from ASC 805-40-55-16 and IFRS 3.IE9)

Company B, a private company, acquires Company A, a public company, in a reverse acquisition on 30 September 20X6.

Immediately before the acquisition date:

- Company A has 100 shares outstanding
- Company B has 60 shares outstanding
- Company B's outstanding shares (i.e., 60 shares) remained unchanged from 1 January 20X6 through the acquisition date

On 30 September 20X6, the acquisition date:

- Company A issues 150 shares in exchange for Company B's 60 shares. This is an exchange ratio of 2.5 shares of Company A for 1 share of Company B
- Earnings [profit] for the consolidated entity for the year ended 31 December 20X6 are CU800

Analysis

EPS for the year ended 31 December 20X6 is computed as follows:

Earnings [profit] for the year ended 31 December 20X6	CU800
Number of common shares outstanding of Company B	60
Exchange ratio	2.5
Number of shares outstanding from 1 January 20X6 through 30 September 20X6	150
Number of shares outstanding from acquisition date through 31 December 20X6	250
Weighted-average number of shares outstanding (150 shares x 9 / 12) + (250 shares x 3 / 12)	175
Earnings per share for year ended 31 December 20X6 (CU800 / 175 shares)	CU4.57

2.11 Applying the acquisition method for variable interest entities and special purpose

The guidance in ASC 805 is also applicable to the consolidation of VIEs that are businesses when control is obtained under the VIE subsections of ASC 810-10. Even if the entity is not considered a business, the VIE subsections of ASC 810-10 refers to the guidance in ASC 805 for the recognition and measurement of assets and liabilities (except for goodwill) when consolidating the VIE [ASC 810-10-30-1 through 30-6]. VIEs that are determined to be businesses must follow the disclosure requirements of ASC 805 [ASC 810-10-50-3].

If the primary beneficiary of a VIE transfers assets or liabilities to the VIE at, after, or shortly before the date that the entity becomes the primary beneficiary, the assets are recognised at the same amounts at which the assets and liabilities would have been measured if they had not been transferred (i.e., no gain or loss is recognised) [ASC 810-10-30-3].

Figure 2-9 provides the applicable guidance for the VIE subsections of ASC 810-10 in connection with a business combination.

Figure 2-9
Variable interest entities and business combinations

Scenario	Application of ASC 805
Acquired group is a: Variable interest entity Business	The consolidation of a VIE when control is obtained is considered a business combination. Apply the acquisition method in ASC 805. In this situation, the date a VIE must be consolidated should be used as the acquisition date. The primary beneficiary, the entity that consolidates the VIE, is identified as the acquirer [ASC 805-10-25-5 through 25-6].
Acquired group is a: Variable interest entity Not a business	The consolidation of the VIE is considered an asset acquisition. Apply sections ASC 805-20-25, ASC 805-20-30, ASC 805-740-25-2 and ASC 805-740-30-1 to recognise and measure the VIE's assets and liabilities, excluding goodwill, at fair value. The difference between (1) the fair value of any consideration transferred, the fair value of the noncontrolling interest in the VIE, and the reported amount of any previously held equity interests in the VIE; and (2) the net amount of the VIE's identifiable assets and liabilities recognised and measured in accordance with ASC 805 will be recognised as a gain or loss. No goodwill is recognised [ASC 810-10-30-3 through 30-6].

Scenario	Application of ASC 805
Acquired group is: Not a variable interest entity	Determine whether the acquired group is a business. If it is a business, apply ASC 805. If it is not a business, apply asset acquisition accounting. See BCG 9 for further information.

IFRS does not include the concept of VIEs. Prior to the adoption of IFRS 10, SIC 12 provided an interpretation of IAS 27 (2008). Special purpose entities (SPEs) are those that are set up to achieve a narrow or specifically defined outcome, and it is often difficult to change their activities [SIC 12.1]. An entity may have no ownership interest in an SPE, but it may, in substance, control it. SIC 12 lists factors that may indicate control. These are, in substance:

- The SPE's activities are being conducted for the benefit of the entity.
- The entity has substantive decision-making powers to realise benefits or it has delegated the powers through an "autopilot" mechanism.
- The entity has access to the majority of the rewards of the SPE and may, therefore, be exposed to the majority of the risks.
- The entity has the majority of ownership or residual risks so that it obtains the majority of the rewards from the SPE.

An entity should apply IFRS 3 if it gains control of an SPE that is a business and account for the transaction as a business combination. An entity that acquires control over an SPE that is not a business and consolidates the SPE, accounts for the transaction as an acquisition of assets in accordance with BCG 9.

IFRS 10 superseded SIC 12. There is no longer specific accounting guidance for special purpose entities because IFRS 10 applies to all types of entities. The application of IFRS 10 includes situations where control is gained through a contract (i.e., structured entities). See BCG 1.6.2 for further information on IFRS 10.

2.12 Conforming accounting policies of the acquiree to those of the acquirer

Absent justification for different accounting policies, the acquiree's policies should be conformed to those of the acquirer. Dissimilar operations or dissimilar assets or transactions of the acquiree may provide justification for different accounting policies. However, the presence of intercompany transfers or the use of common manufacturing facilities or distribution systems are examples of circumstances that would establish a presumption that the operations of the acquiree are similar to those of the acquirer.

The acquirer may want to change its policies to conform to those of the acquiree. Conforming the acquirer's accounting policies to those of the acquiree is a change in accounting principle and the preferability requirements of ASC 250 and IAS 8 must be considered.

2.13 Continuing transition requirements

U.S. GAAP and IFRS companies should generally apply the provisions of the Standards prospectively to business combinations for which the acquisition date was on or after the Standards' effective date. Adjustments to most assets acquired and liabilities assumed that arose from business combinations consummated prior to the effective date of the Standards continue to be accounted for under previous U.S. GAAP or IFRS. However, the Standards should be applied to certain income tax matters (e.g., valuation allowance releases and changes to uncertain tax positions) that arose from business combinations consummated prior to the effective date of the Standards [ASC 805-10-65-1 (2009); IFRS 3.67]. These continuing transition considerations are discussed in more detail below.

2.13.1 Income tax transition provisions

The release of a valuation allowance [initial recognition of acquired deferred tax assets] that does not qualify as a measurement period adjustment is reflected in income tax expense (or as a direct adjustment to equity as required by ASC 740 or IAS 12). The release of a valuation allowance [initial recognition of acquired deferred tax assets] within the measurement period resulting from new information about facts and circumstances that existed at the acquisition date is reflected first as an adjustment to goodwill, then as a bargain purchase [ASC 805-740-45-2; IAS 12.68].

The acquirer must consider whether changes in the acquired deferred tax balances are due to new information about facts and circumstances that existed at the acquisition date or are due to events arising in the postcombination period. Discrete events or circumstances that arise within the measurement period and that did not exist at the acquisition date generally would not be recorded in acquisition accounting [ASC 805-10-25-13; IFRS 3.45].

Unlike the general transition provisions of the Standards, whereby the guidance is applied only to business combinations consummated after the effective date of the Standards, the guidance related to the release of a valuation allowance (ASC 740) or recognition of assets (IAS 12) subsequent to the date of acquisition also applies to business combinations consummated prior to the effective date of the Standards [ASC 805-10-65-1 (2009); IFRS 3.67].

Measurement period adjustments to uncertain tax positions are recorded first as an adjustment to goodwill, and then as a bargain purchase. Other adjustments are recorded in earnings [profit or loss] directly impacting a company's income tax expense and effective tax rate [ASC 805-740-45-4; IAS 12.68]. This guidance related to adjustments to acquisition-related tax uncertainties also applies to business combinations consummated prior to the effective date of the Standards [ASC 805-10-65-1 (2009); IFRS 3.67]. Under IFRS, adjustments related to tax uncertainties recorded in a business combination that (1) were made within one year of the acquisition date and (2) related to matters existing at the acquisition date, are generally recorded as an adjustment to purchase accounting. Otherwise, adjustments are recognised in the income statement.

Question 2-10:

How should excess tax-deductible goodwill from acquisitions made prior to the effective date of ASC 805 be accounted for under U.S. GAAP?

PwC response

In general, when specific transition guidance is not provided, companies should continue to follow the previous guidance for acquisitions consummated prior to the adoption of ASC 805.

Under historical U.S. GAAP guidance,[6] if tax-deductible goodwill exceeded book goodwill as of the acquisition date, no deferred tax asset was recorded. The tax benefit of the excess tax basis is recognised when it is realised on the tax return. ASC 805 amended the guidance for accounting for excess tax-deductible goodwill at the acquisition date. However, no transition guidance was provided for accounting for excess tax-deductible goodwill that arose in acquisitions consummated prior to the effective date of ASC 805.

Therefore, companies should continue to follow the historical guidance for recording the income tax benefit from amortising component-2 tax-deductible goodwill for acquisitions consummated prior to the effective date of ASC 805. For those acquisitions, the tax benefit from the component-2 tax-deductible goodwill is recorded as the benefit is realised on the tax return, first as a reduction to goodwill from the acquisition, second as a reduction to other noncurrent intangible assets related to the acquisition, and third to reduce income tax expense.

2.13.1.1 Acquired tax benefits disclosure

IAS 12 requires the disclosure of the event or change in circumstances that caused the recognition of a deferred tax benefit that was not initially recognised on the acquisition date [IAS 12.81(k)].

Under ASC 740, prior to the adoption of the Standards, companies recorded the tax benefit of excess tax-deductible goodwill over book goodwill when realised on the tax return. That tax benefit was applied first to reduce to zero the goodwill related to that acquisition, second to reduce to zero other noncurrent intangible assets related to that acquisition, and third to reduce income tax expense. While the Standards are silent as to the accounting treatment for excess tax-deductible goodwill upon transition, current practice is for companies to apply the guidance that was in place at the time the acquisition was completed. For acquisitions that took place prior to the adoption

[5] FAS 109, par.263 prior to being amended by ASC 805-740.

of the Standards, companies should continue to follow the previous guidance for recording the income tax benefit for excess tax-deductible goodwill.[5]

For more discussion on the amendments to ASC 740 and IAS 12, and other income tax accounting matters associated with a business combination, see BCG 5.7.

2.13.2 Exit activities—U.S. GAAP

Previously, liabilities for exit activities planned in connection with a business combination could be established under EITF Issue No. 95-3, *Recognition of Liabilities in Connection with a Purchase Business Combination* (EITF 95-3), if certain conditions were met. Subsequent reductions of such liabilities, if the liability exceeded the ultimate cost expended, were usually recorded as adjustments to goodwill, irrespective of when the adjustments were made.

EITF 95-3 was nullified with the issuance of ASC 805, and as a result, companies must now account for any exit activities, whether or not arising in connection with a business combination, using the guidance in ASC 420. Liabilities previously established under EITF 95-3 will not be eliminated upon adoption of ASC 805 and will continue to be accounted for under EITF 95-3 until settled. That is, any subsequent reductions of excess restructuring liabilities related to prior business combinations will usually be recorded to goodwill.

2.13.3 Tax benefits of equity-classified awards that ordinarily result in a tax deduction—U.S. GAAP

Prior to the adoption of ASC 805, entities were not permitted to recognise deferred tax assets at the acquisition date for **replacement share-based payment awards**. Instead, any tax deduction resulting from the exercise of the award was recognised as an adjustment to the cost of the acquisition (usually as a reduction of goodwill) to the extent of the fair value of the award recognised at the acquisition date.

Under ASC 805, a deferred tax asset is recorded at the acquisition date related to the tax benefit derived from recording the fair value of nonqualified share-based payment awards (i.e., awards that would typically result in a tax deduction) that are issued as part of the **consideration transferred** for the acquiree. Upon settlement, if the tax deduction received by the acquirer is greater than the sum of the fair value of the award added to the purchase price plus the cumulative book compensation cost recorded by the acquirer, the tax benefit related to the excess tax deduction (i.e., windfall) should be recorded as an adjustment to additional paid-in capital. If the tax deduction received by the acquirer is less than the sum of the fair value of the award added to the purchase price plus the cumulative book compensation cost recorded by the acquirer, the resulting difference (i.e., shortfall) should be charged first to additional paid-in capital, to the extent of the acquirer's pool of windfall tax benefits. Any remaining shortfall would be recognised in income tax expense. Windfalls and shortfalls generated from replacement awards are included in the acquirer's pool of windfall tax benefits, similar to other awards granted by the acquirer. For business combinations that close after the effective date of ASC 805, adjustments are no longer made to goodwill for the subsequent income tax effects of replacement share-based payment awards issued in an acquisition.

For business combinations that closed prior to the effective date of ASC 805, companies should continue to account for the realised tax benefits from replacement share-based payment awards following their existing practices, which in most cases will be in accordance with the guidance in EITF Issue No. 00-23, *Issues Related to the Accounting for Stock Compensation under APB Opinion No. 25 and FASB Interpretation No. 44* (EITF 00-23), Issue 29.

2.13.4 Resolution of contingent consideration

Under FAS 141 and IFRS 3 (2004), the subsequent resolution of a contingent consideration arrangement based on earnings [profit or loss] was considered additional purchase consideration and usually gave rise to additional goodwill. Under the Standards, however, resolution of a contingent consideration arrangement for an amount different from that recorded in the purchase accounting is reflected in earnings [profit or loss]. See BCG 2.6.4.1 and 2.6.4.2 for the accounting guidance applicable to contingent consideration under U.S. GAAP and IFRS, respectively.

Contingent consideration recorded in acquisitions prior to the effective date of the Standards should continue to follow the guidance of FAS 141 and IFRS 3 (2004) until the contingent consideration is settled. That is, once settled, the amount of contingent consideration should be accounted for as additional purchase price, even if settlement is subsequent to the company's adoption of the Standards.

2.13.5 Contingent consideration of an acquiree

Under U.S. GAAP, a pre-existing contingent consideration arrangement of the acquiree assumed in a business combination should be accounted for by the acquirer in accordance with the guidance for contingent consideration arrangements in ASC 805-30-25-5. This guidance requires that contingent consideration be recognised as part of the consideration transferred in a business combination and measured at its acquisition date fair value. See BCG 2.6.4.1 for further information on the accounting for contingent consideration in a business combination under U.S. GAAP.

In contrast to U.S. GAAP, a pre-existing contingent consideration arrangement of the acquiree would be accounted for as an assumed liability (or in some instances, an asset) of the acquired business under IFRS. As these arrangements would almost always be established by a contract, they would fall within the scope of IAS 39 and be recognised at fair value on the acquisition date. The IASB concluded that such pre-existing arrangements would not constitute contingent consideration under IFRS 3 because the consideration does not arise from the current transaction between the acquirer and the former owners of the acquiree.

Chapter 3: Employee compensation arrangements

3.1 Chapter overview

The **acquirer** in a **business combination** may agree to assume existing compensation arrangements with employees of the **acquiree** or may establish new arrangements to compensate those employees for postcombination services. These arrangements may involve cash payments to the employees or the exchange (or settlement) of share-based payment awards. These replacement share-based payment awards, in many cases, include the same terms and conditions as the original awards and are intended to keep the employees of the acquiree "whole" (i.e., preserve the value of the original awards at the **acquisition date**) after the acquisition. The acquirer may, in other situations, change the terms of the share-based payment awards, often to provide an incentive to key employees to remain with the combined entity.

Employee compensation arrangements should be analysed to determine whether they represent compensation for (1) precombination services, (2) postcombination services, or (3) a combination of precombination and postcombination services. Amounts attributable to precombination services are accounted for as part of the **consideration transferred** for the acquiree. Amounts attributable to postcombination services are accounted for separately from the business combination and are usually recognised as compensation cost in the post-acquisition period. Amounts attributable to a combination of precombination and postcombination services are allocated between the consideration transferred for the acquiree and the postcombination services [ASC 805-10-25-20 and ASC 805-30-30-4; IFRS 3.51].

Contingent payment arrangements with an acquiree may represent consideration transferred for the acquiree or compensation for postcombination services. This chapter discusses the analysis that the acquirer should perform to determine if the contingent consideration is accounted for as part of the consideration transferred or as a transaction separate from the business combination (in the postcombination financial statements).

The acquiree may enter into employee related transactions during the negotiations for a business combination. These transactions might include the settlement or acceleration of vesting for share-based payment awards or bonus payments to employees. The acquirer should assess these transactions to determine whether they should be accounted for in the postcombination financial statements or included as part of the consideration transferred for the acquiree. Transactions that benefit the acquiree are included as part of consideration transferred. If it is determined that a transaction was arranged primarily for the economic benefit of the acquirer (or combined entity), the transaction is not deemed to be part of the consideration transferred for the acquiree and should be accounted for separately from the business combination [ASC 805-10-25-20 through 25-22; IFRS 3.51–52,B52]. Factors to consider in this analysis include:

- The reasons for the transaction
- Who initiated the transaction
- The timing of the transaction [ASC 805-10-55-18; IFRS 3.B50]

The basic principle outlined in ASC 805-10-25-20 and IFRS 3.51 is broadly applicable to other transactions outside of arrangements with employees. This principle and the three factors listed above are discussed in more detail in BCG 2.

This chapter also addresses the accounting for other employee compensation arrangements, such as "stay bonuses" and "golden parachute" agreements with employees of the acquiree.

For guidance on accounting for share-based payment awards under U.S. GAAP, refer to PwC's *Stock-based compensation guide*. For guidance on accounting for share-based payment awards under IFRS 2, refer to the PwC IFRS Manual of Accounting. The accounting for pension and other postretirement benefits in a business combination is addressed in BCG 2.

The key takeaways from this chapter are:

- **Share-based payment awards exchanged in a business combination should be measured at fair value at the acquisition date and attributed to precombination and postcombination services.** Replacement share-based payment awards should be measured at the acquisition date according to the fair-value-based measurement principles of ASC 718 and IFRS 2. If the acquirer is obligated to replace the awards, generally, the portion of the award attributed to precombination services is included in the amount of consideration transferred for the acquiree, while the portion attributed to postcombination services is accounted for in the postcombination financial statements. If the acquirer chooses to issue awards (when it is not obligated to do so) to replace an acquiree's awards that would otherwise expire, the entire fair value of the replacement awards is recognised as postcombination compensation cost.

- **Vested share-based payment awards that are used to replace unvested awards should be measured at fair value at the acquisition date and the amount attributable to the accelerated vesting should be recognised separately from the business combination as additional compensation cost.** The amount of the fair value related to the acquirer's accelerated vesting of unvested share-based payment awards, absent an automatic change in control clause in the acquiree's arrangements, should be recognised separately from the business combination as additional compensation cost. This cost would include any incremental fair value of the replacement awards over the fair value of the acquiree awards.

- **Changes to share-based payment awards after the business combination do not affect the accounting for the business combination.** The effects of modifications of replacement awards, changes in the outcome of awards with performance conditions, and changes in value related to the remeasurement of liability-classified replacement awards after the acquisition date should not adjust the accounting for the business combination. These modifications and changes are accounted for in accordance with ASC 718 and IFRS 2.

- **Contingent payment arrangements may represent consideration transferred for the acquiree or compensation for postcombination**

services. An acquirer may agree to provide contingent payments to the selling shareholders or the former employees of the acquiree. Contingent payments may represent part of the consideration transferred for the acquiree or compensation for postcombination services. A payment for postcombination services is accounted for separately from the business combination. A payment is for postcombination services if the contingent payment is automatically forfeited if employment terminates. The Standards provide a number of indicators to consider if it is not clear whether the payment is consideration transferred for the acquiree or is for postcombination services.

- **Accounting for income tax effects of share-based payment awards differs under U.S. GAAP and IFRS.** The accounting for the income tax effects of awards transferred in a business combination differs between U.S. GAAP and IFRS.

3.2 Assessing what is part of the consideration transferred for the acquiree

Employee compensation arrangements should be analysed to determine whether they represent compensation for (1) precombination services, (2) postcombination services, or (3) a combination of precombination and postcombination services. Amounts attributable to precombination services are accounted for as part of the consideration transferred for the acquiree. Amounts attributable to postcombination services are accounted for separately from the business combination and are costs in the post-acquisition period. The cost of an arrangement that includes precombination and postcombination services is attributed between the consideration transferred for the acquiree and the postcombination services. This assessment will not always be straightforward and may require significant judgment [ASC 805-30-30-9 and ASC 805-10-25-20; IFRS 3.51].

An acquirer may agree to exchange share-based payment awards held by employees of the acquiree for replacement share-based payment awards of the acquirer. The awards held by the employees of the acquiree and the **replacement awards** are measured using the fair-value-based measurement principles of ASC 718 or IFRS 2 on the acquisition date (share-based payment transactions are excluded from the scope of ASC 820) [ASC 805-30-30-11 and ASC 805-30-55-7; IFRS 3.B57]. Throughout this chapter, references to fair value of share-based payment awards mean the "fair-value-based measure" that is determined in accordance with ASC 718 and IFRS 2. The acquirer should then attribute the fair value of the awards to precombination services and postcombination services, as appropriate, based on the principles in the Standards.

The fair value of the awards attributed to precombination services is included as part of the consideration transferred for the acquiree. The fair value of the awards attributed to postcombination services is recorded as compensation cost in the postcombination financial statements of the combined entity [ASC 805-30-55-8 through 55-10; IFRS 3.B57-B59]. Although ASC 805 focuses on the **fair value method**, it also applies to situations where ASC 718 permits the use of the calculated-value method or the intrinsic-value method for both the acquiree awards and the replacement awards [ASC 805-30-55-7].

An acquirer may enter into a contingent consideration arrangement with the selling shareholders of the acquiree, or the acquiree may enter into a transaction for the benefit of the acquirer or the combined entity. These arrangements need to be analysed to determine if they should be included in the consideration transferred for the acquiree, accounted for as a separate transaction apart from the business combination, or a combination of both.

A transaction arranged primarily for the economic benefit of the acquirer (or combined entity) is not deemed to be part of the consideration transferred for the acquiree and should be accounted for separately from the business combination [ASC 805-10-25-20 through 25-22; IFRS 3.51–52, B50]. Factors to consider in this analysis include:

- The reasons for the transaction
- Who initiated the transaction
- The timing of the transaction [ASC 805-10-55-18; IFRS 3.B50]

The basic principle outlined in the Standards and the three factors listed above are discussed in more detail in BCG 2. Throughout this chapter, the analysis of employee compensation arrangements requires consideration of the basic principle and an assessment of the three factors. See BCG 3.3 for information on the indicators to be considered when analysing contingent consideration arrangements.

3.3 Contingent payments—determining whether the arrangement is compensation

Arrangements that include contingent payments are assessed to determine if the consideration is for postcombination services. This assessment requires obtaining an understanding of why the contingent payments are included in the arrangement, which party (the acquiree or the acquirer) initiated the arrangement, and when the parties entered into the arrangement [ASC 805-10-55-24; IFRS 3.B54]. The nature of the arrangement will dictate whether contingent payments to employees (or selling shareholders) are (1) contingent consideration in a business combination or (2) separate transactions. If it is not clear whether an arrangement is part of the exchange for the acquiree or is a separate transaction, the Standards provide eight indicators that should be considered [ASC 805-10-55-24 through 55-25; IFRS 3.B54–B55]. These criteria need to be applied to all arrangements for payments to employees or selling shareholders, including both cash compensation and share-based payment awards. Additionally, arrangements between the selling shareholders and the acquiree's employees should be evaluated to determine whether such arrangements were entered into for the benefit of the acquirer and thus represent compensation.

All of the indicators in the Standards should be considered when analysing whether consideration is for postcombination services. However, the Standards require the consideration to be accounted for as postcombination compensation cost[1] if the consideration is automatically forfeited upon termination of employment.

Excerpts from ASC 805-10-55-25 and IFRS 3.B55

a. Continuing employment. The terms of continuing employment by the selling shareholders who become key employees may be an indicator of the substance of a contingent consideration arrangement. The relevant terms of continuing employment may be included in an employment agreement, acquisition agreement, or some other document. A contingent consideration arrangement in which the payments are automatically forfeited if employment terminates is compensation [remuneration] for postcombination services. Arrangements in which the contingent payments are not affected by employment termination may indicate that the contingent payments are additional consideration rather than compensation [remuneration].

b. Duration of continuing employment. If the period of required employment coincides with or is longer than the contingent payment period, that fact may indicate that the contingent payments are, in substance, compensation [remuneration].

c. Level of compensation [remuneration]. Situations in which employee compensation [remuneration] other than the contingent payments is at a reasonable level in comparison to that of other key employees in the combined entity may indicate that the contingent payments are additional consideration rather than compensation [remuneration].

d. Incremental payments to employees. If selling shareholders who do not become employees receive lower contingent payments on a per-share basis than the selling shareholders who become employees of the combined entity, that fact may indicate that the incremental amount of contingent payments to the selling shareholders who become employees is compensation [remuneration].

e. Number of shares owned. The relative number of shares owned by the selling shareholders who remain as key employees may be an indicator of the substance of the contingent consideration arrangement. For example, if the selling shareholders who owned substantially all of the shares in the acquiree continue as key employees, that fact may indicate that the arrangement is, in substance, a profit-sharing arrangement intended to provide compensation [remuneration] for postcombination services. Alternatively, if selling shareholders who continue as key employees owned only a small number of shares of the acquiree and all selling shareholders receive the same amount of contingent consideration on a per-share basis, that fact may indicate that the contingent payments are additional consideration. The preacquisition ownership interests held by parties related to selling shareholders who continue as key employees, such as family members, also should be considered.

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[1] Compensation cost is typically recorded as expense, unless required or permitted to be capitalized by other standards.

f. Linkage to the valuation. If the initial consideration transferred at the acquisition date is based on the low end of a range established in the valuation of the acquiree and the contingent formula relates to that valuation approach, that fact may suggest that the contingent payments are additional consideration. Alternatively, if the contingent payment formula is consistent with prior profit-sharing arrangements, that fact may suggest that the substance of the arrangement is to provide compensation [remuneration].

g. Formula for determining consideration. The formula used to determine the contingent payment may be helpful in assessing the substance of the arrangement. For example, if a contingent payment is determined on the basis of a multiple of earnings, that might suggest that the obligation is contingent consideration in the business combination and that the formula is intended to establish or verify the fair value of the acquiree. In contrast, a contingent payment that is a specified percentage of earnings might suggest that the obligation to employees is a profit-sharing arrangement to compensate employees for services rendered.

h. Other agreements and issues. The terms of other arrangements with selling shareholders (such as noncompete agreements, executory contracts, consulting contracts, and property lease agreements) and the income tax treatment of contingent payments may indicate that contingent payments are attributable to something other than consideration for the acquiree. For example, in connection with the acquisition, the acquirer might enter into a property lease arrangement with a significant selling shareholder. If the lease payments specified in the lease contract are significantly below market, some or all of the contingent payments to the lessor (the selling shareholder) required by a separate arrangement for contingent payments might be, in substance, payments for the use of the leased property that the acquirer should recognise separately in its postcombination financial statements. In contrast, if the lease contract specifies lease payments that are consistent with market terms for the leased property, the arrangement for contingent payments to the selling shareholder may be contingent consideration in the business combination.

Example 3-1 provides an example of a contingent consideration arrangement that is forfeited upon the termination of employment and therefore is treated as postcombination compensation cost.

EXAMPLE 3-1

Contingent consideration arrangement

Company A (the acquiree) is owned by a sole shareholder, Shareholder X, who is also the chief executive officer (CEO) of Company A. Company A is acquired by Company B (the acquirer). Shareholder X will, per the terms of the purchase agreement, receive additional consideration for the acquisition based upon specific earnings before interest, taxes, depreciation, and amortisation (EBITDA) levels of Company A over the two-year period following the acquisition. Company B believes that retaining the services of Shareholder X for at least two years is critical to transitioning Company A's ongoing business. The arrangement also stipulates that Shareholder X will forfeit any rights to the additional consideration if Shareholder X is not an employee of Company B at the end of the two-year period.

Analysis

A contingent consideration arrangement in which the payments are automatically forfeited if employment terminates is compensation for postcombination services [ASC 805-10-55-25; IFRS 3.B55]. Accordingly, any payments made to Shareholder X for achievement of the specific EBITDA levels would be accounted for as compensation cost in Company B's postcombination financial statements.

See Question 3-7 for a discussion of the accounting for a subsequent modification to an arrangement with contingent payments in a business combination.

3.3.1 Golden parachute and stay bonus arrangements

Employment agreements with executives often include arrangements whereby the executive receives a bonus, in cash or shares, when his or her employment is terminated. These arrangements are often triggered by a business combination and are commonly referred to as "golden parachute" arrangements. These arrangements need to be assessed to determine if they represent compensation for precombination or postcombination services. Generally, if the arrangement was included in the employment agreement prior to contemplation of the business combination and there is no postcombination service required, the consideration is associated with a precombination arrangement. The expense is typically recognised in the preacquisition financial statements of the acquiree and would typically be a liability assumed by the buyer that is therefore included in the application of the acquisition method.

Examples 3-2 and 3-3 include examples of arrangements that compensate for employee services.

EXAMPLE 3-2

Golden parachute arrangement

The employment contract for the CEO of Company B provides that if Company B is acquired by another company, the CEO will receive a CU5 million cash payment if the CEO remains employed through the acquisition date (a "golden parachute" arrangement). Several years after the employment contract is signed, Company B is acquired by Company A. The CEO is not obligated to remain employed after the acquisition date.

Analysis

Company A is required to assess whether the CU5 million cash payment to the CEO is (1) an assumed obligation that should be included in the application of the acquisition method, or (2) a postcombination expense that should be accounted for separately from the business combination. Company A should consider the factors listed in ASC 805-10-55-18 and IFRS 3.B50:

- The reasons for the transaction: The CU5 million payment was originally included in the CEO's employment contract by Company B to secure employment of the CEO through the acquisition date in the event that Company B was acquired in the future.

- Who initiated the transaction: The payment was arranged by Company B to benefit Company B through the acquisition date, in the event of an acquisition.

- The timing of the transaction: The employment contract was in existence prior to any discussions regarding the business combination.

The payment to the CEO is not primarily for the economic benefit of Company A. The CEO is not required to provide continuing services to Company A to receive the payment. Therefore, the payment should be recognised as compensation cost in Company B's precombination financial statements and an assumed obligation included in the application of the acquisition method.

EXAMPLE 3-3

Stay bonus arrangements

Company Z acquires Company Y and agrees to provide each of the key officers of Company Y a cash payment of CU1 million if they remain employed with the combined company for at least one year from the acquisition date. The agreement stipulates that if the key officers resign prior to the first anniversary of the acquisition date, the cash payment of CU1 million will be forfeited. A similar clause was not included in Company Y's key officers' employment agreements prior to the discussions that lead to the business combination.

Analysis

Company Z must assess whether the CU1 million cash payment to each of the key officers is (1) consideration transferred for the acquiree or (2) a postcombination expense that should be accounted for outside of the business combination. Company Z should consider the factors listed in ASC 805-10-55-18 and IFRS 3.B50:

- The reasons for the transaction: The CU1 million payment was offered to the key officers of Company Y by Company Z to facilitate the transition process following the acquisition.

- Who initiated the transaction: The payment was arranged by Company Z to benefit Company Z for the first year following the acquisition.

- The timing of the transaction: The arrangement was negotiated in conjunction with the business combination and was not included in the original employment agreements of the key officers.

The payments to the key officers of Company Y appear to be arranged primarily for the economic benefit of Company Z. The key officers will forfeit the payments if they do not provide service to the combined company for at least one year following the acquisition date. Therefore, the payments are not part of the consideration transferred for Company Y and should be recorded as compensation cost in the postcombination financial statements of the combined company.

3.4 Exchange of employee share-based payment awards

The acquirer may issue its own share-based payment awards (replacement awards) in exchange for awards held by employees of the acquiree. Generally, in such a transaction, the acquirer will replace the existing awards (under which the employees would have received shares of the acquiree) with awards that will be settled in shares of the acquirer. The purpose of this transaction may be to keep the employees "whole" after the acquisition (i.e., preserve the value of the original awards at the acquisition date) or to provide further incentive for employees to remain with the combined entity. Therefore, replacement awards may represent consideration for precombination services, postcombination services, or a combination of both. Replacement awards may contain the same terms as the original acquiree awards; other times, the acquirer may change the terms of the awards depending on its compensation strategy or other factors, such as to provide incentives for key employees to remain with the company.

When the acquirer is obligated to grant replacement awards as part of a business combination, the replacement awards should be considered in the determination of the amount of consideration transferred for the acquiree. An acquirer is obligated to grant replacement awards if the acquiree or the acquiree's employees can legally require the acquirer to replace the awards. For purposes of applying this requirement, the acquirer is considered obligated to grant replacement awards in a business combination if required by one of the following:

- Terms of the acquisition agreement
- Terms of the acquiree's awards
- Applicable laws or regulations [ASC 805-30-30-9; IFRS 3.B56]

An exchange of share-based payment awards in a business combination is treated as a modification under ASC 718 and IFRS 2. The replacement awards and the original acquiree awards should both be measured at fair value at the acquisition date and calculated using the fair-value-based measurement principles in ASC 718 or IFRS 2. The guidance in ASC 805 is also applicable to acquiree and replacement awards valued using the calculated-value method or the intrinsic-value method, where permitted by ASC 718. However, this chapter addresses share-based payment awards measured at fair value under ASC 718.

Once the fair value of the awards has been determined, the replacement awards should be analysed to determine whether the awards relate to precombination or postcombination services. To the extent replacement awards are for precombination services, a portion of the value of the awards should be allocated to consideration transferred for the acquiree. To the extent replacement awards are for postcombination services, the value of the awards should be excluded from payments for the acquired **business** and recognised as compensation cost in the postcombination financial statements [ASC 805-30-30-11 through 30-13, ASC 805-30-55-7 through 55-10; IFRS 3.B57–B60].

Acquiree awards may expire as a consequence of a business combination and the acquirer may not be obligated (as that term is defined in the Standards) to grant replacement awards. If the acquirer grants replacement awards for awards that would otherwise expire and the acquirer is not obligated to do so, the replacement awards are considered separate from the business combination. The entire fair value of the replacement awards should be recognised as compensation cost in the postcombination financial statements [ASC 805-30-30-10; IFRS 3.B56].

Figure 3-1 summarizes the accounting for different arrangements involving the exchange of employee awards in a business combination.

Figure 3-1

The accounting for different arrangements involving the exchange of employee awards in a business combination

Scenarios			Accounting	
Acquirer's obligation	**Replacement of awards**	**Expiration of acquiree awards**	**U.S. GAAP**	**IFRS**
1. The acquirer is obligated[1] to issue replacement awards.	The acquirer issues replacement awards.	Not relevant.	The awards are considered in the determination of the amount of consideration transferred for the acquiree or for postcombination services.	The awards are considered in the determination of the amount of consideration transferred for the acquiree or for postcombination services.
2. The acquirer is not obligated[1] to issue replacement awards to the acquiree.	The acquirer issues replacement awards.	The acquiree awards would otherwise expire.	The entire fair value of the replacement awards is recognised as postcombination compensation cost in the postcombination period.	The entire fair value of the replacement awards is recognised as postcombination compensation cost in the postcombination period.

Scenarios			Accounting	
Acquirer's obligation	**Replacement of awards**	**Expiration of acquiree awards**	**U.S. GAAP**	**IFRS**
3. The acquirer is not obligated[1] to issue replace-ment awards to the acquiree.	The acquirer does not issue replacement awards.	The acquiree awards would not otherwise expire.	The acquirer could account for the continuation of the awards as if the acquirer was obligated to issue replacement awards (see Scenario 1 above). Alternatively, the acquirer could account for the awards separate from the business combination as new grants and recognise the fair value of the awards as compensation cost in the postcombination period.	The acquirer accounts for the continuation of the awards as if the acquirer was obligated to issue replacement awards (see Scenario 1 above).
4. The acquirer is not obligated[1] to issue replaceme nt awards to the acquiree.	The acquirer issues replacement awards.	The acquiree awards would not otherwise expire.	The acquirer could account for the continuation of the awards as if the acquirer was obligated to issue replacement awards (see Scenario 1 above). Alternatively, the acquirer could account for the awards separate from the business combination as new grants and recognise the fair value of the awards as compensation cost in the postcombination period.	The acquirer accounts for the continuation of the awards as if the acquirer was obligated to issue replacement awards (see Scenario 1 above).

[1] An acquirer is obligated to issue replacement awards if required by the terms of the acquisition agreement, the terms of the acquiree's awards, or applicable laws or regulations.

3.4.1 *Determining the fair value attributable to precombination and postcombination services*

The concepts in ASC 718 and IFRS 2 used to attribute compensation costs differ. ASC 718 uses a service-period concept, whereas IFRS 2 uses a vesting-period concept. For purposes of the Standards, the service period and the **vesting period** include only periods of employee service that directly contribute to meeting the specified **vesting conditions** of the award. Therefore, for the attribution of fair value to precombination and postcombination service in a business combination, the service period and the vesting period should generally be the same. An exception to this will be deep out-of-the-money awards that under U.S. GAAP are deemed to have a derived service period.

The portion of the replacement award attributable to precombination service is the fair value of the acquiree awards multiplied by the ratio of the precombination service [vesting] period completed prior to the exchange to the greater of the total service [vesting] period of the replacement awards or the original service [vesting] period of the acquiree awards [ASC 805-30-55-8 through 55-9; IFRS 3.B58].

The fair value of the awards to be attributed to postcombination services would then be calculated by subtracting the portion attributable to precombination services from the total fair value of the acquirer replacement awards [ASC 805-30-55-10; IFRS 3.B59]. Excess fair value which is the incremental amount by which the fair value of the replacement awards exceeds the fair value of the acquiree awards on the acquisition date, should be attributed to postcombination services. The fair value attributable to precombination and postcombination services should be reduced to reflect an estimate of future forfeitures.

Figure 3-2 illustrates how to calculate the amount of fair value attributed to precombination and postcombination services.

Figure 3-2

Calculation of amount of fair value attributed to precombination and postcombination services

Precombination services			Postcombination services
Fair value of the acquiree award	X	Precombination service (vesting) period completed prior to the exchange	Total fair value of the acquirer replacement award Less: portion attributable to precombination services
		Greater of: Total service (vesting) period of the replacement award OR Original service (vesting) period of the acquiree award	

When determining the fair value attributable to precombination and postcombination services, the total service [vesting] period includes both the service [vesting] period of the acquiree's awards completed before the acquisition date and the postcombination service [vesting] period of the replacement awards [ASC 805-30-55-8 through 55-9; IFRS 3.B58].

The amount attributable to precombination services should be included in the consideration transferred for the acquiree. The amount attributable to postcombination services, however, is not part of the consideration transferred for the acquired business. The amount attributable to postcombination services should instead be recognised as compensation cost in the postcombination financial statements over the postcombination requisite service [vesting] period [ASC 805-30-30-12 through 30-13 and ASC 805-30-55-10; IFRS 3.B58–B59].

The method of attributing the fair value of replacement awards between periods of precombination services and postcombination services is the same for equity- and liability-classified awards. All changes in the fair-value-based measure of the awards classified as liabilities after the acquisition date and the related income tax effects are recognised as an expense in the acquirer's postcombination financial statements in the period(s) in which the changes occur [ASC 805-30-55-13; IFRS 3.B61].

Question 3-1

How should fair value be attributed to postcombination services for share options that are deep out-of-the-money at the acquisition date?

PwC response

Under U.S. GAAP, deep out-of-the-money options (i.e., the exercise price is significantly higher than the measurement date share price) may have a derived service period if retention of the awards by the employee is contingent upon employment (e.g., the contractual term of the awards will be truncated upon termination). The awards have a derived service period because the employee may effectively be required to provide service for some period of time to obtain any value from the award. Because the awards have a derived service period after the acquisition date, a portion of the replacement awards would be attributed to postcombination services and recognised as compensation cost in the postcombination financial statements [ASC 718-10-35-5; ASC 718-10-55-69 through 55-79; ASC 805-30-55-8 through 55-9].

For example, assume that, as of the acquisition date, employees of the acquiree are granted replacement awards with the same terms as their original awards. Under the terms of the awards, one year of service is required after the acquisition date for the awards to fully vest (i.e., the awards have an explicit service period of one year) and vested awards are forfeited upon termination of employment. However, on the acquisition date, the awards are deep out of the money. It is determined through the use of a lattice pricing model that the employee would need to provide three years of service to obtain any value from this award based on an expected increase in the company's share price. This three-year service period is considered a derived service period. The postcombination service period should be based on the longer of the explicit service period and the derived service period. Therefore, in this example, the acquirer would use a derived service period of three-years as opposed to the explicit service period of one year. The derived service period should generally be determined using a lattice model. Assessing whether an option is deep out-of-the-money will require judgment and may be impacted by whether the derived service period is substantive. The length of the derived service period will be significantly affected by the volatility of the acquirer's shares.

Under IFRS, the awards would be attributed over the one-year service period.

Question 3-2

How should the fair value of the acquirer's unvested replacement awards included in the consideration transferred for the acquiree reflect an estimate of forfeitures?

PwC response

The Standards provide that replacement share-based payment awards should be measured using the fair-value-based measurement method of ASC 718 or IFRS 2. Under ASC 718 and IFRS 2, no compensation cost is recognised for an award that is not expected to vest [ASC 718-10-30-16; IFRS 2.20]. Accordingly, the amount included in consideration transferred for the acquiree related to unvested awards should be reduced to reflect an estimate of future forfeitures. The estimate of future forfeitures should be based on the acquirer's estimate of prevesting forfeitures. When determining this estimate, the acquirer may need to consider the acquiree's historical employee data as well as the potential impact of the business combination on the employees' future behaviour [ASC 718-10-35-3; IFRS 2.20; ASC 805-30-55-11 through 55-12; IFRS 3.B60]. The amounts recorded in connection with the business combination (e.g., goodwill) should not be adjusted for changes made to the estimated forfeiture rate after the acquisition date.

Question 3-3

How should the compensation cost recognised in the acquirer's postcombination financial statements be adjusted to reflect estimated forfeitures of unvested awards?

PwC response

Both ASC 718 and IFRS 2 require companies to recognise compensation cost based on the number of awards expected to vest. Therefore, companies are required to estimate future forfeitures of unvested awards. For awards that are unvested at the acquisition date, the amount of compensation cost recognised in the postcombination financial statements should be reduced to reflect estimated forfeitures. Postcombination forfeitures, or changes in the estimated forfeiture rate, should be accounted for as adjustments to compensation cost in the period in which the forfeiture or change in estimate occurred [ASC 805-30-55-11 through 55-12; IFRS 3.B60]. When determining this estimate, the acquirer may need to consider the acquiree's historical employee data as well as the potential impact of the business combination on the employees' future behaviour [ASC 718-10-35-3; IFRS 2.20; ASC 805-30-55-11 through 55-12; IFRS 3.B60].

3.4.1.1 *Awards with graded-vesting features*

Awards with graded-vesting features vest in stages (tranches) over an award's contractual term, as opposed to vesting on a specific date. An example of an award with graded-vesting features is an award that vests 25 percent each year over a four-year period. The portion of the award that vests each year is often referred to as a "vesting tranche."

U.S. GAAP requires the attribution of compensation cost for the acquirer's replacement awards in the postcombination financial statements to be based on the acquirer's attribution policy. The company's attribution policy should be applied consistently for all awards with similar features [ASC 805-30-55-11 through 55-12].

Under the straight-line approach, a company recognises compensation cost on a straight-line basis over the **total service period** for the entire award (i.e., over the service period of the last separately vesting tranche of the award), as long as the cumulative amount of compensation cost that is recognised on any date is at least equal to the grant-date fair value of the vested portion of the award on that date. Under the graded-vesting approach, a company recognises compensation cost over the service period for each separately vesting tranche of the award as though the award is, in substance, multiple awards [ASC 718-10-35-8, ASC 718-20-55-25 through 55-34].

IFRS 2 does not provide companies with the option to use the straight-line attribution method for awards with graded-vesting features. Thus, a graded-vesting attribution approach should be used.

See SC 1.11 for information on awards with graded-vesting features.

Question 3-4

Under U.S. GAAP, how does an acquirer's attribution policy impact the amount attributable to precombination services for awards with graded-vesting features?

PwC response

For awards with graded-vesting features, the amount of fair value attributable to precombination services should be determined based on the acquirer's attribution policy for any of its existing awards [ASC 805-30-55-11 through 55-12]. For example, an acquirer exchanges replacement awards with a fair value of CU100 for the acquiree's awards with a fair value of CU100 (measured at the acquisition date). Under their original terms, the replacement awards vest 25 percent each year over four years, based on continued service. At the acquisition date, one year of service has been rendered. The replacement awards have the same vesting period as the original acquiree awards; therefore, three additional years of service are required after the acquisition date for all of the awards to vest. The fair value attributable to precombination services will depend on the acquirer's attribution policy as follows:

- Straight-line attribution approach: If the acquirer's attribution policy is the straight-line approach, the amount attributable to precombination services is CU25 (CU100 x 1/4 years).

- Graded-vesting attribution approach: If the acquirer's attribution policy is the graded-vesting approach, the amount attributable to precombination services is CU52. The calculation of this amount (assuming the fair value of the award was estimated for the entire grant) is illustrated below:

	Total fair value	% Vesting in year 1	Graded-vesting attributed in year 1
Tranche 1	CU25	100%	CU25.00
Tranche 2	25	50%	12.50
Tranche 3	25	33%	8.33
Tranche 4	25	25%	6.25
Total	CU100		CU52.08

Accordingly, if the acquirer's attribution policy is the straight-line approach, CU25 should be included in consideration transferred for the acquiree, and CU75 (CU100 less CU25) should be recognised in the postcombination financial statements. If the acquirer's attribution policy is the graded-vesting approach, CU52 should be included in consideration transferred for the acquiree, and CU48 (CU100 less CU52) should be recognised in the postcombination financial statements.

When acquiree share-based awards with graded-vesting features are granted prior to a business combination, some of the original awards may have vested and been exercised prior to the acquisition. Share-based payment awards of the acquiree that have already been exercised will be included in the consideration transferred for the acquiree's outstanding shares. For replacement awards related to awards still outstanding at the time of the business combination, the acquirer must determine the portion of the awards' fair value attributable to precombination services that will be recorded as part of the consideration transferred. The remainder of the fair value of the replacement awards will be attributable to postcombination services. Example 3-4 illustrates the attribution of the fair value of replacement awards to the precombination and postcombination services when a portion of the original awards has been exercised prior to the acquisition date.

EXAMPLE 3-4

Attribution of the fair value of replacement awards with graded-vesting features to precombination and postcombination services as part of a business combination when a portion of the original awards has been exercised

Company A acquires Company B on 1 July 20X9. Company A issues replacement awards with identical terms for Company B's outstanding awards held by employees. The original awards were issued to employees by Company B on 1 January 20X7 and provided employees with the right to purchase 100 shares of Company B. The original awards vest annually over 5 years (i.e., the original awards vest at a rate of 20% per year on the anniversary of the date of grant). The first two tranches of the original awards were exercised prior to the acquisition and only the unvested tranches remain outstanding at the acquisition date. Company A's accounting policy for recognising compensation cost for share-based awards is the straight-line approach under U.S. GAAP. The fair value of an award to purchase one common share at the acquisition date is CU10. There is no excess fair value of the replacement awards over the fair value of the acquiree awards as of the acquisition date.

Analysis

The first two tranches of the original awards (40 awards with a hypothetical acquisition date fair value of CU400) were exercised and are no longer outstanding. Therefore, the shares issued upon exercise of those awards would have already been included in the consideration transferred for Company B's outstanding shares. Company A will issue replacement awards for the 60 share-based awards outstanding at the acquisition date. The fair value of the 60 replacement awards is CU600 and Company A must determine the total amount attributable to precombination services that will be recorded as part of the consideration transferred for Company B. The remainder will be attributable to postcombination services.

One approach to attribute the fair value of the replacement awards to precombination and postcombination services would be to consider the initial awards to purchase 100 shares of Company B as if none of the awards had been exercised. In this case, the fair value as if all 100 of Company B's awards were outstanding on the acquisition date (i.e., as a single unit) would be CU1,000 (100 awards multiplied by CU10 fair value). The awards would have been 50% vested as 2.5 years have elapsed as of the acquisition date out of the 5 year total service period. The 50% vesting would include the 40 share-based awards that have been exercised as well as the portion of the 20 replacement awards in the third tranche, which are half-way through the vesting period of 1 January 20X9 to 1 January 20Y0. Multiplying the 50% vesting percentage to the awards' entire fair value of CU1,000 results in CU500 attributable to precombination services (consideration transferred for Company B) if all 100 awards were outstanding and being replaced. However, since 40 of the awards with a hypothetical fair value of CU400 have already vested and been exercised (and therefore included as part of consideration transferred for outstanding shares), only CU100 of the CU500 attributable to precombination services is recorded for the replacement awards as part of the consideration transferred for Company B. The aggregate unvested portion (50% or CU500) of the entire awards' fair value of CU1,000 would be attributable to postcombination services. Or, said another way, subtracting the CU100 attributable to precombination services from the CU600 fair value of the 60 replacement awards results in CU500 attributable to postcombination services.

Another approach to attribute the fair value of the replacement awards to precombination and postcombination services may be to determine the hypothetical service inception date for the remaining outstanding awards, as the straight-line method inherently views each tranche as a series of awards with sequential service periods. In this fact pattern, the hypothetical service-inception date would be 1 January 20X9, coincident with the beginning of the vesting period of the third tranche, and the service period would end on 1 January 20Y2, the final vesting date of the fifth tranche of the original award. The 60 remaining outstanding awards are therefore 16.7% vested as 6 months have elapsed (1 January 20X9 to the acquisition date of 1 July 20X9) out of the 3-year service period from the hypothetical service-inception date until the final vesting date of the original award. Multiplying the CU600 fair value of the 60 replacement awards exchanged as of the acquisition date by 16.7% results in CU100 to be attributed to precombination services (consideration transferred for Company B). The remaining CU500 (CU600 - CU100) would be attributable to postcombination services.

Additional analyses may be necessary to attribute the fair value of the replacement awards to precombination and postcombination services in more complex fact patterns. Complex fact patterns may include situations where tranches are only partially exercised, awards do not vest rateably, or complete records are not available to specifically identify the tranche of exercised awards.

If Company A's accounting policy for recognising share-based award compensation cost were to utilize a graded-vesting allocation approach (as required under IFRS and as permitted under U.S. GAAP), the allocation would be calculated differently. Under a graded-vesting allocation approach CU392 of the CU600 fair value of the replacement awards would be attributable to precombination services and be recorded as part of the consideration transferred for Company B. This is calculated as follows:

Replacement awards	Total fair value	% Vesting at acquisition date	Graded-vesting attributed to precombination services
Tranche 3	CU200	83.3%[1]	CU167
Tranche 4	200	62.5%[2]	125
Tranche 5	200	50.0%[3]	100
Total	CU600		CU392

[1] Calculated as 30 months out of 36 months total service period.
[2] Calculated as 30 out of 48 months total service period.
[3] Calculated as 30 out of 60 months total service period.

The remaining value of the 60 replacement awards is attributable to postcombination services. That is, CU600 fair value of the 60 replacement awards less the CU392 attributable to precombination services results in CU208 attributable to postcombination services.

3.4.2 *Service required after the acquisition date is equal to or greater than the original service requirement*

An employee may hold an award that is fully vested under its original terms, but the terms of the replacement award require additional service from the employee. Although the holder of the award performed all of the service as required by the original award granted by the acquiree, the acquirer added an additional service [vesting] period to the replacement awards. Therefore, a portion of the fair value of the replacement award will be attributable to postcombination services.

Consider a scenario in which the original terms of an award require four years of service which were completed as of the acquisition date. However, an additional year of service was added to the terms of the replacement award by the acquirer, resulting in a total service [vesting] period of five years. The acquirer will use the ratio of the four years of service completed compared to the total service [vesting] period of five years, resulting in 80 percent of the fair value of the acquiree award being attributed to precombination services and accounted for as consideration transferred for the acquiree. The remaining fair value of the replacement award, including any excess fair value, would be accounted for over the remaining service [vesting] period of one year in the postcombination financial statements.

3.4.3 Service required after the acquisition date is less than the original service requirement

A replacement award that requires less service after the acquisition than would have been required under the original award effectively accelerates the vesting of the original award, eliminating all or a portion of the postcombination service requirement. See BCG 3.4.3.1 for information on awards with an automatic change in control clause. The amount of fair value attributable to the accelerated vesting of the award should be recognised as additional compensation cost separate from the business combination. The amount included in the consideration transferred for the acquiree is limited to the amount of the acquiree's award attributable to precombination service. The ratio of the precombination service period [portion of the vesting period completed] to the greater of the total service [vesting] period or the original service [vesting] period of the acquiree award should be used when calculating the amount of the replacement award attributable to precombination services.

Example 3-5 further illustrates this guidance [ASC 805-30-55-8 through 55-9, ASC 805-30-55-21 through 55-24; IFRS 3.B58].

EXAMPLE 3-5

Attribution of fair value when service required after the acquisition date is less than the original service requirement

Company X (the acquirer) exchanges replacement awards with a fair value of CU100 for Company Y's (the acquiree) awards with a fair value of CU100. When originally granted, Company Y's awards provided for cliff vesting after a service [vesting] period of four years from the grant date. As of the acquisition date, three of the four years of service required by the original terms of Company Y's awards have been rendered. The replacement awards issued by Company X are fully vested. Company X was obligated to issue replacement awards under the terms of the acquisition agreement.

Analysis

Company X accelerated the vesting of the awards by eliminating the one year of postcombination service that would have been required under the awards' original terms. The amount of Company X's replacement awards' value attributable to precombination services is equal to the fair value of Company Y's awards at the acquisition date, multiplied by the ratio of precombination service period (portion of the vesting period completed) to the greater of the total service [vesting] period or the original service [vesting] period of Company Y's awards.

- The total service [vesting] period is three years (i.e., the years of service rendered as of the acquisition date).
- The original service [vesting] period of Company Y's awards was four years.
- The original service [vesting] period of four years is greater than the total service [vesting] period of three years; therefore, the original service period of four years should be used to determine the amount attributable to precombination services; the amount attributable to precombination services is CU75 (the value of Company Y's awards of CU100 x 3 years precombination service / 4 years original service).
- The fair value of Company Y's replacement awards of CU100, less the amount attributed to precombination services of CU75, or CU25 (the portion for which vesting was accelerated), should be recognised in the postcombination financial statements. Because the replacement awards are vested, the entire CU25 should be recognised immediately in the postcombination financial statements.

3.4.3.1 *Acquiree awards with an automatic change in control provision*

The fair value of acquiree awards that include a preexisting, automatic change in control clause (whereby awards vest immediately upon a change in control) should be included in the consideration transferred for the acquiree. The excess fair value of any replacement awards over the fair value of the acquiree awards should be reflected in the postcombination period [ASC 805-30-55-23 through 55-24; IFRS 3.B56–B59, IE70]. However, a preexisting change in control clause should be assessed carefully to determine if the change in control clause is a transaction separate from the business combination (e.g., considering when the change in control clause was added to the terms of the agreement).

Example 3-6 illustrates the accounting for an award with an automatic change in control provision.

EXAMPLE 3-6

Allocation of fair value when an automatic change in control provision accelerates vesting upon closing of an acquisition

Company X (the acquirer) exchanges vested shares with a fair value of CU100 for Company Y's (the acquiree) awards with a fair value of CU100. Company Y's awards contain a change in control clause, whereby they automatically vest upon closing of an acquisition. When originally granted, Company Y's awards provide for cliff vesting after a service [vesting] period of four years. As of the acquisition date, three of the four years of service required by the original terms of Company Y's awards have been rendered.

Analysis

The change in control clause in Company Y's awards requires that all awards automatically vest upon closing of an acquisition. Due to the fact that the change in control clause was in the original terms of Company Y's awards prior to the acquisition and required automatic vesting of the awards, there is no need to compare the total service [vesting] period to the original service [vesting] period. Therefore, the amount attributable to precombination services is the entire CU100 fair value of the acquiree awards. If the shares exchanged by Company X had a fair value greater than CU100, any excess would have been recognised in the postcombination financial statements of the combined company.

3.4.3.2 *Acquiree awards with a discretionary change in control provision*

Acquiree awards for which vesting is accelerated based on a discretionary change in control clause need to be analysed to determine if the acceleration of the vesting of the awards by the acquiree was arranged primarily for the economic benefit of the acquirer (or combined entity), or if it was for the benefit of the acquiree (as illustrated in Example 3-5). The portion of the fair value of the acquiree's award related to the acceleration of vesting under a discretionary change in control clause would be recognised in the postcombination financial statements of the combined company if it is for the benefit of the acquirer. Refer to BCG 3.2 for the factors to consider in this analysis.

3.4.4 *Excess fair value of the acquirer's replacement award*

Any excess fair value of the replacement awards over the fair value of the acquiree awards at the acquisition date is considered an expense incurred by the acquirer (i.e., additional compensation) outside of the business combination. The excess fair value at the acquisition date, typically, is not significant if the replacement awards have the same terms and conditions as the acquiree awards. The assumptions used to calculate fair value immediately before the business combination may converge with the assumptions used to calculate the fair value of the replacement awards immediately after the modification because the value of the equity of the acquirer and the acquiree will usually reflect the pending acquisition as the closing date approaches.

However, if the acquirer changes the terms and conditions of the awards or the employee's awards are exchanged using a different ratio than that offered to other equity holders (as this would usually be a change to make the awards more valuable to the employees), it is likely that there will be excess fair value. The acquirer should recognise the excess fair value over the remaining service [vesting] period in the postcombination financial statements [ASC 805-30-55-10; IFRS 3.B59]. Refer to ASC 805-30-55-18 through 55-19 and IFRS 3.IE63-IE64 for an example of replacement awards with excess fair value.

3.4.5 Acquiree awards that continue after the business combination

There may be circumstances when acquiree employee awards are not exchanged and do not expire but continue after the business combination. This may occur when the acquirer purchases a target company and the target company continues as a separate **subsidiary** of the acquirer. When the employee awards of the target are not exchanged but continue under the original terms after the business combination, the acquirer accounts for the continuation of the awards as if the acquirer was obligated to issue replacement awards. This is similar to an exchange of awards in a business combination [ASC 805-30-30-9, ACS 805-30-30-11 through 30-13, ASC 805-30-55-7 through 55-10; IFRS 3.B56 and B62A].

Alternatively, under U.S. GAAP, the acquirer could choose to account for the awards separate from the business combination. The acquirer would account for the awards as new grants and recognise the fair value of the awards as compensation cost in the postcombination period.

3.4.6 Awards with performance or market conditions

For awards with performance conditions (as defined by ASC 718 and IFRS 2), the acquirer should follow the same principle outlined in the Standards for awards with service conditions. Consistent with the guidance in the Standards, the amount by which the fair value of the replacement awards exceeds the fair value of the original awards should be recognised in the postcombination financial statements [ASC 805-30-55-10; IFRS 3.B59].

The determination of the fair value attributable to precombination and postcombination services would also be consistent with the analysis performed for awards with service conditions. The amount attributable to precombination services is determined by multiplying the fair value of the acquiree award by the ratio of the precombination service [vesting] period completed prior to the exchange to the greater of the total service [vesting] period or the original service [vesting] period of the acquiree award. The amount attributable to postcombination services would then be calculated by subtracting the portion attributable to precombination services from the total fair value of the acquirer's replacement award. The determination of the postcombination service [vesting] period for the replacement awards should include consideration of the performance condition and the period in which it is probable that the performance condition will be achieved. The acquirer will need to make a probability assessment at the acquisition date.

Example 3-7 illustrates this guidance.

EXAMPLE 3-7

Allocation of fair value for awards with a performance condition

Company Z (the acquirer) exchanges replacement awards with a fair value of CU300 for Company A's (the acquiree) awards with a fair value of CU300. Company Z was obligated to issue replacement awards under the terms of the acquisition agreement. When granted, Company A's awards cliff vest following the completion of the development of a new product. Because the awards contain a performance condition, at the acquisition date Company A had to assess the probability of whether the performance condition would be achieved. Prior to the acquisition, it was considered probable that the product would be finished three years from the grant date. As of the acquisition date, one year has passed since the grant date; therefore, two years remain in the original service [vesting] condition. Company Z assessed the performance condition on the acquisition date and determined that it is still likely that the new product will be completed two years from the acquisition date. This probability assessment should be consistent with the assumptions included in the valuation of Company A's in-process research and development (IPR&D).

Analysis

The amount of Company Z's replacement awards attributable to precombination services is equal to the fair value of Company A's awards at the acquisition date, multiplied by the ratio of the precombination service period (portion of the vesting period completed) to the greater of the total service [vesting] period or the original service [vesting] period of Company A's awards. The original service [vesting] period of Company A's awards was three years. Company Z, at the acquisition date, determined that it is still probable that the development of the new product will be completed in two more years; therefore, the awards will have a total service [vesting] period of three years. That is, the original service [vesting] period and the total service [vesting] period are both three years. The amount attributable to precombination services is CU100 (CU300 x 1 year precombination service / 3 years original service). The remaining fair value of the awards of CU200 should be recognised in the postcombination financial statements over the remaining service [vesting] period of two years because the awards have not yet vested.

Had the acquirer determined on the acquisition date that it was probable that the product would be completed one year from the acquisition date, then the amount attributable to precombination services (CU100) would remain the same. This would be the case since the original service [vesting] period of three years is greater than the total service [vesting] period of two years. The remaining fair value of CU200, however, would be recognised over the remaining service [vesting] period of one year.

Question 3-5

How should the acquirer account for the exchange of an equity settled award with a performance (nonmarket) condition (as defined by ASC 718 and IFRS 2), assuming it is not probable both before and after the exchange that the condition will be achieved?

PwC response

Under ASC 718 and IFRS 2, the probability that an award with a service or performance condition will vest is not incorporated into the fair value of the award; instead, compensation cost is recognised only for awards expected to vest. In other words, compensation cost is recognised if and when it is probable that the performance condition will be achieved [ASC 718-10-35-3; IFRS 2.20].

The Standards provide that replacement share-based payment awards should be measured using the fair-value-based measurement method of ASC 718 or IFRS 2 [ASC

805-30-30-11 and ASC 805-30-55-7; IFRS 3.B57]. Under ASC 718 and IFRS 2, no compensation cost is recognised for an award with a performance condition that is not expected to vest. Accordingly, if it is not probable both before and after the exchange that the performance condition will be achieved, then no amount should be recorded for that replacement award in connection with the business combination. The acquirer should not record any compensation cost in the postcombination financial statements unless and until achievement of the performance condition becomes probable [ASC 718-10-35-3; IFRS 2.20].

Once achievement of the performance condition becomes probable, the company should begin recognising cumulative compensation cost from the date it becomes probable based on the fair value of the replacement award as of the acquisition date. No adjustment should be made to the amounts recorded in connection with the business combination (e.g., goodwill) [ASC 805-30-55-11 through 55-12; IFRS 3.B60]. The approach in the **consolidated financial statements** of the combined entity would be the same under U.S. GAAP and IFRS.

For awards with a market condition, the acquirer should follow the same principle outlined in the Standards for awards with service conditions. Because a market condition is reflected in the fair value of an award, the market condition should be taken into consideration when calculating the fair value of the acquirer's replacement awards. Consistent with the guidance in the Standards, any excess fair value should be recognised as compensation cost in the postcombination financial statements.

The determination of the fair value attributable to precombination and postcombination services is consistent with the analysis performed for awards with service conditions. The determination of the precombination and postcombination service [vesting] periods for the replacement awards should include consideration of the market condition. As noted in BCG 3.4.4, the assumptions used to calculate fair value immediately before the business combination may converge with the assumptions used to calculate the fair value of the replacement awards immediately after the exchange.

3.4.7 Illustrative summary of attributing fair value to precombination and postcombination services

The examples presented in Figure 3-3 are based on the following assumptions: (1) the original terms of the acquiree's awards cliff vest following four years of service, (2) the acquirer is obligated to issue replacement awards under the terms of the acquisition agreement (except as specified in Example 6) , and (3) the fair value of the replacement awards is equal to the fair value of the acquiree awards on the acquisition date (except as specified in Example 3). See BCG 3.4.1.1 for information on awards with graded-vesting features.

Figure 3-3
Attribution of fair value to precombination and postcombination services

Acquiree's awards	Acquirer's replacement awards	Greater of total service [vesting] period or original service [vesting] period	Fair value attributable to pre-combination services	Fair value attributable to post-combination services
Example 1:				
4 years of service required under original terms. All required services rendered prior to acquisition.	No service required after the acquisition date.	4 years. The original service [vesting] period and the total service [vesting] period are the same.	100% (4 years pre-combination service/4 years total service).	0%
Example 2:				
4 years of service required under original terms. 3 years of service rendered prior to acquisition.	1 year of service required after the acquisition date.	4 years (3 years prior to acquisition plus 1 year after acquisition). The original service [vesting] period and the total service [vesting] period are the same.	75% (3 years precombination service/4 years total service).	25% (total fair value of the replacement award less the 75% for precombination services). This amount is recognised in the post-combination financial statements over the remaining service [vesting] period of 1 year.
Example 3:				
4 years of service required under original terms. 4 years of service rendered prior to acquisition.	1 year of service required after the acquisition date. The employee has agreed to the additional year of service because the fair value of the replacement awards is greater than the fair value of the acquiree awards.	5 years (4 years completed prior to acquisition plus 1 year required after acquisition). The total service [vesting] period of 5 years is greater than the original service [vesting] period of 4 years.	80% of the acquiree award (4 years precombination service/5 years total service).	20% of the acquiree award and the excess fair value of the replacement award (total fair value of the replacement award less the 80% for precombination services). This amount is recognised in the postcombination financial statements over the remaining service [vesting] period of 1 year.

Acquiree's awards	Acquirer's replacement awards	Greater of total service [vesting] period or original service [vesting] period	Fair value attributable to pre-combination services	Fair value attributable to post-combination services
Example 4:				
4 years of service required under original terms. 1 year of service rendered prior to acquisition.	2 years of service required after the acquisition date. Therefore, the replacement awards require one less year of service.	4 years (since only 2 years of service are required postcombination, the total service [vesting] period for the replacement awards is 3 years, which is less than the original service [vesting] period of 4 years). Therefore, the original service [vesting] period is greater than the total service [vesting] period.	25% (1 year precombination service/4 years original service [vesting] period).	75% (total fair value of the replacement award less the 25% for precombination services). This amount is recognised in the postcombination financial statements over the remaining service [vesting] period of 2 years.
Example 5:				
4 years of service required under original terms. 3 years of service rendered prior to acquisition. There was no change in control clause in the terms of the acquiree awards.	No service required after the acquisition date.	4 years (since no additional service is required, the total service [vesting] period for the replacement awards is 3 years, which is less than the original service [vesting] period of 4 years). Therefore, the original service [vesting] period is greater than the total service [vesting] period.	75% (3 years precombination service / 4 years original service [vesting] period).	25% (total fair value of the replacement award less the 75% for precombination services). This amount is recognised in the postcombination financial statements immediately because no future service is required.
Example 6:				
4 years of serivce required under original terms. 3 years of service rendered prior to acquisition. There was a change in control clause in the original terms of the acquiree awards when granted that accelerated vesting upon a change in control.	No service required after the acquisition date.	Not applicable. Because the awards contain a pre-existing change in control clause, the total fair value of the acquiree awards is attributable to precombination services.	100%. For acquiree awards with a change in control clause that accelerates vesting, the total fair value of the acquiree awards is attributable to precombination services.	0%. For acquiree awards with a pre-existing change in control caluse, no amount is attributable to postcombination services because there is no future service required.

3.5 Cash settlement of employee share-based payment awards

An acquirer may elect to pay cash to settle outstanding awards held by employees of the acquiree instead of granting replacement awards. The accounting for the cash settlement of share-based payment awards outside of a business combination is addressed by ASC 718 and IFRS 2 [ASC 718-20-35-7; IFRS 2.28]. The accounting for the cash settlement of share-based payment awards within a business combination is not explicitly addressed by the Standards. However, we believe many of the same principles that apply to the exchange of share-based payment awards should be applied to these transactions. That is, determine the portion of the cash settlement to be attributed to precombination services or postcombination services using the guidance for the exchange of share-based payment awards and the allocation formula described in Figure 3-2. The following sections discuss cash settlements initiated by the acquirer as well as cash settlements initiated by the acquiree. Determining who initiated the cash settlement may require analysis of the factors listed in BCG 3.2 and 3.3 [ASC 805-10-55-18 and ASC 805-10-55-25; IFRS 3.B50, IFRS 3.B55].

3.5.1 *Initiated by the acquirer*

Cash payments made by the acquirer to settle vested awards should be included in the consideration transferred for the acquiree up to an amount equal to the fair value of the acquiree's awards measured at the acquisition date. To the extent the cash payment is greater than the fair value of the acquiree's awards, the excess fair value amount is considered an expense incurred by the acquirer outside of the business combination rather than as consideration transferred for the acquiree. Accordingly, the excess amount of cash paid over the fair value of the acquiree's awards should be immediately recognised as compensation cost in the postcombination financial statements [ASC 805-30-55-10; IFRS 3.B59].

If cash payments are made by the acquirer to settle unvested awards (assuming no future service is required to receive the cash payment), the acquirer has effectively accelerated the vesting of the awards by eliminating the postcombination service requirement and settled the awards for cash. The portion attributable to precombination service provided to the acquiree should be included in the consideration transferred for the acquiree. The remaining portion of the cash payment to the acquiree's employees, attributable to the postcombination service, should be immediately recognised as compensation cost in the postcombination financial statements. This analysis is similar to the illustration in Example 3-5, in which vested replacement share-based payment awards are transferred for unvested acquiree awards [ASC 805-30-55-10 and ASC 805-30-55-23 through 55-24; IFRS 3.IE70–IE71].

An acquirer may pay cash in exchange for unvested awards of the acquiree and additional postcombination service, with the cash payment made at the completion of the additional service [vesting] period. In this case, the acquirer will need to determine the portion of the payment attributable to precombination services and postcombination services. The amount attributable to precombination services is determined by multiplying the fair value of the acquiree award by the ratio of the precombination service [vesting] period completed prior to the payment, to the greater of the total service [vesting] period or the original service [vesting] period of the acquiree award. The amount attributable to postcombination services would be recognised in the postcombination financial statements over the remaining service [vesting] period.

3.5.2 Initiated by the acquiree

The acquiree (as opposed to the acquirer) may cash-settle outstanding awards prior to the acquisition. However, these transactions, including their timing, should be carefully assessed to determine whether the cash settlement, or a portion thereof, was arranged primarily for the economic benefit of the acquirer (or the combined entity). Even though the form of the transaction may indicate that the acquiree initiated the cash settlement, it may be determined that, in substance, the acquirer reimbursed the acquiree for the cash settlement (either directly or as part of the consideration transferred for the acquiree). This assessment should include an analysis of the factors listed in BCG 3.2 [ASC 805-10-55-18; IFRS 3.B50].

If the acquiree cash-settles its awards and it is determined that the transaction was for the economic benefit of the acquiree, the settlement should be recorded in the acquiree's financial statements prior to the business combination [ASC 718-20-35-7; IFRS 2.28]. If it is determined that the acquirer reimbursed the acquiree for the cash settlement (either directly or as part of the transaction price paid for the acquiree), the accounting by the acquirer should generally be the same as if the acquirer had settled the awards directly. Example 3-8 illustrates this guidance.

EXAMPLE 3-8

Example of cash settlement of awards by the acquiree

Company D (the acquiree) cash-settles the outstanding unvested awards held by its employees immediately prior to being acquired by Company C (the acquirer). The amount of cash paid by Company D is CU100 million, which is equal to the current fair value of the awards. At the time of settlement, the employees had completed 75 percent of the service required to vest in the awards (and 25 percent of the service period remained).

Analysis

Company C should determine whether a portion of the consideration transferred for Company D is attributable to the settlement of unvested awards held by Company D's employees. The settlement of the portion of the unvested awards not attributable to precombination services may be a transaction arranged primarily for the economic benefit of Company C. Factors to consider in this analysis (as discussed in ASC 805-10-55-18 and IFRS 3.B50) include:

- The reasons for the transaction: Why did Company D elect to cash-settle the outstanding awards?

- Who initiated the transaction: Did Company C direct Company D to settle the awards? Was the settlement a condition of the acquisition?

- The timing of the transaction: Was the settlement in contemplation of the business combination?

If Company D was requested by Company C to cash-settle the awards, the settlement of the unvested awards would be deemed a transaction arranged primarily for the economic benefit of Company C. Therefore, a portion of the total consideration transferred should be attributed to the cash settlement of the awards and excluded from the consideration transferred to acquire Company D. In this example, the fair value of the unvested awards that is not attributable to precombination services, or CU25 million (the fair value of the awards of CU100 million remaining service [vesting] period of 25%), is the amount that would be excluded from consideration transferred and recognised as expense in Company C's postcombination financial statements. The CU25 million should be recognised immediately because no postcombination service is required.

3.6 Other arrangements

Other forms of compensation arrangements may be provided to the employees of the acquiree in conjunction with a business combination. Two common arrangements are "last-man-standing" arrangements and "dual trigger" arrangements.

3.6.1 "Last-man-standing" arrangements

Awards granted to a group of employees and reallocated equally among the remaining employees if any of the employees terminate employment prior to completion of the service [vesting] period are often described as 'last man standing' arrangements. The accounting for these arrangements, if cash-settled, is the same under U.S. GAAP and IFRS. However, if the arrangement involves equity-settled share-based payment awards, there is a difference in the accounting model under U.S. GAAP and IFRS. Under U.S. GAAP, a reallocation of awards in a "last-man-standing" arrangement is accounted for as a forfeiture of the original awards and a grant of new awards. Under IFRS, the estimated number of awards that are expected to vest does not change; therefore, a reallocation of awards would generally not have an accounting impact.

Example 3-9 illustrates "last-man-standing" arrangements that are provided as share-based payment awards; Example 3-10 illustrates those that are payable in cash.

EXAMPLE 3-9

"Last-man-standing" arrangement involving share-based payment awards

On 1 January 2X10, Company M (the acquirer) acquires Company G (the acquiree) and, as part of the acquisition agreement, grants 100 awards to each of five former executives of Company G. Each set of awards has a fair value of CU300 on the acquisition date. The awards cliff vest upon two years of continued employment with the combined company. However, if the employment of any one of the executives is terminated prior to 1 January 2X12, any awards forfeited by that executive are reallocated equally among the remaining executives who continue employment. The reallocated awards will continue to cliff vest on 1 January 2X12. On 1 January 2X11, one of the five executives terminates employment with the combined company. The

100 unvested awards (100 awards x 1 executive) are forfeited and redistributed equally to the other four executives. At the time of the forfeiture, the fair value of each set of awards is CU360.

Analysis:

Under U.S. GAAP, the fair value of all awards granted to the executives on the acquisition date is CU1,500 (CU300 x 5 sets of awards), which should be recognised over the two-year service [vesting] period in the postcombination financial statements, as long as each employee continues employment with the combined company.

The accounting for a reallocation under a "last-man-standing" arrangement is effectively a forfeiture of the original awards and a grant of new awards. That is, if an employee terminates employment and the awards are reallocated to the other employees, the reallocation of the forfeited awards should be treated as (1) a forfeiture of the terminated employee's awards and (2) a new award granted to the remaining employee(s). In this example, 100 unvested awards (100 awards x 1 executive) were forfeited and regranted to the remaining four employees (25 awards each). Company M would reverse CU150 (CU300 x 1 terminated executive x 1/2 of the service [vesting] period completed) of previously recognised compensation for the terminated employee's forfeited awards. Company M would then recognise an additional CU90 (CU360 / 4 executives) for each of the four remaining executives over the new service [vesting] period of one year.

Under IFRS, the estimated number of total awards that will ultimately vest is not expected to change; therefore, there is no accounting consequence arising from the reallocation.

EXAMPLE 3-10

"Last-man-standing" arrangement involving cash consideration

Company B (the acquirer) acquires Company A (the acquiree) for cash consideration of CU250. The selling shareholders of Company A were all key employees of Company A prior to the acquisition date and will continue as employees of the combined business following the acquisition by Company B. Company B will pay the selling shareholders additional consideration in the event Company A achieves pre-determined sales targets for the 3 years following the acquisition. This additional consideration will be paid to the previous shareholders in proportion to their relative previous ownership interests. Any shareholders who resign their employment with Company A during the 3-year period forfeit their portion of the additional payments. Amounts forfeited are redistributed among the previous shareholders who remain as employees for the 3-year period. If none of the previous shareholders remain employed at the end of the 3-year period, but the relevant sales targets are still achieved, all of the previous shareholders will receive the additional payment in proportion to their previous ownership interests. The selling shareholders will have the ability to influence sales volumes if they continue as employees.

Analysis

The contingent payments are not automatically forfeited if all the selling shareholders cease employment. However, each of the selling shareholders controls their ability to earn their portion of the additional payment by continuing employment. The selling shareholders have the ability to influence sales volumes if they continue as employees. The commercial substance of the agreement incentivises the selling shareholders to continue as employees. Further, the scenario where all selling shareholders cease employment is unlikely because the last selling shareholder remaining in employment would not likely voluntarily leave employment and forfeit the entire amount of additional payment. The entire additional payment, given this combination of factors, would be accounted for as compensation expense in the postcombination period.

3.6.2 *"Dual trigger" arrangements*

Preexisting employment agreements often include clauses that accelerate vesting upon a change of control and termination of employment within a defined period of time from the acquisition date, often referred to as dual trigger arrangements. Employment agreements of the acquiree should be carefully assessed to determine whether acceleration of vesting is primarily for the economic benefit of the acquirer by considering the following factors:

- The reasons for the transaction
- Who initiated the transaction
- The timing of the transaction [ASC 805-10-55-18; IFRS 3.B50]

If it is determined the clause or transaction that accelerates vesting is primarily for the economic benefit of the acquirer, the acceleration of vesting of unvested awards should be accounted for separately from the business combination and will be recognised as compensation cost to the acquirer [ASC 805-10-25-20 through 25-22; IFRS 3.51–52, B50].

The dual trigger clause effectively places the decision to retain the acquiree's employees in the control of the acquirer, and thus the decision would be made primarily for the acquirer's economic benefit (e.g., reduce cost). Therefore, since the acquirer makes the decision to terminate the employees, the acquirer should recognise cost in the postcombination period for the acceleration of the unvested portion of the awards (measured as of the acquisition date using the methodology described in ASC 805-30-30-12 through 30-13 and ASC 805-30-55-10; IFRS 3.B58–B59).

An acquiree may put in place a new, or alter an existing, compensation arrangement at the direction of the acquirer. In these instances, it may be necessary to record compensation cost in both the acquirer's post-acquisition financial statements and the acquiree's pre-acquisition financial statements. These scenarios typically arise when the acquiree legally incurred the related obligation, and other accounting standards require the acquiree to recognise the related cost even though the cost was incurred for the benefit of the acquirer.

Example 3-11 illustrates the accounting for a dual trigger arrangement.

EXAMPLE 3-11

Accelerated vesting conditioned upon a dual trigger consisting of change in control and termination

Company A acquires Company B in a business combination, and Company A is obligated to grant replacement awards as part of the business combination [ASC 805-30-30-9; IFRS 3R.B56].

Company B has an existing employment agreement in place with one of its key employees that states that all of the key employee's unvested awards will fully vest upon a change in control and termination of employment within 12 months following the acquisition date. The employment agreement was in place before Company A and Company B began negotiations for the acquisition of Company B. The awards vest only if the employee is subsequently terminated without cause or leaves for good reason as defined in the employment contract. Prior to the acquisition date, Company A had determined it would not offer employment to the key employee of Company B, effectively terminating employment on the acquisition date. This resulted in the acceleration of all the key employee's unvested awards upon closing of the acquisition.

Analysis

Company A should immediately recognise compensation cost related to the accelerated vesting of the awards (measured as of the closing of the acquisition using the methodology described in ASC 805-30-30-12 through 30-13 and ASC 805-30-55-10; IFRS 3.B58–B59) in its postcombination period. The accelerated vesting is conditioned upon both a change in control of the acquiree and the termination of employment of the key employee. At the acquisition date, both conditions were triggered. The decision not to employ the key employee was in the control of Company A and effectively made for its primary economic benefit (e.g., reduce cost) and, therefore, should be recorded separately from the business combination [ASC 805-10-25-20 through 25-22; IFRS 3.51–52].

3.7 Postcombination accounting for share-based payment awards

Compensation cost associated with share-based payment awards that is recorded in the acquirer's postcombination financial statements should be accounted for in accordance with ASC 718 or IFRS 2 [ASC 718-20-35-3 through 35-4; IFRS 2.26–29]. For example, the determination of whether the acquirer's replacement awards should be classified as equity or as a liability and the period over which compensation cost is recognised should be based on the guidance in ASC 718 or IFRS 2.

Modifications of awards after the acquisition date should be accounted for based on the modification guidance in ASC 718 or IFRS 2. No adjustments are made to the accounting for the business combination as a result of changes in forfeiture estimates (refer to Questions 3-2 and 3-3) or modifications of replacement awards after the acquisition date [ASC 805-30-55-11 through 55-12; IFRS 3.B60]. This includes fair value adjustments for the remeasurement of liability-classified awards at each balance sheet date until the settlement date [ASC 805-30-55-13; IFRS 3.B61].

New share-based payment awards (as opposed to replacement awards) granted by the acquirer to the former employees of the acquiree will be subject to the guidance in ASC 718 or IFRS 2, and will not affect the accounting for the business combination.

Question 3-6

How should an acquirer account for the acceleration of unvested share-based payment awards that is triggered when the acquirer does not issue equivalent replacement awards as part of a business combination?

PwC response

If the provision that accelerates vesting is primarily for the benefit of the acquirer, the acceleration of vesting of unvested awards should be accounted for separately from the business combination and be recognised as compensation cost in the acquirer's postcombination financial statements [ASC 805-10-25-20 through 25-22; IFRS 3.51–52]. The aquirer's decision not to issue replacement awards is in the control of the acquirer. Therefore, the acquirer should immediately recognise compensation cost in the postcombination period for the acceleration of the unvested portion of the awards. The accounting would be the same if the acquirer issued fully vested replacement awards.

Question 3-7

How should the acquirer account for a modification to an arrangement with contingent payments in a business combination when the modification occurs during the measurement period?

PwC response

A subsequent change to a compensation arrangement does not lead the acquirer to reassess its original conclusion under ASC 805-10-55-25 or IFRS 3.B55 regarding whether the arrangement is treated as consideration transferred or is accounted for outside of the business combination. Assuming the original conclusion reached as of the acquisition date was not an error, the original treatment should be respected even if the subsequent change was made during the measurement period.

Example 3-12 illustrates an arrangement that includes contingent payments that is modified during the measurement period.

EXAMPLE 3-12

Accounting for modifications during the measurement period to compensation arrangements

Company A acquired Company B in a business combination. Company A wanted to retain the services of the former Company B shareholders to help transition the business.

Therefore, Company A agreed to pay a portion of the consideration to the former shareholders of Company B over the length of their new employment contracts (3 years) with the combined entity. The former shareholders would forfeit any unearned portion of the contingent payment if employment were voluntarily terminated.

After considering the guidance in ASC 805-10-55-25 or IFRS 3.B55, Company A appropriately determined that it should account for the contingent payment as compensation cost and not as an element of consideration transferred. The contingent payment to the former shareholders was linked to their continued employment.

Six months after the business combination, Company A decided it no longer needed the former shareholders for transition purposes and terminated their employment. As part of the termination, Company A agreed to settle the contingent payment arrangement with an additional payment to the former shareholders.

Analysis

Company A appropriately concluded at the acquisition date that the arrangement should be treated as compensation cost. A subsequent change to that arrangement does not cause Company A to reassess its original conclusion under ASC 805-10-55-25 or IFRS 3.B55. This would also apply even if the subsequent change was made while Company A was in the process of finalizing any measurement period adjustments. Company A should consider the payment to the former shareholders of Company B as being made to settle their employment contracts with Company A (i.e., Company A accelerated the service period) and not as consideration transferred to acquire Company B.

3.8 U.S. GAAP and IFRS differences—income tax effects of share-based payment awards

The accounting for the income tax effects of share-based payment awards differs under ASC 718 and IFRS 2. Therefore, the accounting for the income tax effects of awards transferred in a business combination will also differ between U.S. GAAP and IFRS. Under U.S. tax law, employers may be entitled to a tax deduction equal to the intrinsic value (i.e., current market value of the underlying equity less exercise price) of a share option at the exercise date (or vesting date in the case of restricted shares) [ASC 718-740-05-4]. Tax deductions are also available for share-based payment transactions in some non-U.S. jurisdictions.

3.8.1 Accounting for the income tax effects of replacement awards—U.S. GAAP

Compensation cost for U.S. GAAP purposes is generally recorded before the tax deduction is generated, thus creating a **temporary difference** (and a **deferred tax asset**) under ASC 740. Therefore, a deferred tax asset is recognised equal to the compensation cost that has been recorded for awards that ordinarily result in a tax deduction (e.g., nonqualified options granted to U.S. employees) multiplied by the applicable tax rate under ASC 718. The deferred tax asset for equity classified awards is not subsequently adjusted to reflect changes in the company's share price [ASC 718-740-05-4 and ASC 718-740-25-2 through 25-3].

3.8.1.1 Awards that ordinarily result in a tax deduction

For awards that ordinarily result in a tax deduction, a deferred tax asset should be recorded at the acquisition date related to the fair value of a replacement award. If the acquirer is obligated to grant the replacement award, the fair value of the award and the deferred tax asset related to precombination services should be included in the consideration transferred for the acquiree. This deferred tax asset represents a future tax benefit that the acquirer has obtained the right to receive as a result of the acquisition. If the acquirer is not obligated to grant the replacement award and the acquiree award would otherwise expire, the entire fair value of the award should be recognised as compensation cost in the postcombination financial statements. For the fair value of a replacement award that is attributed to postcombination services, a deferred tax asset is recorded in the postcombination financial statements each period as the service period is completed and the compensation cost is recognised.

Equity-classified awards that ordinarily result in a tax deduction

A deferred tax asset should be recorded at the acquisition date for replacement awards that ordinarily result in a tax deduction and are included in the consideration transferred for the acquiree. The resulting income tax effects of equity-classified awards (e.g., stock options or restricted shares) exchanged in a business combination should be accounted for in accordance with ASC 718. If the tax deduction received by the acquirer upon the exercise of stock options or vesting of restricted shares is greater than the sum of the fair value of the award added to the purchase price plus the cumulative U.S. GAAP compensation cost recorded by the acquirer, the tax benefit related to the excess tax deduction (i.e., windfall) should be recorded as an adjustment to additional paid-in capital. If the tax deduction received by the acquirer upon the exercise of stock options or vesting of restricted shares is less than the sum of the fair value of the award included in the purchase price plus the cumulative U.S. GAAP compensation cost recorded by the acquirer, the resulting difference (i.e., shortfall) should be charged first to additional paid-in capital, to the extent of the acquirer's pool of windfall tax benefits. Any remaining shortfall would be recognised in income tax expense. Windfalls and shortfalls generated from replacement awards are included in the acquirer's pool of windfall tax benefits, similar to other awards granted by the acquirer.

Example 3-13 illustrates this guidance; it does not consider the par value of the common stock issued or cash received for the option's exercise price.

EXAMPLE 3-13

Income tax accounting for a vested equity-classified nonqualified option under U.S. GAAP

Company K (the acquirer) exchanges replacement awards with a fair value of CU50 at the acquisition date for Company L's (the acquiree) awards with a fair value of CU50. Company K was obligated to issue replacement awards under the terms of the acquisition agreement. When granted, Company L's awards had a service period of four years. As of the acquisition date, all four years of service have been rendered. The awards are nonqualified options and, therefore, result in a tax deduction upon exercise of the awards. The exercise price of the awards is CU30. Company K's applicable tax rate is 40 percent. All of the awards are exercised six months after the acquisition date when the market price of Company K's shares is CU90.

Analysis

As the replacement awards do not have any excess fair value at the acquisition date and 100 percent (4 years precombination service / 4 years total service) of the fair value of the awards is attributable to precombination services, the entire CU50 should be included in the consideration transferred for the acquiree:

Goodwill (as residual)	CU50[1]	
Equity (additional paid-in capital)		CU50

[1] All computations have been provided on an individual award basis.

Company K should also record a deferred tax asset equal to CU20 (CU50 x 40%) because at the time of the acquisition, the awards are expected to result in a tax deduction (assuming that it is more likely than not that the deferred tax asset will be realised):

Deferred tax asset	CU20	
Goodwill (as residual)		CU20

Upon exercise of the awards, Company K will be entitled to a tax deduction of CU60 (CU90 market price of Company K's shares less CU30 exercise price). The tax benefit of the tax deduction (i.e., the reduction in taxes payable) is CU24 (CU60 x 40%). The excess tax benefit of CU4 (tax benefit of CU24 less deferred tax asset of CU20) is recorded to additional paid-in capital (i.e., windfall tax benefit). Assuming that Company K has sufficient taxable income such that the tax deduction results in a reduction in taxes payable (in accordance with ASC 718-740-25), the journal entries to record the income tax effects of the option exercise would be to (1) reverse the deferred tax asset against deferred tax expense and (2) reduce taxes payable:

Deferred tax expense	CU20	
Deferred tax asset		CU20
Taxes payable	CU24	
Current tax expense		CU20
Equity (additional paid-in capital)		CU4

The income tax effects of equity classified replacement awards that were exchanged in a business combination and are attributable to postcombination services should be recorded in the postcombination financial statements in the period those effects arise, as if the awards were issued outside a business combination. No adjustment should be made to the accounting for the business combination for the related tax effects.

For example, if a partially vested replacement award is granted on the acquisition date, a deferred tax asset would only be recorded for the portion of the award's fair value that was attributed to precombination services. A deferred tax asset related to the portion of the award's fair value attributed to postcombination services would be recorded in the postcombination financial statements each period as the service period is completed. For the portion of the award's fair value attributed to postcombination services, no deferred tax asset would be recorded as part of the consideration transferred for the acquiree (i.e., there are no adjustments to **goodwill** for the deferred tax asset related to awards attributed to postcombination services).

Example 3-14 illustrates this guidance. The following example does not consider the par value of the common stock issued or cash received for the option's exercise price.

EXAMPLE 3-14

Income tax accounting for a partially vested equity-classified nonqualified option under U.S. GAAP

Company K (the acquirer) exchanges replacement awards with a fair value of CU50 at the acquisition date for Company L's (the acquiree) awards with a fair value of CU50. Company K was obligated to issue replacement awards under the terms of the acquisition agreement. When granted, Company L's awards had a service period of four years. Three of the four years of service required by the original terms of Company L's awards had been rendered as of the acquisition date. The replacement awards have the same terms as the original awards. The awards are nonqualified options and, therefore, are expected to result in a tax deduction upon exercise. The exercise price of the awards is CU30. Company K's applicable tax rate is 40 percent. All of the awards are exercised two years after the acquisition date when the market price of Company K's shares is CU90.

Analysis

As of the acquisition date, 75 percent (3 years precombination service / 4 years total service) of the fair value of the awards is attributable to precombination services. The replacement awards had no excess fair value over the acquiree awards, therefore, CU37.5 (CU50 x 75%) should be included in the consideration transferred for the acquiree:

Goodwill (as residual)	CU37.5[1]	
Equity (additional paid-in capital)		CU37.5

[1] All computations have been provided on an individual award basis.

Company K should also record a deferred tax asset equal to CU15 (CU37.5 x 40% tax rate) for the portion of the awards attributed to precombination services because at the time of the acquisition, 75 percent of the awards are expected to result in a tax deduction (assuming that it is more likely than not that the deferred tax asset will be realised):

Deferred tax asset	CU15	
Goodwill (as residual)		CU15

One year after the acquisition date, the remaining year of service is completed, resulting in the vesting of the replacement awards. Company K should record compensation cost of CU12.5 (CU50 x 25%) in the postcombination financial statements for the remaining 25 percent of the fair value of the awards. A deferred tax asset equal to CU5 (CU12.5 x 40% tax rate) should also be recorded for the portion of the awards attributed to postcombination services, since the awards are expected to result in a tax deduction (assuming that it is more likely than not that the deferred tax asset will be realised):

Compensation cost	CU12.5	
Equity (additional paid-in capital)		CU12.5
Deferred tax asset	CU5	
Deferred tax expense		CU5

Upon exercise of the awards, Company K will be entitled to a tax deduction of CU60 (CU90 market price of Company K's shares less CU30 exercise price). The tax benefit of the tax deduction (the reduction in taxes payable) is CU24 (CU60 x 40%). The excess tax benefit of CU4 (tax benefit of CU24 less deferred tax asset of CU20) is recorded to additional paid-in capital (i.e., windfall tax benefit). Assuming Company K has sufficient taxable income such that the tax deduction results in a reduction in taxes payable (in accordance with ASC 718-740-25), the journal entries to record the income tax effects of the option exercise would be to (i) reverse the deferred tax asset against deferred tax expense and (ii) reduce taxes payable:

Deferred tax expense	CU20	
Deferred tax asset		CU20
Taxes payable	CU24	
Current tax expense		CU20
Equity (additional paid-in capital)		CU4

The income tax effects of replacement awards (i.e., windfalls and shortfalls), are accounted for through adjustments to the total pool of windfall tax benefits of the consolidated company, reflecting the windfall tax benefits of all awards granted by the company (not only the replacement awards). In other words, the income tax effects of awards for precombination services or postcombination services are considered against a single pool of windfall tax benefits. The single pool includes the tax effects of all awards, including those unrelated to the business combination, granted by the acquirer to its employees or any of its consolidated subsidiaries as of the exercise or settlement date. See SC 4 for further information.

For those replacement awards granted as part of a business combination that was consummated prior to the effective date of ASC 805 (i.e., where no deferred tax asset was recorded at the acquisition date under FAS 141), the acquirer should adjust goodwill for the tax benefits realised upon the settlement of the awards. See BCG 11 for further information on adjustments to goodwill.

Liability-classified awards that ordinarily result in a tax deduction

The income tax accounting for liability classified awards exchanged in a business combination is similar to that for equity-classified awards. If the acquirer is obligated to grant the replacement award, the fair value of the award and the deferred tax asset related to precombination services should be included in the consideration transferred for the acquiree. However, for liability-classified awards, U.S. GAAP compensation cost and the related deferred tax asset should be remeasured every reporting period. Therefore, liability-classified awards generally will not generate a windfall or a shortfall because the tax deduction will equal U.S. GAAP compensation cost upon settlement. All changes in the fair value of liability-classified awards after the acquisition date and the related income tax effects are recognised in the postcombination financial statements of the acquirer in the period(s) in which the change occurs [ASC 805-30-55-13].

3.8.1.2 Awards that do not ordinarily result in a tax deduction

The acquirer should not recognise a deferred tax asset at the acquisition date for awards that do not ordinarily result in a tax deduction (e.g., an incentive stock option). The awards are not expected to result in a tax benefit; thus, no deferred tax asset is recorded at the acquisition date. The acquirer may receive a tax deduction, in some circumstances, due to events that occur after the acquisition date (e.g., the disqualifying disposition of an incentive stock option because the employee did not hold the underlying shares for the minimum holding period required by the Internal Revenue Code). The tax effect of a disqualifying disposition should be recognised when it occurs [ASC 805-740-25-11]. However, ASC 805 does not address where in the financial statements the tax benefit of such an event should be recorded. We believe there are two acceptable approaches. The first approach is to record the entire tax benefit of the disqualifying disposition in equity (i.e., additional paid-in capital). The second approach is to record the tax benefit in the income tax provision up to the amount of the tax benefit related to the fair value of the award that was included in the consideration transferred, with the remaining portion of the tax benefit recorded as an adjustment to additional paid-in capital.

Incentive stock options that do not ordinarily result in a tax deduction and for which an award's fair value was attributed to postcombination services should be accounted for in the same manner as awards that were granted outside a business combination. That is, the tax effects, if any, should be reported in the postcombination financial statements in the period they arise, and no adjustment should be made to the accounting for the business combination [ASC 805-740-25-11].

Any limitations on the deductibility of compensation imposed by the local taxing authority should be considered when determining the deferred tax asset that should be recognised.

3.8.2 Accounting for the income tax effects of replacement awards—IFRS

IAS 12 provides guidance for instances in which an item has a tax base (the amount the tax authorities will permit as a deduction in future periods with respect to goods or services consumed to date), but is not recognised as an asset or liability in the entity's balance sheet. For equity-settled awards under IFRS 2, employee services are expensed and their **carrying amount** is zero. Assuming the employer will be entitled to a tax deduction equal to the options' intrinsic value on the exercise date, an estimate of the value of the tax base at the end of each reporting period is determined by multiplying the options' current intrinsic value by the proportion of the total vesting period that has elapsed. The difference between the tax base of the employee services received to date and the carrying amount of zero is a temporary difference that results in a deferred tax asset, provided the company has sufficient future taxable profit against which the deferred tax asset can be utilised [IAS 12.9–11,68A–68C].

When an award is exchanged in a business combination, the income tax accounting will differ between (1) the portion included in the consideration transferred for the acquiree and (2) the portion of the award for which expense will be recognised in the postcombination financial statements.

For the portion of the replacement award included in consideration transferred for the acquiree, a deferred tax asset is recorded based on the intrinsic value at the acquisition date, subject to the deferred tax asset recognition criteria of IAS 12 noted above. The recognition of this deferred tax asset will reduce net assets acquired (e.g., goodwill). Any change in the intrinsic value of the award and, therefore, the deferred tax asset, and any change in the recoverability of the deferred tax asset will be reflected through an adjustment to the deferred tax asset in the period in which the change arises, and will be reflected in the postcombination financial statements. There is diversity in practice as to where the movement in the deferred tax asset is recognised. One view asserts that the deferred tax movement should be reflected directly in equity similar to the method used for deferred tax movements relating to share-based payments that exceed the total share-based payment expense. This view is based on the rationale that since no expense was reflected in the income statement when the replacement award was originally recorded through acquisition accounting, no expense should be recorded when the movement in the deferred tax asset is recognized. Another view asserts that some or all of the movement can be presented in the income statement because the amounts treated as purchase consideration represent benefits earned pre-acquisition that are analogous to book expenses. The guidance is not specific, and given the diversity in practice, management should make a policy choice and apply it consistently.

For the portion of the replacement award accounted for in the postcombination financial statements, a deferred tax asset should be recorded equal to the tax benefit related to the estimated future tax deduction, multiplied by the proportion of the postcombination vesting period that has elapsed. No deferred tax asset would be recorded at the acquisition date because none of the vesting period for this portion of the award has elapsed as of the acquisition date. However, as the award vests, the deferred tax asset balance should be based on the tax benefit related to the estimated tax deduction at the end of each period (measured using the current share price) in accordance with IFRS 2 and IAS 12 [IAS 12.9–11,68A–68C].

Any limitations on the deductibility of compensation imposed by the local taxing authority should be considered when determining the deferred tax asset that should be recognised.

Example 3-15 illustrates the deferred tax guidance.

EXAMPLE 3-15

Income tax accounting for a vested equity-classified option under IFRS

Company K (the acquirer) exchanges replacement awards with a fair value of CU50 at the acquisition date for Company L's (the acquiree) awards with a fair value of CU50. Company K was obligated to issue replacement awards under the terms of the acquisition agreement. When granted, Company L's awards had a service [vesting] period of four years. The replacement awards have the same terms as the original awards. As of the acquisition date, all four years of service required by the original terms of Company L's awards have been rendered; therefore, the replacement awards are vested and require no further service. A tax deduction for the replacement awards will not arise until the options are exercised. The tax deduction will be based on the stock options' intrinsic value at the exercise date. The exercise price of the awards is CU40. At the acquisition date, the market price of Company K's shares is CU60. The intrinsic value at the acquisition date is CU20 (market price of Company K's shares of CU60 less the exercise price of CU40). Company K's applicable tax rate is 40 percent.

Analysis

Because the replacement awards do not have any excess fair value over the acquiree awards at the acquisition date and 100 percent (4 years precombination service / 4 years total service) of the fair value of the replacement awards is attributable to precombination services, the entire CU50 should be included in the consideration transferred for the acquiree.

Company K should record a deferred tax asset equal to CU8 (CU20 intrinsic value x 40% tax rate) because at the time of the acquisition, the awards are expected to result in a tax deduction based on intrinsic value. The deferred tax asset will be recorded as follows:

Deferred tax asset	CU8[1]	
Goodwill (as residual)		CU8

[1] All computations have been provided on an individual award basis.

3.9 U.S. GAAP and IFRS difference—recognition of social charges

Payroll taxes on employee share-based payment awards are not recognised until the date of the event triggering the measurement and payment of the tax to the taxing authority. For a nonqualified option in the United States, this date is usually the exercise date. For restricted shares, this date is usually the vesting date(s) [ASC 718-10-25-22]. Therefore, practice has been not to record a liability for social charges at the acquisition date, nor adjust the consideration transferred for the acquiree. There is no liability to the company until the award is exercised; therefore, the liability will generally be recognised in the postcombination financial statements when the award is exercised (or vested for restricted shares).

Under IFRS, social charges, such as payroll taxes levied on the employer in connection with share-based payment awards, are usually recognised as an expense in the same period as the related share-based payment compensation cost. Therefore, a liability should be recorded in the business combination for social charges related to outstanding awards. When share-based payment awards are deemed to be part of the consideration transferred in a business combination, the related social charges on such awards is also deemed to be part of the consideration for the acquiree.

Chapter 4: Intangible assets acquired in a business combination

4.1 Chapter overview

An essential part of the **acquisition method** is the recognition and measurement of **identifiable intangible assets**, separate from **goodwill**, at **fair value**. This chapter discusses the key criteria for recognising intangible assets separately in a **business combination** and covers some of the challenges that companies face in recognising and measuring intangible assets. These challenges include those related to customer-related intangible assets, intangible assets used in **research and development activities**, contracts and lease agreements, and grouping of complementary intangible assets. BCG 7 discusses the valuation of acquired assets and assumed liabilities in a business combination in more detail, including intangible assets. BCG 9 discusses the accounting for intangible assets in connection with **asset acquisitions**.

For the most part, the initial recognition and measurement of intangible assets acquired in a business combination are the same for companies that report under U.S. GAAP or IFRS. However, there are differences in the subsequent accounting for intangible assets. These differences primarily relate to the recognition and measurement of impairment losses and the accounting for subsequent research and development costs. The various approaches to impairment under U.S. GAAP are discussed in BCG 10, and the approach under IFRS is discussed in BCG 12. The accounting for subsequent research and development costs for both U.S. GAAP and IFRS is discussed in BCG 4.3.5.1.

Active FASB and IASB projects may result in amendments to existing guidance. These possible amendments may impact the guidance in this chapter. Specifically, these include the Boards' joint project on lease accounting. This project is intended to result in a largely converged standard for leases. It is also expected to result in the recognition of assets and liabilities arising from lease contracts in the statement of financial position. Also, in the United States during 2013 the **Private Company Council (PCC)** and the FASB began exploring alternatives for the recognition, measurement, and disclosure of intangible assets that could reduce the costs and complexity for financial statement preparers. The timeline for any final standard, if any, that may result from these deliberations is undetermined.

The key takeaways from this chapter are:

- **Intangible assets separate from goodwill are recognised and measured at fair value at the acquisition date.** Intangible assets are identified based on the contractual-legal and separability criteria described in the Standards. All identifiable intangible assets are presumed to be reliably measurable and should be recognised and measured at fair value.

- **Intangible assets used in research and development activities are recognised at the acquisition date.** Intangible assets used in research and development projects acquired in a business combination are recognised and measured at fair value, regardless of whether there is an alternative future use for the research and development.

- **Separate intangible assets that complement each other may sometimes be grouped together for purposes of measuring their fair value.** If the assets that complement each other meet the Standards' identifiable criteria for separate recognition and have similar useful lives, an acquirer may choose to recognise and measure them as a single intangible asset. Only limited grouping is permitted under IFRS.

- **Intangible assets that an acquirer does not intend to use or intends to use in a way other than their highest and best use or differently than other market-participants should be recognised and measured at fair value.** Intangible assets that an acquirer does not intend to use or intends to use in a way other than their highest and best use or differently than other market-participants should be recognised and measured at fair value, without consideration of the acquirer's intended use.

4.2 Intangible assets and the identifiable criteria

Intangible assets are assets, excluding financial assets, that lack physical substance. In determining whether an identifiable intangible asset should be recognised separately from goodwill, the acquirer should evaluate whether the asset meets either of the following criteria:

- **Contractual-legal criterion:** The intangible asset arises from contractual or other legal rights (regardless of whether those rights are transferable or separable from the acquired business or from other rights and obligations) [ASC 805-20-55-2; IFRS 3.A].

- **Separability criterion:** The intangible asset is capable of being separated or divided from the acquired business and sold, transferred, licensed, rented, or exchanged. An intangible asset that the acquirer would be able to sell, license, or otherwise exchange for something of value meets the **separability criterion**, even if the acquirer does not intend to sell, license, or otherwise exchange it. If an intangible asset cannot be sold, transferred, licensed, rented, or exchanged individually, it is still considered separable if it can be sold, transferred, licensed, rented, or exchanged in combination with a related contract, asset, or liability. However, there cannot be restrictions on the transfer, sale, or exchange of the asset [ASC 805-20-55-3 through 55-4; IFRS 3.B33].

Intangible assets that meet either of these criteria are considered identifiable and are separately recognised at fair value on the **acquisition date**. Certain intangible assets, however, do not typically meet either of the identifiable criteria and, therefore, would not be recognised as separate intangible assets. Examples include:

- Customer base or unidentifiable "walk-up" customers

- Noncontractual customer relationships that are not separable

- Customer service capability

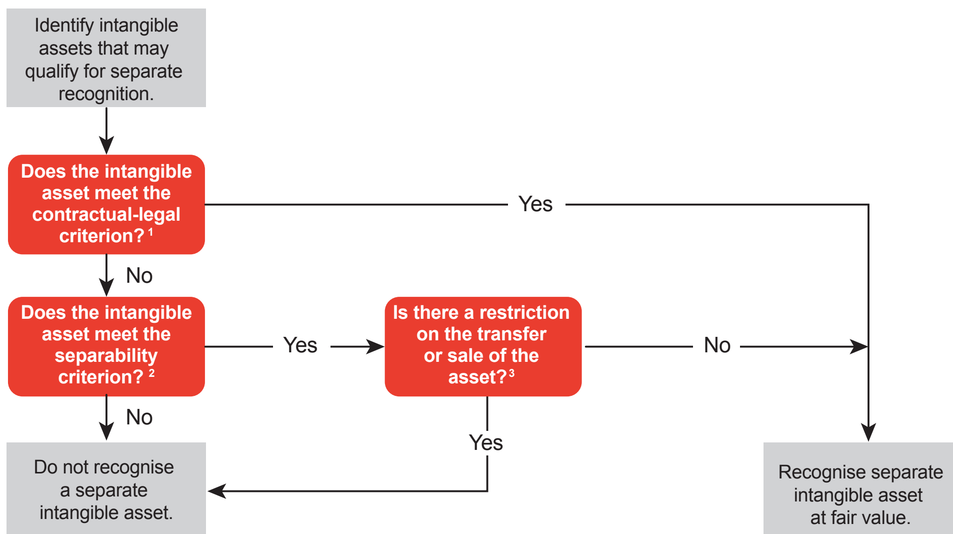
- Presence in geographic locations or markets

- Specially trained employees

The Standards do not permit an assembled workforce to be recognised as a separate intangible asset [ASC 805-20-55-6; IFRS 3.B37]. See BCG 4.3.4.2 for further information on assembled workforce.

The flowchart in Figure 4-1 outlines a process that may be used to determine whether an intangible asset meets the identifiable criteria for separate recognition.

Figure 4-1
Does an intangible asset meet the identifiable criteria?



[1] Consider whether the intangible asset arises from contractual or other legal rights, even if the asset is not transferable or separable from the acquiree [ASC 805-20-55-2; IFRS 3.B32].

[2] Consider whether the intangible asset is capable of being separated; whether there are sales of similar types of assets in the market; or whether it is separable in conjunction with a related contract, asset, or liability [ASC 805-20-55-3 through 55-4; IFRS 3.B33].

[3] Consider whether the terms of confidentiality or other agreements prohibit an entity from selling, leasing, or otherwise exchanging the underlying information [ASC 805-20-55-3 through 55-4; IFRS 3.B33].

4.2.1 *Contractual-legal criterion*

Intangible assets that arise from contractual or other legal rights are recognised separately from goodwill, even if the asset is not transferable or separable from the **acquiree** or from other rights and obligations [ASC 805-20-55-2; IFRS 3.A]. Intangible assets may arise from licenses, contracts, lease agreements, or other types of arrangements that the acquired business has entered into with other parties.

The Standards do not define the term "contractual or other legal rights," but the list of contractual-legal intangible assets included in the Standards makes it clear that the definition is intended to be broad. For instance, a purchase order, even if cancellable, meets the **contractual-legal criterion**, although it may not be considered a contract from a legal perspective in certain jurisdictions. Customer relationships meet the contractual-legal criterion if an entity has a practice of establishing contracts with its customers, regardless of whether there is an outstanding contract or purchase order at the acquisition date [ASC 805-20-55-25; IFRS 3.IE29]. In addition, the use of the contractual-legal criterion to recognise intangible assets under the Standards may be broader than that used in other accounting literature in U.S. GAAP and IFRS. For example, a signed contract is not necessary at the acquisition date to recognise a customer-related intangible asset. However, in applying other accounting literature in U.S. GAAP and IFRS, an entity may be precluded from recognising revenue without a signed contract because it may not be able to support evidence of an arrangement.

Contracts or agreements may also contain clauses that explicitly prohibit the transfer or sale of a specified item separately from the acquiree (e.g., transfer restrictions related to a government contract). These types of prohibitions should not affect an acquirer from recognising the contractual rights as an intangible asset [ASC 805-20-55-23; IFRS 3.IE26]. However, such restrictions may affect the fair value of the intangible asset. For example, a restriction to sell an asset may impact its fair value if such restrictions would transfer to **market-participants** [ASC 820-10-35-15].

Sometimes a contract of the acquired entity states that the right to an asset (such as a license or permit) does not survive a change in **control**, but reverts back to the issuer. The new owner of the business must execute a new arrangement to acquire the asset from the issuer. In such circumstances, the contractual asset is not an asset of the acquiree to be recognised in the acquisition accounting.

Contracts may also be cancellable at the option of either party. The ability to cancel a contract does not affect its recognition as a separate intangible asset acquired in a business combination, although it may affect its fair value [ASC 805-20-55-54; IFRS 3.IE30(a)].

4.2.2 Separability criterion

The determination of whether an intangible asset meets the separability criterion can be challenging. An acquirer should determine whether the asset is capable of being separated from the acquired business, regardless of the intent of the acquirer with respect to that particular asset. For example, a brand is generally capable of being separated from the acquired business and, therefore, would meet the separability criterion, even if the acquirer does not intend to sell it.

In determining whether an intangible asset is capable of separation, a company could observe sales or exchanges in the market for the same or similar types of assets. Sales of the same or similar types of assets indicate that the asset is able to be sold separately, regardless of the acquirer's involvement in such sales or the frequency of such transactions [ASC 805-20-55-3 through 55-4; IFRS 3.B33]. Intangible assets may be closely related to a contract, identifiable asset, or liability, and cannot be separated individually from the contract, asset, or liability. An intangible asset will still meet the separability criterion as long as it is transferable in combination with a related contract, identifiable asset, or liability [ASC 805-20-55-5; IFRS 3.B34].

However, to meet the separability criterion, there cannot be restrictions on the transfer, sale, or exchange of the asset. For example, customer information is often protected by a confidentiality agreement. A customer list that cannot be leased or sold due to a confidentiality agreement would not be considered capable of being separated from the rest of the acquired business and would not meet the separability criterion [ASC 805-20-55-4; IFRS 3.B33]. Accordingly, the customer list subject to such restrictions would not meet the separability criterion.

4.2.3 Examples of applying the identifiable criteria

Examples 4-1 to 4-3 demonstrate the application of the identifiable criteria.

EXAMPLE 4-1

Sales to customers through contracts

Company X acquires Company Y in a business combination on 31 December 20X0. Company Y does business with its customers solely through purchase orders. At the acquisition date, Company Y has customer purchase orders in place from 60 percent of its customers, all of whom are recurring customers. The other 40 percent of Company Y's customers are also recurring customers. However, as of 31 December 20X0, Company Y does not have any open purchase orders with those customers.

Analysis

Company X needs to determine whether any of the acquired customer relationships are identifiable intangible assets that should be recognised. The purchase orders (whether cancellable or not) in place at the acquisition date from 60 percent of Company Y's customers meet the contractual-legal criterion. Consequently, the relationships with customers through these types of contracts also arise from contractual rights and, therefore, meet the contractual-legal criterion. The fair value of these customer relationships are recognised as an intangible asset apart from goodwill. Additionally, since Company Y has established relationships with the remaining 40 percent of its customers through its past practice of establishing contracts, those customer relationships would also meet the contractual-legal criterion and be recognised at fair value. Therefore, even though Company Y does not have contracts in place at the acquisition date with a portion of its customers, Company X would consider the value associated with all of its customers for purposes of recognising and measuring Company Y's customer relationships.

EXAMPLE 4-2

Deposit liabilities and related depositor relationships

A financial institution that holds deposits on behalf of its customers is acquired. There are no restrictions on sales of deposit liabilities and the related depositor relationships.

Analysis

Deposit liabilities and the related depositor relationship intangible assets may be exchanged in observable exchange transactions. As a result, the depositor relationship intangible asset would be considered identifiable, because the separability criterion has been met since the depositor relationship intangible asset can be sold in conjunction with the deposit liability [ASC 805-20-55-5; IFRS 3.B34].

EXAMPLE 4-3

Unpatented technical expertise closely related to a trademark

An acquiree, a restaurant chain, sells prepared chicken using a secret recipe. The acquiree owns a registered trademark, a secret recipe formula, and unpatented technical expertise used to prepare and sell its famous chicken. If the trademark is sold, the seller would also transfer all knowledge and expertise associated with the trademark, which would include the secret recipe formula and the unpatented technical expertise used to prepare and sell chicken.

Analysis

The acquirer would recognise an intangible asset for the registered trademark based on the contractual-legal criterion. Separate intangible assets would also be recognised for the accompanying secret recipe formula and the unpatented technical expertise based on the separability criterion. The separability criterion is met because the secret recipe formula and unpatented technical expertise would be transferred with the trademark. As discussed in BCG 4.4, the acquirer may group complementary intangible assets (registered trademark, related secret recipe formula, and unpatented technical expertise) as a single intangible asset if their useful lives are similar [ASC 805-20-55-18; IFRS 3.IE21].

4.3 Types of identifiable intangible assets

Figure 4-2 includes a list of intangible assets by major category and identifies whether the asset would typically meet the contractual-legal criterion or the separability criterion. In certain cases, an intangible asset may meet both criteria. However, the table highlights the primary criterion under which the specific intangible asset would be recognised. The list is not intended to be all-inclusive; therefore, other acquired intangible assets might also meet the criteria for recognition apart from goodwill.

Figure 4-2

Intangible assets that generally meet the criteria for separate recognition [ASC 805-20-55-11 through 55-45 and 55-52 through 55-57; IFRS 3.IE16–IE44]

Intangible asset	Contractual-legal criterion	Separability criterion
Marketing-related:		
Trademarks, trade names	✓	
Service marks, collective marks, certification marks	✓	
Trade dress (unique colour, shape, or package design)	✓	
Newspaper mastheads	✓	
Internet domain names	✓	
Noncompetition agreements	✓	
Customer-related:		
Customer lists		✓
Order or production backlog	✓	
Customer contracts and related customer relationships	✓	
Noncontractual customer relationships		✓
Artistic-related:		
Plays, operas, ballets	✓	
Books, magazines, newspapers, other literary works	✓	
Musical works, such as compositions, song lyrics, advertising jingles	✓	
Pictures, photographs	✓	
Video and audiovisual material, including motion pictures, music videos, television programmes	✓	

Intangible asset	Contractual-legal criterion	Separability criterion
Contract-based:		
Licensing, royalty, standstill agreements	✓	
Advertising, construction, management, service, or supply contracts[1]	✓	
Lease agreements[1]	✓	
Construction permits	✓	
Franchise agreements	✓	
Operating and broadcast rights	✓	
Use rights,[2] such as drilling, water, air, mineral, timber cutting, and route authorities	✓	
Servicing contracts (e.g., mortgage servicing contracts)	✓	
Employment contracts[3]	✓	
Technology-based:		
Patented technology	✓	
Research and development		✓
Computer software and mask works	✓	
Unpatented technology		✓
Databases, including title plants		✓
Trade secrets, such as secret formulas, processes, recipes	✓	

✓ Indicates the primary criterion under which the specific intangible asset would typically be recognised.

[1] In most cases, such intangibles would be favourable or unfavourable contracts. See BCG 4.3.4.5 for further information.

[2] Only in certain circumstances, see BCG 4.3.4.3 for further information.

[3] Only in certain circumstances, see BCG 4.3.4.2 for further information.

4.3.1 *Marketing-related intangible assets*

Marketing-related intangible assets are primarily used in the marketing or promotion of products or services. They are typically protected through legal means and, therefore, generally meet the contractual-legal criterion for recognition separately as an intangible asset [ASC 805-20-55-14; IFRS 3.IE18].

The following sections discuss common marketing-related intangible assets recognised and measured in a business combination.

4.3.1.1 *Trademarks, trade names, and other types of marks*

Trademarks, trade names, and other marks are often registered with governmental agencies or are unregistered, but otherwise protected. Whether registered or unregistered, but otherwise protected, trademarks, trade names, and other marks have some legal protection and would meet the contractual-legal criterion. If trademarks or other marks are not protected legally, but there is evidence of similar sales or exchanges, the trademarks or other marks would meet the separability criterion [ASC 805-20-55-17; IFRS 3.IE20].

A brand is the term often used for a group of assets associated with a trademark or trade name. An acquirer can recognise a group of complementary assets, such as a brand, as a single asset apart from goodwill if the assets have similar useful lives and either the contractual-legal or separable criterion is met [ASC 805-20-55-18; IFRS 3.IE21]. See BCG 4.4 for further information on complementary intangible assets and grouping of other intangible assets.

4.3.1.2 *Trade dress, newspaper mastheads, and internet domain names*

Trade dress refers to the unique colour, shape, or packaging of a product [ASC 805-20-55-14; IFRS 3.IE18]. If protected legally (as discussed above in relation to trademarks), then the trade dress meets the contractual-legal criterion. If the trade dress is not legally protected, but there is evidence of sales of the same or similar trade dress assets, or if the trade dress is sold in conjunction with a related asset, such as a trademark, then it would meet the separability criterion.

Newspaper mastheads are generally protected through legal rights, similar to a trademark and, therefore, would meet the contractual-legal criterion. If not protected legally, a company would look at whether exchanges or sales of mastheads occur to determine if the separability criterion is met.

Internet domain names are unique names used to identify a particular Internet site or Internet address. These domain names are usually registered and, therefore, would meet the contractual-legal criterion [ASC 805-20-55-19; IFRS 3.IE22].

4.3.1.3 *Noncompetition agreements*

Noncompetition ("noncompete") agreements are legal arrangements that generally prohibit a person or business from competing with a company in a certain market for a specified period of time. An acquiree may have preexisting noncompete agreements in place at the time of the acquisition. As those agreements arise from a legal or contractual right, they would meet the contractual-legal criterion and represent an acquired asset that would be recognised as part of the business combination. The terms, conditions, and enforceability of noncompete agreements may affect the fair value assigned to the intangible asset, but would not affect their recognition.

Other payments made to former employees that may be described as noncompete payments might actually be compensation for services in the postcombination period. See BCG 3 for further information on accounting for employee compensation arrangements.

A noncompete agreement negotiated as part of a business combination generally prohibits former **owners** or key employees from competing with the combined entity. The agreement typically covers a set period of time that commences after the acquisition date or termination of employment with the combined entity. A noncompete agreement negotiated as part of a business combination will typically be initiated by the acquirer to protect the interests of the acquirer and the combined entity. Transactions are to be treated separately if they are entered into by or on behalf of the acquirer or primarily for the benefit of the acquirer [ASC 805-10-25-21 through 25-22; IFRS 3.52]. As such, noncompete agreements negotiated as part of a business combination should generally be accounted for as transactions separate from the business combination.

A noncompete agreement will normally have a finite life requiring amortisation of the asset. The amortisation period should reflect the period over which the benefits from the noncompete agreement are derived. Determining the period is a matter of judgment in which all terms of the agreement, including restrictions on enforceability of the agreement, should be considered. See BCG 10 for further information on postacquisition accounting for noncompete agreements under U.S. GAAP, and see BCG 12 for further information on accounting under IFRS.

4.3.2 Customer-related intangible assets

Customer-related intangible assets include, but are not limited to: (1) customer contracts and related customer relationships, (2) noncontractual customer relationships, (3) customer lists, and (4) order or production backlog [ASC 805-20-55-20; IFRS 3.IE23].

In many cases, the relationships that an acquiree has with its customers may encompass more than one type of intangible asset (e.g., customer contract and related relationship, customer list, and backlog). The interrelationship of various types of intangible assets related to the same customer can pose challenges in recognising and measuring customer-related intangible assets. The values ascribed to other intangible assets, such as brand names and trademarks, may impact the valuation of customer-related intangible assets as well. Also, because the useful lives and the pattern in which the economic benefits of the assets are consumed may differ, it may be necessary to separately recognise intangible assets that relate to a single customer relationship [ASC 805-20-55-24; IFRS 3.IE27].

Additionally, customer award or loyalty programmes may create a relationship between the acquiree and the customer. Such programmes may enhance the value of a customer-related intangible asset. These programmes are expected to meet the term "contractual" in ASC 805 and IFRS 3 because the parties have agreed to certain terms and conditions, have had a previous contractual relationship, or both. In addition to evaluating the need to recognise and measure a customer-related intangible asset for these programmes, the acquirer must separately evaluate the need to recognise and measure any assumed liabilities related to these programmes on the date of acquisition. Given the range of terms and conditions associated with these programmes, careful consideration should be given in assessing the recognition and measurement of any related intangible assets.

The following sections discuss the common customer-related intangible assets recognised and measured in a business combination.

4.3.2.1 Customer contracts and related customer relationships

A customer relationship exists between a company and its customer if (1) the company has information about the customer and has regular contact with the customer, and (2) the customer has the ability to make direct contact with the company [ASC 805-20-55-25; IFRS 3.IE28].

If the entity has a practice of establishing relationships with its customers through contracts, the customer relationship would meet the contractual-legal criterion for separate recognition as an intangible asset, even if no contract (e.g., purchase order or sales order) is in place on the acquisition date. A practice of regular contact by sales or service representatives may also give rise to a customer relationship. A customer relationship may indicate the existence of an intangible asset that should be recognised if it meets the contractual-legal or separable criteria [ASC 805-20-55-25; IFRS 3.IE28].

Overlapping customers

An acquirer may have relationships with the same customers as the acquiree (sometimes referred to as "overlapping customers"). If the customer relationship meets the contractual-legal or separable criteria, an intangible asset should be recognised for the customer relationships of the acquiree, even though the acquirer may have relationships with those same customers. Determining the fair value of the acquired asset will depend on facts and circumstances. The acquired customer relationship may have value because the acquirer has the ability to generate incremental cash flows, based on the acquirer's ability to sell new products to the customer.

The fair value of the overlapping customer relationship would be estimated by reflecting the assumptions market-participants would make about their ability to generate incremental cash flows. For example, if market-participants may not receive much value from the relationship, the resulting intangible asset may have a nominal value. However, if market-participants would expect to receive significant value from the relationship with the acquired customer, the resulting intangible asset may have significant value. See BCG 7 for further information on valuation of intangible assets.

Examples 4-4 and 4-5 demonstrate the assessment of the contractual-legal criterion for various contract-related customer relationships.

EXAMPLE 4-4

Cancellable and noncancellable customer contracts

An acquired business is a manufacturer of commercial machinery and related aftermarket parts and components. The acquiree's commercial machines, which comprise approximately 70 percent of its sales, are sold through contracts that are noncancellable. Its aftermarket parts and components, which comprise the remaining 30 percent of the acquiree's sales, are also sold through contracts. However, the customers can cancel those contracts at any time.

Analysis

The acquiree has a practice of establishing contractual relationships with its customers for the sale of commercial machinery and the sale of aftermarket parts and components. The ability of those customers that purchase aftermarket parts and components to cancel their contracts at any time would factor into the measurement of the intangible asset, but would not affect whether the contractual-legal recognition criterion has been met.

EXAMPLE 4-5

Potential contracts being negotiated at the acquisition date

An acquiree is negotiating contracts with a number of new customers at the acquisition date for which the substantive terms, such as pricing, product specifications, and other key terms, have not yet been agreed to by both parties.

Analysis

Although the acquirer may consider these prospective contracts to be valuable, potential contracts with new customers do not meet the contractual-legal criterion, because there is no contractual or legal right associated with them at the acquisition date. Potential contracts also do not meet the separability criterion, because they are not capable of being sold, transferred, or exchanged, and therefore, are not separable from the acquired business. In this fact pattern, the value of these potential contracts is included in goodwill. Changes to the status of the potential contracts subsequent to the acquisition date would not result in a reclassification from goodwill to an intangible asset. However, the acquirer should assess the facts and circumstances surrounding the events occurring shortly after the acquisition to determine whether a separately recognisable intangible asset existed at the acquisition date [ASC 805-20-55-7; IFRS 3.B38].

Question 4-1

Should the acquirer recognise a customer relationship intangible asset when the acquirer is a customer of the acquiree?

PwC response

We believe that when the acquirer is a customer of the acquiree, it would not be appropriate for the acquirer to recognise a customer relationship intangible asset with itself since a "customer relationship" no longer exists after the acquisition. A customer relationship with oneself does not meet either the contractual-legal or the separable criterion of the Standards and, therefore, would not be recognised as a separate intangible asset. In addition, from the perspective of the consolidated entity, the definition of an asset is not met, since the asset cannot be disposed of and there are no future economic benefits from the customer relationship.

All preexisting relationships between two parties that have consummated a business combination should be evaluated to determine whether settlement of a preexisting relationship has occurred requiring accounting separate from the business combination [ASC 805-10-55-21; IFRS 3.IE28]. See BCG 2.7.3 for further information on the settlement of preexisting relationships between the acquirer and the acquiree.

4.3.2.2 Noncontractual customer relationships

Customer relationships that do not arise from contracts between an acquiree and its customers (i.e., noncontractual customer relationships) do not meet the contractual-legal criterion. However, there may be circumstances in which these relationships can be sold or otherwise exchanged without selling the acquired business, thereby meeting the separability criterion. If a noncontractual customer relationship meets the separability criterion, the relationship is recognised as an intangible asset [ASC 805-20-55-27; IFRS 3.IE31].

Evidence of separability of a noncontractual customer relationship includes exchange transactions for the same or similar type of asset. These transactions do not need to occur frequently for a noncontractual customer relationship to be recognised as an intangible asset apart from goodwill. Instead, recognition depends on whether the noncontractual customer relationship is capable of being separated and sold or transferred [ASC 805-20-55-3 through 55-4; IFRS 3.B33]. Noncontractual relationships that are not separately recognised, such as customer bases, market share, and unidentifiable "walk-up" customers, should be included as part of goodwill.

4.3.2.3 Customer lists

A customer list represents a list of known, identifiable customers that contains information about those customers, such as name and contact information. A customer list may also be in the form of a database that includes other information about the customers (e.g., order history and demographic information).

A customer list does not usually arise from contractual or other legal rights and, therefore, typically does not meet the contractual-legal criterion. However, customer lists may be leased or otherwise exchanged and, therefore, meet the separability criterion. An acquired customer list does not meet the separability criterion if the terms of confidentiality or other agreements prohibit an acquiree from leasing or otherwise exchanging information about its customers [ASC 805-20-55-21; IFRS 3.IE24]. Restrictions imposed by confidentiality or other agreements pertaining to customer lists do not impact the recognition of other customer-related intangible assets that meet the contractual-legal criterion.

Customer list intangible assets generally have a relatively low fair value and a short life because of the nature of the customer information, how easily it may be obtained by other sources, and the period over which the customer information provides a benefit.

4.3.2.4 Customer base

A customer base represents a group of customers that are not known or identifiable (e.g., persons who purchase newspapers from a newsstand or customers of a fast-food franchise or gas station). A customer base may also be described as "walk-up" customers. A customer base is generally not recognised separately as an intangible asset because it does not arise from contractual or legal rights and is not separable. However, a customer base may give rise to a customer list if information is obtained about the various customers. For example, a customer list may exist, even if only basic contact information about a customer, such as name and address or telephone number, is available.

4.3.2.5 Order or production backlog

Order or production backlog arises from unfulfilled purchase or sales order contracts and may be significant in certain industries, such as manufacturing or construction. The order or production backlog acquired in a business combination meets the contractual-legal criterion and, therefore, may be recognised separately as an intangible asset, even if the purchase or sales order contracts are cancellable [ASC 805-20-55-22; IFRS 3.IE25]. However, the fact that contracts are cancellable may affect the measurement of the fair value of the associated intangible asset.

Example 4-6 demonstrates the recognition of customer-related intangible assets due to purchase orders.

EXAMPLE 4-6

Identification of customer-related intangible assets due to purchase orders

Company M is acquired in a business combination by Company Y and has the following two customers:

- Customer A is a recurring customer that transacts with Company M through purchase orders and certain purchase orders are outstanding at the acquisition date.

- Customer B is a recurring customer that transacts with Company M through purchase orders; however, there are no purchase orders outstanding at the acquisition date.

Analysis

Company Y assesses the various components of the overall customer relationship that may exist for the acquired customers. As a result of this assessment, Company Y would recognise an intangible asset(s) for Customers A and B based on the contractual-legal criterion. The customer relationship with Customer A meets the contractual-legal criterion as there is a contract or agreement in place at the acquisition date. Customer B's customer relationship also meets the contractual-legal criterion as there is a history of Company M using purchase orders with this customer, even though there are no purchase orders outstanding on the acquisition date.

4.3.3 Artistic-related intangible assets

Artistic-related intangible assets are creative assets that are typically protected by copyrights or other contractual and legal means. Artistic-related intangible assets are recognised separately if they arise from contractual or legal rights, such as copyrights [ASC 805-20-55-30; IFRS 3.IE33]. Artistic-related intangible assets include (1) plays, operas, ballets; (2) books, magazines, newspapers, other literary works; (3) musical works, such as compositions, song lyrics, advertising jingles; (4) pictures and photographs; and (5) video and audiovisual material, including motion pictures or films, music videos, and television programmes [ASC 805-20-55-29; IFRS 3.IE32]. Copyrights can be assigned or licensed, in part, to others. A copyright-protected intangible asset and related assignments or license agreements may be recognised as a single complementary asset, as long as the component assets have similar useful lives [ASC 805-20-55-30; IFRS 3.IE33]. See BCG 4.4 for further information on grouping of complementary assets.

4.3.4 Contract-based intangible assets

Contract-based intangible assets represent the value of rights that arise from contractual arrangements. Customer contracts are one type of contract-based intangible assets. Contract-based intangible assets include (1) licensing, royalty, and standstill agreements; (2) advertising, construction, management, service, or supply contracts; (3) construction permits; (4) franchise agreements; (5) operating and broadcast rights; (6) contracts to service financial assets; (7) employment contracts; (8) use rights; and (9) lease agreements [ASC 805-20-55-31; IFRS 3.IE34]. Contracts whose terms are considered at-the-money, as well as contracts in which the terms are favourable relative to market may also give rise to contract-based intangible assets. If the terms of a contract are unfavourable relative to market, the acquirer recognises a liability assumed in the business combination. See BCG 4.3.4.5 for further information on **favourable and unfavourable contracts**.

The following sections discuss the common contract-based intangible assets recognised and measured in a business combination.

4.3.4.1 *Contracts to service financial assets*

Contracts to service financial assets may include collecting principal, interest, and escrow payments from borrowers; paying taxes and insurance from escrowed funds; monitoring delinquencies; executing foreclosure, if necessary; temporarily investing funds pending distribution; remitting fees to guarantors, trustees and others providing services; and accounting for and remitting principal and interest payments to the holders of beneficial interests in the financial assets.

Although servicing is inherent in all financial assets, it is not recognised as a separate intangible asset unless (1) the underlying financial assets (e.g., receivables) are sold or securitised and the servicing contract is retained by the seller; or (2) the servicing contract is separately purchased or assumed [ASC 860-50-25-1 through 25-4; ASC 805-20-55-33 through 55-34; IFRS 3.IE35]. For U.S. GAAP companies, ASC 860-50, *Servicing Assets and Liabilities* (ASC 860-50), provides guidance on the accounting for service contracts.

If mortgage loans, credit card receivables, or other financial assets are acquired in a business combination, along with the contract to service those assets, then neither of the above criteria has been met and the servicing rights will not be recognised as a separate intangible asset. However, the fair value of the servicing rights should be considered in measuring the fair value of the underlying mortgage loans, credit card receivables, or other financial assets [ASC 805-20-55-35; IFRS 3.IE36].

4.3.4.2 *Employment contracts*

Employment contracts may result in contract-based intangible assets or liabilities [ASC 805-20-55-36; IFRS 3.IE37]. An employment contract may be above or below market in the same way as a lease or a servicing contract. See BCG 4.3.4.6 for further information on at-the-money contracts. However, the recognition of employment contract intangible assets and liabilities is rare in practice. Employees can choose to leave employment with relatively short notice periods, and employment contracts are usually not enforced. In addition, the difficulty of substantiating market compensation for specific employees may present challenges in measuring such an asset or liability.

An exception might be when a professional sports team is acquired. The player contracts may well give rise to employment contract intangible assets and liabilities. The athletes often work under professional restrictions, such that they cannot leave their contracted teams at will and play with another team to maintain their professional standing. Player contracts may also be separable, in that they are often the subject of observable market transactions.

Preexisting employment contracts in the acquired business may also contain noncompetition clauses. These noncompetition clauses may have value and should be assessed separately as intangible assets when such contracts are part of a business combination. See BCG 4.3.1.3 for further information on noncompetition agreements.

Assembled workforce

An assembled workforce is defined as an existing collection of employees that permits an acquirer to continue to operate from the date of the acquisition [ASC 805-20-55-6; IFRS 3.B37]. Although individual employees may have employment agreements with the acquiree, which may, at least theoretically, be separately recognised and measured as discussed in above, the entire assembled workforce does not have such a contract. Therefore, an assembled workforce does not meet the contractual-legal criterion. Furthermore, the Boards concluded that an assembled workforce is not considered separable, because it cannot be sold or transferred without causing disruption to the acquiree's business [FAS 141(R).B178; IFRS 3.BC178]. An assembled workforce is not an identifiable intangible asset that is to be separately recognised and, as such, any value attributable to the assembled workforce is included in goodwill.

An intangible asset may be recognised for an assembled workforce acquired in an asset acquisition under U.S. GAAP. However, we believe these situations would be infrequent, as an assembled workforce may be indicative that a business was acquired. IFRS does not permit an assembled workforce to be recognised in asset acquisitions. See BCG 9 for information on the accounting for asset acquisitions.

The intellectual capital that has been created by a skilled workforce may be embodied in the fair value of an entity's other intangible assets that would be recognised at the acquisition date as the employer retains the rights associated with those intangible assets. For example, in measuring the fair value of proprietary technologies and processes, the intellectual capital of the employee groups embedded within the proprietary technologies or processes would be considered [FAS 141(R).B180; IFRS 3.BC180].

Collective bargaining agreements

A collective bargaining or union agreement typically dictates the terms of employment (e.g., wage rates, overtime rates, and holidays), but does not bind the employee or employer to a specified duration of employment. The employee is still an at-will employee and has the ability to leave or may be terminated. Therefore, similar to an assembled workforce, typically no intangible asset would be separately recognised related to the employees covered under the agreement. However, a collective bargaining agreement of an acquired entity may be recognised as a separate intangible asset or liability if the terms of the agreement are favourable or unfavourable when compared to market terms.

4.3.4.3 Use rights

Use rights, such as drilling, water, air, mineral, timber cutting, and route authorities' rights are contract-based intangible assets. Use rights are unique in that they may have characteristics of both tangible and intangible assets. Use rights should be recognised based on their nature as either a tangible or intangible asset. For example, mineral rights, which are legal rights to explore, extract, and retain all or a portion of mineral deposits, are tangible assets [ASC 805-20-55-37; IFRS 3.IE38].

4.3.4.4 Insurance and reinsurance contract intangible assets

An intangible asset (or a liability) may be recognised at the acquisition date for the difference between the fair value of all assets and liabilities arising from the rights and obligations of any acquired insurance and reinsurance contracts and their **carrying amounts**. See BCG 13.4 for further information on the accounting for insurance and reinsurance contract intangible assets.

4.3.4.5 Favourable and unfavourable contracts

Intangible assets or liabilities may be recognised for certain contracts, such as lease arrangements, whose terms are favourable or unfavourable compared to current market terms. In making this assessment, the terms of a contract should be compared to market prices at the date of acquisition to determine whether an intangible asset or liability should be recognised. If the terms of an acquired contract are favourable relative to market prices, an intangible asset is recognised. On the other hand, if the terms of the acquired contract are unfavourable relative to market prices, then a liability is recognised [ASC 805-20-55-31; IFRS 3.IE34]. The Boards have characterised the differences in contract terms relative to market terms as assets and liabilities, but these adjustments in value are unlikely to meet the definitions of an asset and liability under the U.S. GAAP and IFRS accounting frameworks. Within this guide, these adjustments are referred to as assets and liabilities for consistency with the treatment by the Boards.

A significant area of judgment in measuring favourable and unfavourable contracts is whether contract renewal or extension terms should be considered. The following factors should be considered in determining whether to include renewals or extensions:

- Whether renewals or extensions are discretionary without the need to renegotiate key terms or within the control of the acquiree. Renewals or extensions that are within the control of the acquiree would likely be considered if the terms are favourable to the acquirer.

- Whether the renewals or extensions provide economic benefit to the holder of the renewal right. The holder of a renewal right, either the acquiree or the counterparty, will likely act in their best interest. For example, if the acquiree is the lessee in a favourable operating lease, the renewals would likely be considered, because the acquirer would likely plan to exercise the renewal right and realise the acquiree's benefit of the favourable terms. If the acquiree is the lessor in a favourable operating lease, the acquirer would usually not presume that the lessee (third party) would renew its unfavourable lease.

- Whether there are any other factors that would indicate a contract may or may not be renewed.

Each arrangement is recognised and measured separately. The resulting amounts for favourable and unfavourable contracts are not offset.

Examples 4-7 and 4-8 demonstrate the recognition and measurement of favourable and unfavourable contracts.

EXAMPLE 4-7

Favourable purchase contract

Company N acquires Company O in a business combination. Company O purchases electricity through a purchase contract, which is in year three of a five-year arrangement. At the end of the original term, Company O has the option at its sole discretion to extend the purchase contract for another five years. The annual cost of electricity per the original contract is CU80 per year, and the annual cost for the five-year extension period is CU110 per year. The current annual market price for electricity at the acquisition date is CU200; and market rates are not expected to change during the original contract term or the extension period. For the purpose of this example, assume that Company N does not account for the contract as a derivative.

Analysis

Company O's purchase contract for electricity is favourable. Both the original contract and extension terms allow Company O to purchase electricity at amounts below the annual market price of CU200. Because the contract terms are favourable based on the remaining two years of the original contractual term and the extension terms are favourable, Company N would likely consider the five-year extension term as well in measuring the favourable contract.

EXAMPLE 4-8

Unfavourable purchase contract

Assume the same facts above, except that the current annual market price for electricity at the acquisition date is CU50 per year and market rates are not expected to change during the original contract term or the extension period.

Analysis

Company O's purchase contract is unfavourable. Both the original contract and extension term require it to pay amounts in excess of the current annual market price of CU50. While Company N would recognise and measure a liability for the two years remaining under the original contract term, the extension term would not be considered in measuring the unfavourable contract because Company N can choose not to extend the unfavourable contract.

The fair value of an intangible asset or liability associated with favourable and unfavourable contract terms would generally be determined based on present-value techniques. For example, the difference between the contract price and the current market price for the remaining contractual term, including any expected renewals, would be calculated and then discounted to arrive at a net present-value amount. The fair value of the intangible asset or liability would then be amortised over the remaining contract term, including renewals, if applicable.

4.3.4.6 At-the-money contracts

At-the-money contracts should be evaluated for any intangible assets that may need to be separately recognised. At-the-money contract terms reflect market terms at the date of acquisition. However, the contract may have value for which market-participants would be willing to pay a premium because the contract provides future economic benefits [ASC 805-20-25-13; IFRS 3.B30].

In assessing whether a separate intangible asset exists for an at-the-money contract, an entity should consider other qualitative reasons or characteristics, such as (1) the uniqueness or scarcity of the contract or leased asset; (2) the unique characteristics of the contract; (3) the efforts to date that a seller has expended to obtain and fulfill the contract; or (4) the potential for future contract renewals or extensions. The existence of these characteristics may make the contract more valuable, resulting in market-participants being willing to pay a premium for the contract.

Leases of airport gates and customer contracts in the home-security industry are examples of at-the-money contracts that are bought or sold in observable exchange transactions and have resulted in the recognition of separate intangible assets.

4.3.4.7 Lease agreements

A lease agreement represents an arrangement in which one party obtains the right to use an asset from another party for a period of time, in exchange for the payment of consideration. Lease arrangements that exist at the acquisition date may result in the recognition of various assets and liabilities, including separate intangible assets based on the contractual-legal criterion. The type of lease (e.g., operating versus capital [finance]) and whether the acquiree is the lessee or the lessor to the lease will impact the various assets and liabilities that may be recognised in a business combination. See BCG 2.5.17 for further information on the classification of assumed leases in a business combination. Differences in the recognition and measurement of these assets and liabilities between U.S. GAAP and IFRS should be considered. For example, one difference is in the area of recognition of assets subject to operating leases if the acquiree is the lessor.

Acquiree is a lessee

An acquiree may be the lessee in an operating lease agreement containing rental rates that are favourable or unfavourable compared to the market terms of leases for similar items at the acquisition date. An intangible asset or liability should be recognised for such a favourable or unfavourable arrangement. There may also be value associated with an at-the-money lease contract depending on the nature of the leased asset. See BCG 4.3.4.6 for further information on at-the-money contracts. In addition, other assets may be identifiable if the terms of the lease contain purchase or renewal options. Lastly, leasehold improvements of the acquired entity would be recognised as tangible assets on the acquisition date at their fair value.

No separate intangible asset or liability would typically be recognised for the lease contract terms if the acquiree is a lessee in a capital [finance] lease. Any value inherent in the lease (i.e., fair value associated with favourable or unfavourable rental rates, renewal or purchase options, or "in-place" leases), is typically reflected in the amount assigned to the asset under capital lease and the capital lease obligation. In measuring the amount to record for the property under capital lease, the acquirer should determine whether it is expected that the acquirer will obtain ownership of the leased property by the end of the lease term. Factors to consider when making this determination include contractual requirements or a bargain purchase option. If it is expected that the acquirer will obtain ownership of the leased property, then the acquirer should record the property under capital lease at the fair value of the underlying property. If it is not expected that the acquirer will obtain ownership of the leased property, then the acquirer should record the property under capital lease at an amount equal to the fair value of the leasehold interest (i.e., the fair value of the right to use the property until the end of the lease). In addition, any related leasehold improvements would be recognised and measured at fair value.

A liability for the remaining rent payments due under a capital [finance] lease would also be recognised and measured at fair value. The assumptions used in measuring the liability, such as the lease term, should be consistent with the assumptions used in measuring the asset.

Acquiree is a lessor

Under U.S. GAAP, the asset subject to the lease would be recognised and measured at fair value unencumbered by the related lease(s) if the acquiree is a lessor in an operating lease. In other words, the leased property (including any acquired tenant improvements) is measured at the same amount, regardless of whether an operating lease(s) is in place. An intangible asset or liability may also be recognised if the lease contract terms are favourable or unfavourable as compared to market terms. In addition, in certain circumstances, an intangible asset may be recognised at the acquisition date for the value associated with the existing lease(s) (referred to as an "in-place" lease(s), as further discussed in the chapter) and for any value associated with the relationship the lessor has with the lessee [ASC 805-20-30-5]. Further, a liability may be recognised for any unfavourable renewal options or unfavourable written purchase options if the exercise is beyond the control of the lessor.

Under IFRS, the asset subject to the lease would be recognised at its fair value as encumbered by the existing lease, if the acquiree is a lessor in an operating lease. Therefore, a separate intangible asset or liability associated with the favourable or unfavourable terms, and any value associated with "in-place" leases would not be separately recognised but instead is included in the value of the leased asset [IFRS 3.B42]. However, it may be appropriate to amortise separately amounts related to favourable or unfavourable lease terms [IAS 16.44]. Additionally, an intangible asset may be recognised for any value associated with the relationship the lessor has with the lessee.

Under both U.S. GAAP and IFRS, the acquired entity may also be a lessor in a lease other than an operating lease, such as a direct finance or sales-type lease. In those situations, the acquirer recognises and measures a financial asset that represents its remaining investment in the lease. Such investment would be recognised in accordance with ASC 840 or IAS 17, based on the nature of the lease arrangement, and would typically include any value associated with the existing "in-place" lease. Further, the acquirer lessor would recognise and measure the residual value, if any, of the leased asset. Additionally, an intangible asset may be recognised for any value associated with the relationship the lessor has with the lessee.

If the lease is classified as an operating lease and provides for non-level rent payments, the acquiree will have recorded an asset or liability to recognise rent expense or revenue on a straight-line basis. Such asset or liability would not be carried forward by the acquirer. Rather, the acquirer would recognise rent expense or revenue prospectively on a straight-line basis. See BCG 2.5.17 for further information on deferred charges arising from leases.

Figure 4-3 summarises the typical items to consider in the recognition of assets and liabilities associated with lease arrangements in a business combination.

Figure 4-3

Items to consider when recognising lease-related assets and liabilities

Lease classification	U.S. GAAP	IFRS
Acquired entity is a lessee in an operating lease.	□ Favourable or unfavourable rental rates (BCG 4.3.4.5) □ Premium paid for certain at-the-money contracts (BCG 4.3.4.6) □ Purchase or renewal options □ Leasehold improvements	□ Favourable or unfavourable rental rates (BCG 4.3.4.5) □ Premium paid for certain at-the-money contracts (BCG 4.3.4.6) □ Purchase or renewal options □ Leasehold improvements

Lease classification	U.S. GAAP	IFRS
Acquired entity is a lessee of a capital [finance] lease.	□ Property under capital lease (recognised at an amount equal to the fair value of the underlying property if lease meets ASC 840-10-25-1 criteria) □ Property under capital lease (recognised at an amount equal to the fair value of the leasehold interest if lease meets ASC 840-10-25-1 criteria) □ Leasehold improvements owned □ Lease obligation, including lease payments for the remaining noncancellable term and possibly payments required under renewal and purchase options	□ Property under finance lease (recognised at an amount equal to the fair value of the underlying property if ownership is reasonably certain to transfer to the lessee) □ Property under finance lease (recognised at an amount equal to the fair value of the leasehold interest if ownership is not reasonably certain to transfer to the lessee) □ Leasehold improvements owned □ Lease obligation recognised for remaining lease payments
Acquired entity is lessor in an operating lease.	□ Leased asset (including tenant improvements) recognised without regard to the lease contract □ Favourable or unfavourable rental rates □ "In-place" leases □ Unfavourable renewal or written purchase options □ Customer (or tenant) relationships	□ Leased asset (including tenant improvements) recognised, taking lease terms into account □ Customer (or tenant) relationships

Lease classification	U.S. GAAP	IFRS
Acquired entity is lessor in a finance lease (IFRS) or a sales-type, direct financing, or leveraged lease (U.S. GAAP).	◻ Financial asset for remaining lease payments (including any guaranteed residual value and the payments that would be received upon the exercise of any renewal or purchase options that are considered reasonably assured of exercise) and any unguaranteed residual value is recognised ◻ Customer (or tenant) relationships ◻ Residual value of leased asset, if any	◻ Financial asset that represents its remaining investment in the lease, measured in accordance with IAS 17, is recognised ◻ Customer (or tenant) relationships ◻ Residual value of leased asset, if any

Intangible assets related to "in-place" leases—U.S. GAAP

There may be value associated with leases that exist at the acquisition date (referred to as "in-place" leases) when the acquiree leases assets to others through operating leases. That value may relate to the economic benefit of acquiring the asset or property with "in-place" leases, rather than an asset or property that was not leased. At a minimum, the acquirer would typically avoid costs necessary to obtain a lessee, such as any sales commissions, legal, or other lease incentive costs. That value, in addition to any recognised customer-related intangible assets and favourable or unfavourable contract assets or liabilities, is typically recognised as a separate intangible asset in a business combination. Further, the underlying property subject to the operating leases would be measured at fair value, without regard to the underlying lease contracts.

Measurement attribute of leased assets and liabilities

Under the Standards, assets and liabilities that arise on the acquisition date from leases assumed in a business combination are not exempt from the general fair value measurement principle. Accordingly, these assets and liabilities should be measured at their fair value on the acquisition date.

For U.S. GAAP companies, ASC 805 reflects the guidance in ASC 840 for the classification of leases (e.g., capital or operating) assumed in a business combination. That guidance states that the classification of a lease determined at lease inception in accordance with ASC 840 should not be changed as a result of a business combination, unless the provisions of the lease are modified [ASC 840-10-35-5]. IFRS 3 incorporates similar guidance [IFRS 3.17]. See BCG 2.5.18 for further information on the lease classification exception under the Standards.

Two approaches have developed to measure the fair value of the assets and liabilities on the acquisition date arising from a lease assumed in a business combination. Under the first approach, the acquirer follows ASC 840 for lease classification and assumes the same lease term that was used by the acquiree in establishing the original lease classification when determining the fair value of the lease assets and liabilities at the acquisition date. For example, if, at the inception of the lease contract, the acquiree determined that a renewal option was reasonably assured to be exercised at the end of the noncancellable term, the acquiree would have included the period covered by the renewal option in the lease term in classifying and accounting for the lease. In this case, the acquirer would assume the same lease term, including the period covered by the renewal option, for purposes of measuring the lease assets and liabilities. This would be true even if the rental payments that would be due during the period covered by the renewal option were unfavourable to market terms at the acquisition date and the acquirer had no intention of exercising the renewal option. Under the second approach, the acquirer applies ASC 840 only to the classification of the lease. Following this approach, the assumptions used by the acquirer in measuring the lease assets and liabilities at fair value on the acquisition date are not required to be consistent with the assumptions used by the acquiree at the inception of the lease.

Summary example of lease assets and liabilities recognised

Example 4-9 illustrates the recognisable intangible and tangible assets related to leases acquired in a business combination.

EXAMPLE 4-9

Lease-related assets and liabilities

Company A, the lessor of a commercial office building subject to various operating leases, was acquired by Company G in 20X0. Included in the assets acquired is a building fully leased by third parties with leases extending through 20X9. As market rates have fluctuated over the years, certain of the leases are at above-market rates and others are at below-market rates at the acquisition date. All of the leases are classified as operating leases, as determined by the acquiree at lease inception.

U.S. GAAP Analysis

Using the acquisition method, Company G would consider the following in recognising and measuring the assets and liabilities, if applicable, associated with the lease arrangements:

- **Building:** A tangible asset would be recognised and measured at fair value. Although the building is fully leased, it should be valued without regard to the lease contracts [FAS 141(R).B147]. Company G may also need to recognise other lease or building-related tangible assets (e.g., tenant or building improvements, furniture, and fixtures) not included in this example.

- **Favourable or unfavourable leases:** Intangible assets or liabilities would be recognised and measured for the original lease contracts that are considered favourable or unfavourable, as compared to market terms at the acquisition date. For purposes of measuring the liability associated with an unfavourable lease, renewal provisions would likely be considered because there would be an expectation that a lessee would renew. On the other hand, it would be difficult to assume renewals of favourable leases as the lessees typically would not be economically motivated to renew. (See BCG 4.3.4.5 for further information on favourable and unfavourable contracts.)

- **"In-place" leases:** An intangible asset that represents the economic benefit associated with the building being leased to others would be recognised because the acquirer would avoid costs necessary to obtain lessees (e.g., sales commissions, legal, or other lease incentive costs). The "in-place" lease value recognised should not exceed the value of the remaining cash payments under the lease; otherwise, the asset would be immediately impaired.

- **Customer (tenant) relationships:** An intangible asset may be recognised, if applicable, for the value associated with the existing customer (tenant) base at the acquisition date. Such value may include expected renewals, expansion of leased space, etc.

IFRS Analysis

Using the acquisition method, Company G would consider the following in recognising and measuring the building and the assets and liabilities, if applicable, associated with the lease arrangements:

- **Building:** A tangible asset would be recognised and measured at fair value, taking into account the terms of the leases in place at the acquisition date. Therefore, the acquirer would not recognise separate intangible assets or liabilities related to the favourable/unfavourable leases or for the value of "in-place" leases. However, it may be appropriate to depreciate separately amounts related to favourable or unfavourable lease terms relative to market terms in accordance with IAS 16.

- **Customer (tenant) relationships:** An intangible asset may be recognised, if applicable, for the value associated with the existing customer (tenant) base at the acquisition date. Such value may include expected renewals, expansion of leased space, etc.

Treatment of leases between an acquirer and an acquiree at the acquisition date

An acquirer may have a **preexisting relationship** with the acquiree in the form of an operating lease agreement (e.g., the acquirer is the lessor and the acquiree is the lessee). The lease contract will effectively be settled for accounting purposes as a result of the acquisition (as the acquirer consolidates the acquiree following the acquisition).

The acquirer recognises a gain or loss on the effective settlement of the preexisting relationship in an amount equal to the lesser of (a) the amount by which the lease is favourable or unfavourable from the perspective of the acquirer relative to market terms, or (b) the amount of any stated settlement provisions in the lease available to the counterparty to whom the contract is unfavourable. See BCG 2.7.3 for further information on the accounting for the settlement of preexisting relationships.

Question 4-2

How should the acquirer account for the acquisition of an existing capital [finance] lease arrangement with the acquiree (e.g., acquirer leased assets under a capital [finance] lease from acquiree) in its acquisition accounting?

PwC response

Before the acquisition, the acquirer would have recognised a leased asset and a capital [finance] lease liability while the acquiree may have recognised a finance lease receivable. As a result of the acquisition, the lease arrangement will cease to exist for accounting purposes because it will represent an intercompany relationship beginning on the acquisition date. The capital [finance] lease liability of the acquirer shall be derecognised on the settlement of the preexisting relationship in accordance with ASC 470 and IAS 39. As a result, the acquirer should recognise a gain or loss for the effective settlement of a preexisting relationship. See BCG 2.7.3.1 for further information on calculating the settlement of preexisting relationships. The acquirer does not adjust the carrying amount of the existing leased asset. However, there may be a residual interest in the leased asset that has been acquired as a result of the business combination. In that case, an additional acquired asset should be recognised representing the fair value of the residual interest acquired. Finally, the acquirer should also reconsider the useful life of the formerly leased assets.

4.3.5 Technology-based intangible assets

Technology-based intangible assets generally represent innovations on products or services, but can also include collections of information held electronically [ASC 805-20-55-38; IFRS 3.IE39].

The following sections discuss the common technology-based intangible assets recognised and measured in a business combination.

4.3.5.1 Intangible assets used in research and development activities

Intangible assets used in research and development activities acquired in a business combination are initially recognised at fair value and classified as indefinite-lived [not available for use] assets until completion or abandonment. Research and development activities acquired in a business combination are not required to have an alternative future use to be recognised as an intangible asset. In subsequent periods, the intangible assets are subject to periodic impairment testing. Additionally, research and development projects should be capitalised at the project level for purposes of recognition, measurement, and amortisation or subsequent impairment testing. Determining useful lives and potential impairment issues related to intangible assets used in research and development activities under U.S. GAAP and IFRS is discussed in Chapters 10 and 12, respectively.

In December 2013, the American Institute of Certified Public Accountants (AICPA) issued the *AICPA Accounting and Valuation Guide Assets Acquired to Be Used in Research and Development Activities* (the IPR&D Guide). It replaces the AICPA's 2001 practice aid, *Assets Acquired in a Business Combination to Be Used in Research and Development Activities: A Focus on Software, Electronic Devices & Pharmaceutical Industries*. The Guide does not contemplate accounting or reporting under IFRS. While the IPR&D Guide is non-authoritative, it reflects the input of financial statement preparers, auditors, and regulators and serves as a U.S. GAAP accounting and reporting resource for entities that acquire IPR&D.

The accounting for subsequent research and development expenditures differs under U.S. GAAP and IFRS. Under U.S. GAAP, subsequent costs for both research and development are generally not eligible for capitalisation in accordance with ASC 730. Under IFRS 3, subsequent costs incurred for acquired projects that are in the development stage are capitalised, subject to impairment testing, if they meet the recognition criteria. If they do not, then subsequent costs are expensed.

4.3.5.2 Patented technology, unpatented technology, and trade secrets

Patented technology is protected legally and, therefore, meets the contractual-legal criterion for separate recognition as an intangible asset.

Unpatented technology is typically not protected by legal or contractual means and, therefore, does not meet the contractual-legal criterion. Unpatented technology, however, is often sold in conjunction with other intangible assets, such as trade names or secret formulas. As it is often sold with a related asset, the unpatented technology generally would meet the separability criterion.

Trade secrets are information, including a formula, pattern, recipe, compilation, programme, device, method, technique, or process, that derives independent economic value from not being generally known and is the subject of reasonable efforts to maintain its secrecy. If the future economic benefits from a trade secret acquired in a business combination are legally protected, then that asset would meet the contractual-legal criterion. Even if not legally protected, trade secrets acquired in a business combination are likely to be identifiable based on meeting the separability criterion. That is, an asset would be recognised if the trade secrets could be sold or licensed to others, even if sales are infrequent or if the acquirer has no intention of selling or licensing them [ASC 805-20-55-44 through 55-45; IFRS 3.IE44].

4.3.5.3 Computer software, mask works, databases, and title plants

Mask works are software permanently stored on read-only memory chips. Mask works, computer software, and programme formats are often protected legally, through patent, copyright, or other legal means. If they are protected legally, they meet the contractual-legal criterion. If they are not protected through legal or contractual means, these types of assets may still meet the separability criterion if there is evidence of sales or exchanges of the same or similar types of assets [ASC 805-20-55-41; IFRS 3.IE41].

Databases are collections of information, typically stored electronically. Sometimes databases that include original works of authorship can be protected by legal means, such as copyrights, and if so, meet the contractual-legal criterion. More frequently, databases are information collected through the normal operations of the business, such as customer information, scientific data, or credit information. Databases, similar to customer lists, are often sold or leased to others and, therefore, meet the separability criterion [ASC 805-20-55-42; IFRS 3.IE42].

In the United States, title plants are a historical record of all matters affecting title to parcels of land in a specific area. These assets are sold or licensed to others and, therefore, meet the separability criterion [ASC 805-20-55-43; IFRS 3.IE43].

4.4 Complementary intangible assets and grouping of other intangible assets

Separate intangible assets often work together or complement each other. In some cases, an acquirer may wish to group these complementary intangible assets together for purposes of measuring their initial fair value at the acquisition date and for subsequent amortisation and impairment testing. An example is a brand or brand names. Only limited grouping is permitted under IFRS.

A brand is a general marketing term that refers to a group of complementary intangible assets, such as a trademark and its related trade name, formula, recipe, and technology. If the assets that make up that group meet the Standards' identifiable criteria for separate recognition and have similar useful lives, an acquirer is not precluded from recognising them as a single intangible asset [ASC 805-20-55-18; IFRS 3.IE21].

An acquirer may also recognise other groups of complementary intangible assets as a single asset. The conclusion in the Standards, with respect to a brand, may also be applied to other assets for which the underlying component assets have similar useful lives. Examples of assets that may be recognised as a single asset if the useful lives are similar include:

- A nuclear power plant and the license to operate the plant [ASC 805-20-55-2; IFRS 3.B32(b)]
- A copyright intangible asset and any related assignments or license agreements [ASC 805-20-55-5; IFRS 3.B34]
- A series of easements that support a gas pipeline
- A group of permits issued by governmental agencies, all of which are required to operate a single facility

In making this assessment, the acquirer would identify the component assets and determine each component asset's **useful life** to evaluate whether such lives are similar.

4.4.1 *Assessment of other factors in determining grouping of complementary assets—U.S. GAAP*

An acquirer should also consider other factors in determining whether the component assets should be combined as a single asset. ASC 350-30-35 addresses when separately recognised indefinite-lived intangible assets should be combined into a single unit of accounting for purposes of impairment testing, and provides a list of factors to be considered. See BCG 10 for further information. In accordance with ASC 350-30-35, separately recorded indefinite-lived intangible assets should be combined into a single unit for accounting purposes if those assets are operated as a single asset and, as such, are essentially inseparable from one another. Although this guidance applies to grouping of assets for impairment testing purposes, it may be useful in determining whether acquired complementary assets should be grouped as of the acquisition date.

4.5 *Intangible assets that the acquirer does not intend to use or intends to use differently than other market-participants*

The Standards clarify that the intended use of an asset by the acquirer does not affect its fair value. Rather, the acquirer should look to an asset's highest and best use under both U.S. GAAP and IFRS when measuring its fair value [ASC 805-20-30-6; IFRS 3.B43]. The fair value of the intangible asset, therefore, should be based on assumptions made by market-participants, not acquirer-specific assumptions.

An intangible asset acquired in a business combination that the acquirer does not intend to actively use but does intend to prevent others from using is commonly referred to as a **"defensive intangible asset"** or a "locked-up asset." The asset is likely contributing to an increase in the cash flows of other assets owned by the acquirer. Conversely, an intangible asset acquired in a business combination that the acquirer does not intend to actively use and does not intend to prevent others from using is not a defensive intangible asset.

Examples 4-10 and 4-11 demonstrate how to distinguish defensive intangible assets from other intangible assets.

EXAMPLE 4-10

Defensive intangible asset

Company A, a consumer products manufacturer, acquires an entity that sells a product that competes with one of Company A's existing products. Company A plans to discontinue the sale of the competing product within the next six months, but will maintain the rights to the trade name, at minimal expected cost, to prevent a competitor from using it. As a result, Company A's existing product is expected to experience an increase in market share. Company A does not have any current plans to reintroduce the acquired trade name in the future.

Analysis

Because Company A does not intend to actively use the acquired trade name, but intends to hold the rights to the trade name to prevent its competitors from using it, the trade name meets the definition of a defensive intangible asset [ASC 350-30-55-28H through 55-28I].

EXAMPLE 4-11

Not a defensive intangible asset

Company A acquires a business and one of the assets acquired is billing software developed by the selling entity for its own use. After a six-month transition period, Company A plans to discontinue use of the internally developed billing software. In valuing the billing software in connection with the acquisition, Company A determines that a market-participant would use the billing software, along with other assets in the asset group, for its full remaining economic life (that is, Company A does not intend to use the asset in a way that is its highest and best use). Due to the specialised nature of the software, Company A does not believe the software could be sold to a third party without the other assets acquired.

Analysis

Although Company A does not intend to actively use the internally developed billing software after a six month transition period, Company A is not holding the internally developed software to prevent its competitors from using it. Therefore, the internally developed software asset does not meet the definition of a defensive intangible asset [ASC 350-30-55-28K through 55-28L]. However, consistent with other separable and identifiable acquired intangible assets, Company A should recognise and measure an intangible asset for the billing software utilising market-participant assumptions and amortise the intangible asset over the billing software's expected remaining useful life to Company A.

ASC 350-30-55 contains the U.S. GAAP accounting guidance related to certain aspects of accounting for defensive intangible assets. IFRS companies may also apply these principles in accounting for defensive assets as ASC 350-30-55 does not conflict with IFRS. ASC 350-30-55 contains the following guidance:

- A defensive asset should be considered a separate unit of accounting. This means that a defensive asset should be accounted for as an individual asset and should not be grouped with the acquirer's existing asset(s) whose value it may enhance.

- The useful life of a defensive asset should reflect the acquiring entity's consumption of the defensive asset's expected benefits. The consumption period should reflect the period over which the defensive asset is expected to contribute directly and/or indirectly to the acquiring entity's future cash flows.

- Classification of a defensive intangible asset as an indefinite-lived intangible asset would be rare.
- A defensive intangible asset cannot be considered immediately abandoned following its acquisition.
- Acquired research and development intangible assets are excluded from the scope of ASC 350-30-25-5 and should continue to be accounted for in accordance with ASC 350-30-35-17A.

See BCG 7.4 for further information on the valuation of intangible assets based on their highest and best use/market-participant assumptions. See BCG 10 and BCG 12 for further information on the postacquisition accounting for intangible assets under U.S. GAAP and IFRS, respectively.

4.6 Summary of intangible assets and typical useful life characteristics found in major industries

Figure 4-4 highlights typical intangible assets found in major industries and their typical life characteristics. This table serves as a broad overview only and is not intended to reflect all of the intangible assets that may be present for an industry participant or in a particular situation. In determining the useful lives of its recognised intangible assets, an entity must perform a thorough evaluation of the relevant facts and circumstances.

Figure 4-4

Typical intangible assets found in major industries and some of their typical life characteristics

Industry	Typical significant intangible assets	Typical life characteristics
Retail & consumer products	□ Trade and brand names □ Franchise rights □ Customer and supplier contracts □ Favourable/unfavourable contract or lease terms □ Process technology and know-how □ Liquor licenses □ Customer relationships (e.g., pharmacy script files) □ Customer lists □ Internet domain names	Trade, brand names, and franchise rights are likely to be long or possibly indefinite-lived if sustainable; otherwise, are short to moderate. Supplier arrangements are based on contractual terms, assuming renewals when appropriate (excluding a reacquired right). Contractual relationships are driven by contractual life or longer for low-cost renewals. Technology and know-how range from short- to long-term.
Industrial products	□ Trade names □ Customer and supplier contracts □ Favourable/unfavourable contract or lease terms □ Process technology and know-how □ Customer relationships	Trade names are likely to be long or possibly indefinite-lived if sustainable; otherwise, are short to moderate. Contractual relationships are driven by contractual life or longer for low-cost renewals. Technology and know-how range from short- to long-term. Customer relationships are often short to moderate but may be longer depending on rate of customer churn.

Industry	Typical significant intangible assets	Typical life characteristics
Real estate	□ Tenant relationships □ Favourable/unfavourable lease terms □ “In-place” leases	Determined by lease life and expectation of tenant renewals.
Banking	□ Core deposit intangibles (CDI) □ Distribution channels (e.g., agents) □ Brands and trade names □ Customer relationships (including purchased credit card relationships) □ Customer lists	CDI is short to moderate, based on customer churn, although may be longer for companies based outside the United States. Brands and trade names are long and possibly indefinite-lived if sustainable. Others are typically short to moderate. Contractual relationships are driven by contractual life.
Insurance	□ Customer relationships, such as renewal rights on short-duration insurance contracts, cross-selling opportunities, and customer/member lists □ Distribution channels (including the distributor’s ability to generate new business from new customers) □ Insurance licenses □ Service contracts and provider contracts (particularly relevant for health insurers) □ Brands and trade names □ Process technology and know-how	Customer relationships and distribution channels are moderate. Trade names are long and possibly indefinite-lived if sustainable; otherwise, are short to moderate. Certain insurance licenses can be maintained indefinitely without substantial cost.

Industry	Typical significant intangible assets	Typical life characteristics
Investment management	□ Trade names □ Customer relationships □ Fund manager contracts	Trade names are long and possibly indefinite-lived if sustainable; otherwise, are short to moderate. Customer relationships are moderate, but may be longer where focus is on institutional clients rather than retail. Fund manager contracts and the customer relationships of the funds are interdependent and require special analysis. The lives of fund manager contracts are driven by the expectation of renewal with the funds and are likely to be moderate- to long-term, or possibly indefinite-lived.

Industry	Typical significant intangible assets	Typical life characteristics
Technology	□ Trade names □ Customer and supplier contracts □ Favourable/unfavourable contract terms □ Process technology and know-how □ Customer relationships □ Computer software and mask works □ Internet domain names □ Databases □ IPR&D	Trade names are likely to be long or possibly indefinite-lived if sustainable; otherwise, are short to moderate. Contractual relationships are driven by contractual life or longer for low-cost renewals. Technology and know-how range from short- to long-term. Customer relationships are often short to moderate but may be longer depending on rate of customer churn. IPR&D would be an indefinite-lived [not available for use] intangible asset until the asset is abandoned or put to use or in operation as a product, at which time the life may be short to moderate, depending on the product.

Industry	Typical significant intangible assets	Typical life characteristics
Life sciences and pharmaceuticals	□ Brands and trade names □ Patents, product rights, and know-how □ Partnering and alliance arrangements □ IPR&D □ Customer relationships and customer base □ Supplier contracts	Brands and trade names are likely short to moderate, depending on product portfolio (i.e., remaining legal life of identifiable intangible assets). The exception is where brands and trade names have value and are sustainable, which could be long and possibly indefinite-lived. IPR&D would be an indefinite-lived [not available for use] intangible asset until the asset is abandoned or put to use or in operation as a product, at which time the life may be short to moderate, depending on the product.
Entertainment and media	□ Trade names/trademarks □ Artistic properties (e.g., cartoon characters, copyrights) □ Licenses (e.g., broadcast licenses, programme material licenses) □ Favourable/unfavourable contract terms	Trade names/trademarks and certain licenses and artistic properties likely to be longer term or possibly indefinite-lived if sustainable.

Industry	Typical significant intangible assets	Typical life characteristics
Telecommunications	□ Trade names □ Licenses and rights of use □ Installed base □ Technology □ Customer relationships	Trade names likely to be long or possibly indefinite-lived if sustainable; otherwise, short to moderate. Other intangible assets range from short (technology) to long or indefinite (licenses), depending on ability to renew and risk of obsolescence. Customer relationships are often short to moderate but may be longer depending on rate of customer churn.
Energy & resources (including oil & gas)	□ Trade and brand names where downstream operations are present (e.g., retail front) □ Contractual relationships □ Favourable/unfavourable contract terms (e.g., drilling contract) □ Agreements (franchise service, interconnection, operations and maintenance, railroad crossing) □ Contracts (purchased power, fuel, and other supply contracts) □ Easements, rights of way, and rights of use □ Siting, environmental, and other licenses □ Customer relationships[1]	Trade or brand names likely to be longer term or possibly indefinite-lived, if sustainable; otherwise, short to moderate. Contractual relationships are driven by contractual life or longer for low-cost renewals. Customer relationships are often short to moderate but may be longer depending on rate of customer churn.

[1] If there is a monopoly in place, an intangible asset would generally not exist as it would be unlikely that the customer relationship would be separable from the business.

Chapter 5: Income tax implications in business combinations

5.1 Chapter overview

Business combinations often give rise to a variety of complicated issues when accounting for income taxes under both U.S. GAAP and IFRS [ASC 740, *Income Taxes*; IAS 12, *Income Taxes*]. This chapter discusses the accounting for the income tax effects of business combinations, and is structured to follow the process typically used when determining the income tax implications of a business combination.

Tax in the financial statements comprises current and deferred tax. Current tax is primarily based on taxable and deductible amounts that are included in the income tax return for the current year. The amounts reported in the tax return may differ from the amounts reported in the financial statements. Tax laws and financial accounting standards recognise and measure income, expenditure, assets, and liabilities in different ways. For example, an item of expenditure accrued in the financial statements may only be tax-deductible when paid in the future. Deferred tax aims to address this mismatch.

Deferred tax accounting compares the amount recorded in the financial statements (**the book base)** to the amount attributable to that asset or liability for tax purposes (**the tax base**.) The tax base depends on the individual territory tax rules.

An **acquirer** should recognise and measure deferred taxes arising from the assets acquired and liabilities assumed in a business combination in accordance with ASC 740 and IAS 12. The acquirer also should account for the potential tax effects of an acquiree's temporary differences, **carryforwards**, and income tax uncertainties that exist at the acquisition date or that arise as a result of the acquisition [ASC 805-740-25-2, ASC 805-740-30-1; IFRS 3.24-25].

These are the steps generally performed when accounting for deferred taxes in a business combination:

- **Determine the tax structure of the transaction and tax status of the entities involved in the business combination.** Determine the legal structure and the tax status of the entities acquired (e.g., corporate entities, partnerships, limited liability corporations), and determine the tax structure of the transaction (i.e., taxable or nontaxable). In a **taxable transaction**, the tax bases of the assets acquired and liabilities assumed generally are adjusted to **fair value** based on the rules of the specific tax jurisdiction. In a **nontaxable transaction**, the historical tax bases of the assets and liabilities, **net operating losses**, and other tax attributes of the target generally carry over to the acquirer.

- **Determine financial statement and tax bases of the net assets acquired.** Determine the financial statement reported amounts (i.e., book bases) of the **identifiable** assets acquired and liabilities assumed. The Standards require the acquired net assets to be recorded at fair value, with certain exceptions. This chapter uses fair value as a general term to describe the financial reporting bases determined as prescribed under the Standards. The tax bases of the identifiable assets acquired and liabilities assumed are determined based on each specific tax jurisdiction and related tax laws and regulations.

- **Identify and measure temporary differences.** Identify the **temporary differences** related to the book bases and tax bases of the acquired identifiable assets and assumed liabilities. Determine whether the temporary differences are tax-deductible temporary differences or taxable temporary differences, and recognise the appropriate **deferred tax assets** (DTAs) or **deferred tax liabilities** (DTLs) [ASC 805-740-25-2; IFRS 3.24].

- **Identify acquired tax benefits.** Determine whether there are any acquired net operating losses (NOLs), credit carryforwards, or other relevant tax attributes that should be recorded as part of the business combination [ASC 805-740-25-2]. Determine whether under U.S. GAAP a valuation allowance is required to reduce DTAs if they are not considered to be realisable. Determine whether under IFRS the DTAs can be recognised and recorded in the financial statements based on the probability of future taxable profits [IFRS 3.25].

- **Consider the treatment of tax uncertainties and indemnifications.** Identify and determine the accounting requirements for uncertain tax positions and indemnifications [ASC 805-740-25-2; IFRS 3.25].

- **Consider deferred taxes related to goodwill.** Determine whether a DTA should be recognised for temporary differences associated with tax-deductible **goodwill** [ASC 805-740-25-3; IAS 12.32A].

BCG 5.8 discusses certain income tax accounting considerations of transactions with noncontrolling shareholders. BCG 3 includes a discussion of income tax accounting considerations related to share-based payment awards.

The key takeaways from this chapter are:

- **Deferred taxes are recognised for differences between financial reporting amounts and tax bases of identifiable assets acquired and liabilities assumed.** At the acquisition date, deferred taxes are recognised when applying the acquisition method. The acquirer recognises deferred taxes for most differences between the recorded amounts of identifiable assets and liabilities (usually fair value) and their tax bases, including acquired loss and credit carryforwards. However, deferred taxes are not recognised for nontax-deductible goodwill.

- **Release of a valuation allowance or initial recognition of acquired deferred tax assets subsequent to the acquisition date is recognised in earnings [profit or loss].** At the acquisition date, a valuation allowance may be established under U.S. GAAP, or acquired deferred tax assets may not be fully recognised under IFRS. Release of the U.S. GAAP valuation allowance, or initial recognition of acquired deferred tax assets under IFRS, subsequent to the acquisition date, is recognised in earnings [profit or loss], unless that adjustment qualifies as a measurement period adjustment.

- **Adjustments to acquired income tax uncertainties are recognised in earnings [profit or loss].** These adjustments are recognised in earnings [profit or loss], unless they qualify as measurement period adjustments.

- **Changes in an acquiring entity's existing income tax balances as a result of the acquisition are recognised in earnings [profit or loss].** Income tax effects that are specific to the acquirer's existing assets and liabilities should not be considered in the application of acquisition accounting (e.g., the release of an acquirer's valuation allowance under U.S. GAAP).

5.1.1 U.S. GAAP and IFRS differences

Income taxes in a business combination are accounted for similarly under ASC 740 in U.S. GAAP and IAS 12 in IFRS. However, both standards may use different terminology or approaches to describe the same concept or to arrive at a similar outcome. The following items should be kept in mind while reading this chapter.

- **Use of "more likely than not" versus "probable."** ASC 740 uses the term "more likely than not" when describing uncertain tax positions and valuation allowances, whereas IAS 12 uses the term "probable." The use of "probable" in IAS 12 has the same meaning as "more likely than not" under ASC 740.

- **Use of a valuation allowance versus reducing the amount recorded for a DTA.** Under ASC 740, DTAs are recorded at their gross value. A valuation allowance is recognised if it is more likely than not that some or all of the DTAs will not be realised [ASC 740-10-30-5(e)]. Under IAS 12, a DTA is recorded to the extent it is probable that sufficient taxable profit will be available against which the DTA can be utilised [IAS 12.36]. IAS 12 does not make use of a valuation allowance,but rather deferred tax assets are recognised only to the extent they are deemed realisable. The approaches may vary, but both standards generally affect the balance sheet and income statement in the same way.

- **Release of a valuation allowance versus initial recognition.** Under ASC 740, if it becomes more likely than not that DTAs will be realised, a previously recorded valuation allowance is released, which provides full or partial recognition of the DTAs. Under IAS 12, if it becomes probable that DTAs will be realised, the DTAs are recognised or adjusted to provide full or partial recognition.

5.2 Determine the tax structure of the transaction and tax status of the entities involved in the business combination

The legal structure and tax status of the entities acquired and the tax structure of the transaction should be considered to determine the appropriate deferred tax balances to record in acquisition accounting. Additionally, the tax rules of the various tax jurisdictions should be considered.

5.2.1 Determining whether the business combination is taxable or nontaxable

The tax laws in most jurisdictions generally differentiate between taxable and nontaxable business combinations. The distinction is important because the type of transaction determines the tax bases of the acquired assets and assumed liabilities.

The acquisition of a business through the direct purchase of its assets and assumption of its liabilities (an "**asset acquisition**") generally is treated as a "taxable" transaction, while the acquisition of a business through the purchase of its corporate shares (a "share" or "stock" acquisition) generally is treated as a "nontaxable" transaction. However, in some jurisdictions, a share acquisition can be treated as an asset acquisition for tax purposes if the appropriate tax election is made and approved by the relevant taxing authorities.

5.2.2 Identifying the tax status of the entities involved

Business combinations may involve the acquisition of taxable enterprises (e.g., corporations), nontaxable enterprises (e.g., partnerships and multimember LLCs), or a combination of both. The acquired enterprise's tax status will determine the deferred tax assets and liabilities to be recorded in acquisition accounting.

When the acquiree is a corporation, the acquirer generally recognises deferred taxes on each of the acquiree's identifiable assets and liabilities, including tax carryforwards and credits (referred to as "inside basis differences"). When the acquiree is a partnership, however, the acquirer generally recognises deferred taxes only for differences between the financial statement carrying amount of the acquirer's investment and its tax basis (referred to as "outside basis differences"). This is the case regardless of whether the partnership is accounted for as a consolidated entity or as an investment for financial reporting purposes.

Sometimes a portion of the outside basis difference in a partnership acquiree is attributable to assets for which deferred taxes generally would not be recognised if the acquiree was a corporation (e.g., nontax-deductible goodwill and the partnership's investment in foreign subsidiaries). In these situations, an acquirer should choose and consistently apply a policy to either (1) look through the outside basis of the partnership and exclude from the computation of deferred taxes basis differences arising from items for which there is a recognition exception under ASC 740 or IAS 12, or (2) not look through the outside basis of the partnership and record deferred taxes based on the entire difference between the financial reporting and tax bases of its investment.

The remainder of this chapter assumes the acquisition of a taxable entity, such as a corporation.

5.3 Determine financial statement and tax bases of the net assets acquired

The recognised tax bases (the amount that is attributable for tax purposes) of the assets and liabilities are compared to the financial reporting values of the acquired assets and assumed liabilities (book bases) to determine the appropriate temporary differences [ASC 805-740-25-3; IAS 12.19]. Tax laws differ by jurisdiction; therefore, each tax jurisdiction should be evaluated separately to determine the appropriate tax bases of the acquired assets and assumed liabilities.

5.3.1 *Determining tax bases in a taxable transaction*

In a taxable transaction (e.g., an asset acquisition or a share acquisition treated as an asset acquisition), the acquirer records the tax bases of the assets acquired and liabilities assumed at their fair values based on the applicable tax law. The allocation methodology for determining tax bases is often similar to the requirements of the Standards. Sometimes the acquisition price exceeds the fair value of identifiable assets acquired and liabilities assumed. The excess often is treated as goodwill for tax purposes, and may be tax-deductible. However, there could be differences in the allocation methodology because the tax allocation follows the relevant tax law. For example, the U.S. federal tax code requires a specific allocation method to determine the new tax bases in a taxable transaction. The allocation methodologies for book and tax purposes may differ in cases where the aggregate fair value of the net assets acquired exceeds the **consideration transferred**, because bargain purchases may not be recognised for tax purposes in some jurisdictions.

Differences between assigned values for financial reporting and tax purposes should be analysed. Regulatory bodies in various jurisdictions could question differences in the allocation of values for book and tax purposes. An inaccurate determination of fair value for tax purposes could impact the financial statements. For example, an improper tax valuation allocation between amortisable **intangible assets** and goodwill could result in inaccurate deferred taxes being recorded for those jurisdictions where goodwill is not tax-deductible.

5.3.2 *Determining tax bases in a nontaxable transaction*

In a nontaxable transaction (e.g., share acquisitions), the historical tax bases of the acquired assets and assumed liabilities, net operating losses, and other tax attributes of the acquiree carry over from the acquired company. No new tax goodwill is created. However, tax goodwill of the acquiree that arose in a previous acquisition may carry over and will need to be considered in determining temporary differences. See BCG 5.7.1 for further information.

5.4 *Identify and measure temporary differences*

The acquirer should identify and measure the tax-deductible and taxable temporary differences of the acquired business and record the resulting deferred tax assets and liabilities. The acquirer should consider applicable tax law when measuring both temporary differences and the related deferred tax assets and liabilities.

5.4.1 *Basic methodology for recognition of deferred taxes on acquired temporary differences and tax benefits*

Recognition of deferred tax assets and liabilities is required for substantially all temporary differences and acquired taxloss carryforwards and credits. Exceptions include (1) temporary differences for nontax-deductible goodwill, and (2) the acquired basis difference between the **parent's** carrying amount of the **subsidiary's** net assets (or investment) in the financial statements and its basis in the shares of the subsidiary (also referred to as the outside basis difference) [ASC 805-740-25-3; IAS 12.39; IFRS 3.24,25].

The exception for nontax-deductible goodwill does not extend to identifiable intangible assets with an indefinite life. These assets may seem similar to goodwill, but are significantly different in their nature because, unlike goodwill, they do not represent residual values. Therefore, differences between the book bases and tax bases of all acquired identifiable intangible assets are temporary differences for which deferred taxes should be provided.

Example 5-1 provides an example for recognising and measuring deferred taxes.

EXAMPLE 5-1

Recording deferred taxes on acquired temporary differences

Company Z acquires Company X in a share acquisition (nontaxable transaction) for total consideration of CU1,000. The fair value of the acquired identifiable net assets was CU800. The carryover historical tax bases of the acquired net identifiable assets was CU500. The tax rate is 40% in this jurisdiction.

Analysis

Company Z recorded the following journal entries in acquisition accounting:

Net asset	CU800	
Goodwill	CU320[1]	
Cash		CU1,000
Net deferred tax liability		CU120[2]

[1] Goodwill is calculated as the residual after recording the identifiable net assets acquired and associated deferred tax assets and liabilities (CU1,000 – (CU800 – CU120)).

[2] The net deferred tax liability is calculated as the difference between the book bases (in this case, the fair value) of the identifiable net assets acquired and the carryover tax bases at the applicable tax rate ((CU800 – CU500) x 40%).

Both U.S. GAAP and IFRS generally require that identified assets and liabilities are presented gross and separate from the related deferred tax balances.

5.4.2 *Expected manner of recovery or settlement*

A temporary difference is the difference between the carrying amount of an asset or liability in the statement of financial position and its tax basis. It will result in taxable or tax-deductible amounts in future years when the reported amount of the asset is recovered or the liability is settled. The tax basis of an asset or liability is the amount used or attributed to the asset or liability under the tax law [ASC 740-10-25-50; IAS 12.5]. In measuring deferred taxes, tax basis is the amount considered more likely than not [probable] to be sustainable. Hence, the tax basis used in measuring deferred taxes may not always be the tax basis claimed on a tax return.

The carrying amount of an asset will generally be recovered through use, sale, or both. The tax consequences of using an asset or settling a liability are sometimes different from selling net assets and may directly affect the tax that would be payable in the future. There may be different tax rates for regular income and capital gain income. Assets may sometimes be revalued or indexed to inflation for tax purposes only if the asset is sold (i.e., the tax basis is increased for the purpose of determining capital gain income but not regular income). Moreover, the ability to file consolidated, combined, or unitary tax returns, and elections or postacquisition transactions may affect the tax that would be payable from the recovery of an asset. In some jurisdictions, recovery of assets through use will have no tax consequences, while recovery through sale will have tax consequences. The expected manner of recovery needs to be considered to determine the future tax consequences and corresponding deferred taxes in acquisition accounting.

5.4.3 Deferred taxes related to outside basis differences

A business combination may include the acquisition of certain temporary differences for which both IAS 12 and ASC 740 provide an exception for recording deferred taxes. For example, the tax basis in the shares of certain entities may differ from the financial reporting basis (i.e., the outside basis difference). No deferred tax liability is required for the outside basis difference if the parent can establish the intent and ability to indefinitely delay reversal of the difference [it is probable that the temporary difference will not reverse in the foreseeable future]. This exception applies to all subsidiaries, branches, **associates**, and interests in joint ventures under IFRS if the indefinite delay and reversal criterion is met. This exception applies to foreign subsidiaries and foreign corporate joint ventures that are essentially permanent in duration under U.S. GAAP. Additionally, this exception applies to domestic subsidiaries under U.S. GAAP, if the parent has the intent and can demonstrate an ability to eliminate the outside basis difference in a tax-free manner [ASC 740-10-25-3, ASC 740-30-25-7; IAS 12.39,40].

A company meets the indefinite reversal criteria if it can assert the intent and ability to indefinitely reinvest earnings abroad and not repatriate the earnings [it is probable that the temporary difference related to the outside basis difference will not reverse in the foreseeable future] [ASC 740-30-25-17; IAS 12.40]. The determination of whether deferred taxes related to the outside basis differences should be recorded at the acquisition date is based on the acquirer's intent regarding the acquired investments. For example, if the acquirer intends to repatriate earnings from the acquired entity and cause a reversal of the outside basis difference, then a deferred tax liability should be recognised in acquisition accounting because the liability existed at the acquisition date and was assumed by the acquirer. This is true even if the acquiree had previously not recorded deferred taxes on its outside basis differences.

The impact of the acquirer's intent related to assets already owned by the acquirer should be evaluated separately from the acquirer's intent related to assets acquired. The effect of a change in the assertion related to an acquirer's intent and ability to indefinitely delay the reversal of temporary differences related to subsidiaries it owned prior to the acquisition is recorded outside of acquisition accounting. From a U.S. GAAP perspective, the tax effect of a change in assertion related to current year activity (e.g., current year foreign currency translation) is recorded in the same financial statement element (i.e., income statement, OCI) as the pre-tax activity. The tax effect of the change related to prior years' activity (including effects derived from foreign currency translation) is recorded in the income statement because backwards tracing[1] is not allowed under ASC 740 for these types of items. However, IFRS requires backwards tracing; and thus some of the effects could be recorded in equity and some directly in the income statement of the acquirer [ASC 740-30-25-19, ASC 740-20-45-3; IAS 12.58].

The outside tax basis of an investment may exceed the book basis. ASC 740 prohibits the recognition of a deferred tax asset for an investment in a subsidiary or corporate joint venture that is essentially permanent in duration unless the temporary difference is expected to reverse in the foreseeable future [ASC 740-30-25-9]. IFRS includes similar guidance, which is broader in scope. IAS 12 prohibits the recognition of a deferred tax asset for an investment in a subsidiary, branch, associate, or joint venture unless the temporary difference will reverse in the foreseeable future and taxable profit will be available against which the temporary difference can be utilised [IAS 12.44]. An entity, in most cases, is unlikely to be able to control the timing of the reversal of temporary differences of associates and joint ventures.

Example 5-2 illustrates the application of deferred tax accounting recognition and measurement to an acquired outside taxable basis difference.

EXAMPLE 5-2

Deferred tax accounting related to acquired outside basis difference when a U.S. IRC section 304 restructuring transaction is implemented following a business combination—under both U.S. GAAP and IFRS

Parent, a U.S.-based multinational, acquired all of the shares of Target, another U.S.-based multinational, in a nontaxable transaction. Both U.S. companies have a Dutch holding company through which they own several lower-tier foreign subsidiaries. In conjunction with the acquisition, Parent intends to consolidate the respective businesses and achieve operational, process, and tax efficiencies by restructuring the ownership of Target's Dutch holding company. Under the restructuring plan, Parent's Dutch holding company (Dutch Co. A) will buy from Target all of the shares of Target's Dutch holding company (Dutch Co. B). The two Dutch companies will form a parent-subsidiary consolidated tax return group in the Netherlands. Parent has historically maintained an indefinite reinvestment assertion and, thus, has not recorded a U.S. deferred tax liability for the outside basis difference related to its investment in Dutch Co. A. The determination not to record this deferred tax liability

[1] U.S. GAAP and IFRS require the allocation of income tax expense or benefit to elements of the financial statements (e.g., income statement, equity). Under IAS 12, changes to deferred tax balances resulting from circumstances, such as a change in tax rates or a change in the assessment of recoverability of a deferred tax asset, are "backward traced" and charged or credited to the element where the original tax effect was recognised [IAS 12.60]. Under ASC 740, most subsequent changes in deferred taxes are recorded in income tax expense from continuing operations and are not "backward traced" to the original element affected [ASC 740-20-45-3].

would be the same under both U.S. GAAP and IFRS. Parent also intends to similarly defer the U.S. tax consequences (i.e., assert indefinite reinvestment) with respect to the acquired basis difference (in Dutch Co. B) beyond any amount that will reverse in the restructuring. The following table summarises the relevant book and tax bases immediately before the restructuring:

	Parent's investment in Dutch Co. A	Target's investment in Dutch Co. B
Book basis	CU10,000	CU3,000
Tax basis	CU3,000	CU1,000
Earnings & Profits (E&P)	CU7,000	CU2,000
Previously Taxed Income (PTI)	CU2,000	None

To implement the restructuring, Dutch Co. A paid CU3,000 in exchange for all of the shares of Dutch Co. B. For U.S. federal tax purposes, the transaction is subject to IRC section 304. Under that Code section, if one corporation purchases shares of a related corporation in exchange for property, the transaction generally is recharacterised as a redemption that produces a dividend. In this case, the dividends (CU3,000) are taxable to the extent of the accumulated earnings and profits (E&P) of the two Dutch companies (CU9,000), subject to the following ordering rule: Dutch Co. A's E&P is considered first; if the value of the distribution exceeds its E&P, the excess is considered to be paid from Dutch Co. B's E&P. If either corporation has foreign source income that has already been taxed under the IRC subpart F rules (referred to as "previously taxed income" or PTI), the distribution is considered to be made first from PTI (distribution of PTI) and is taxable only to extent of unrecognised foreign exchange gains or losses.

Analysis

In this example, the first CU2,000 is considered to be a distribution of PTI from Dutch Co. A, taxable only to the extent of any foreign exchange gain; the remaining CU1,000 is considered to be a fully taxable dividend distribution from Dutch Co. A's E&P. Therefore, the tax effect should be recorded outside of acquisition accounting under both U.S. GAAP and IFRS. The tax impact related to a Parent's outside basis it already owns should be accounted for outside of acquisition accounting and the following journal entry would be recorded:

Income tax expense	CU350	
Current tax payable		CU350[1]

[1] CU1,000 fully taxable distribution x 35% (applicable U.S. tax rate) = CU350. (For simplicity, assume no foreign tax credits are claimed for this taxable distribution and that there are no unrecognised currency exchange gains or losses related to PTI.)

Assume the same facts in the illustration above except that Dutch Co. A has no accumulated E&P. In this circumstance, the first CU2,000 is considered to come from Dutch Co. A's PTI and the remaining CU1,000 is considered to come from Dutch Co. B's accumulated E&P. The tax impact related to an acquired outside basis difference should be recorded in acquisition accounting and the following journal entry would be recorded:

Goodwill	CU350	
Deferred tax liability		CU350[2,3]

[2] CU1,000 fully taxable distribution x 35% (applicable U.S. tax rate) = CU350. (For simplicity, assume no foreign tax credits are claimed for this taxable distribution and that there are no unrecognised currency exchange gains or losses related to PTI.)

[3] When the distribution occurs, the acquired deferred tax liability would be reversed and a current tax liability would be recognised.

In measuring deferred taxes for acquired assets and liabilities, Parent would consider the expected method of recovery or settlement and, when applicable, its intent and ability to avoid or trigger tax consequences on acquired outside basis differences. The tax impact of Parent's intention related to an outside basis difference it already owned should be accounted for outside of acquisition accounting, whereas the tax impact of Parent's intention related to an acquired outside basis difference should be recorded in acquisition accounting.

Parent's intent related to the CU2,000 acquired outside basis difference is to defer the tax consequences for the foreseeable future and therefore no DTL is recognised in acquisition accounting. Alternatively, if the IRC 304 restructuring had resulted in some portion (or all) of the acquired outside basis difference in Dutch Co. B reversing, the tax effects related to that reversal would be recorded in acquisition accounting consistent with Parent's expectation as to the manner in which the acquired outside basis difference would likely be recovered.

Although this example illustrates the analysis and accounting for an IRC 304 restructuring, which is defined only under U.S. tax law, the analysis for a similar restructuring transaction in a non-U.S. tax jurisdiction would generally be the same.

5.4.4 *Recording the tax effect of contingencies and contingent consideration in business combinations*

Acquisition accounting under the Standards includes the recognition of acquired contingent assets or assumed contingent liabilities and **contingent consideration**, all of which affect the amount of book goodwill recorded at the **acquisition date**. [ASC 805-20-25-19, ASC 805-30-25-5; IFRS 3.23,56].

However, these items generally are not recognised for tax purposes until the amounts are fixed and reasonably determinable or, in some jurisdictions, until they are paid. These conditions often are not met until a future financial statement period. As a result, these items would not have tax basis on the acquisition date. In a taxable transaction, the tax basis in the newly created goodwill does not include an incremental amount related to these contingencies (there is no tax-deductible goodwill created in a nontaxable transaction). Therefore, the difference in treatment for these items could give rise to temporary differences for which deferred taxes should be recognised at the date of acquisition and adjusted in subsequent periods as the contingency or contingent consideration is adjusted for financial reporting purposes.

A temporary difference for which deferred taxes should be recorded generally exists if the resolution of the contingency or contingent consideration will result in a future tax consequence (i.e., deduction or income) [ASC 740-10-25-20; IAS 12.51]. The tax consequence upon resolution of the contingency or contingent consideration is affected by whether the business combination was a taxable or nontaxable transaction. For example, the resolution of a contingent liability in a nontaxable transaction may result in a tax deduction, in which case a deferred tax asset should be recorded on the acquisition date. In a taxable transaction, the resolution of a contingent liability may affect the amount of tax-deductible goodwill, in which case the exceptions to recognition of deferred taxes related to goodwill at the acquisition date may need to be considered. See BCG 5.7 for further information on deferred taxes related to goodwill.

If the resolution of the contingency or contingent consideration will increase or decrease the amount of tax-deductible goodwill, an acquirer may take one of two acceptable approaches to account for the related deferred taxes.

One approach is to consider the impact on tax-deductible goodwill in the initial comparison to book goodwill as if the contingent liability or contingent consideration was settled at its book basis at the acquisition date. See BCG 5.4.4.1 for further information on this approach.

Another approach is to treat the contingency or contingent consideration as a separate tax-deductible item. A deferred tax asset would be recorded in acquisition accounting because the liability, when settled, will result in a future tax deduction (i.e., tax-deductible goodwill). That is, a deferred tax asset is recognised at the acquisition date since there is a basis difference between book and tax related to the liability, without regard to the impact it would have on the comparison of tax-deductible goodwill to book goodwill. The deferred tax asset would be calculated by multiplying the temporary difference by the applicable tax rate. The second approach ignores the initial comparison of book goodwill to tax-deductible goodwill for this particular component even though the liability will be added to tax-deductible goodwill when settled.

The approach adopted is an accounting policy choice and should be applied consistently for all acquisitions.

Figure 5-1 summarises the deferred tax accounting associated with the most common scenarios for contingencies and contingent consideration in a taxable transaction, using the first approach described above, and in a nontaxable transaction. See BCG 5.4.4.1 for further information and examples related to taxable transactions and BCG 5.4.4.2 for further information related to nontaxable transactions.

Figure 5-1
Contingencies and contingent consideration

Topic	At acquisition date	Upon adjustment	Upon settlement
Financial reporting (pretax)			
Contingencies	Under U.S. GAAP, record at fair value if determinable or if not, at an amount determined by applying ASC 450, *Contingencies*. Under IFRS, record at fair value if present obligations are reliably measureable [IFRS 3.23].	Adjust the contingency periodically, as required.	Reverse the contingency through payment or other settlement.
Financial reporting (pretax)			
Contingent consideration	Record at fair value.	Record at fair value each period except for equity classified arrangements.	Reverse the contingency through payment or other settlement.
Taxable transaction			
Deferred tax treatment	If settlement would result in tax-deductible goodwill, then the recorded amount of the contingency is added to the tax basis goodwill balance. A deferred tax asset would be recorded for any excess tax-deductible goodwill (as adjusted) over book goodwill. If settlement would result in a tax-deductible asset (other than goodwill), then the recorded amount of the contingency is added to the tax basis of such asset. Record deferred taxes on the resulting book versus tax basis difference if required under ASC 740 or IAS 12.	If settlement would result in tax-deductible goodwill, then record deferred taxes on the amount of the adjustment. Do not reperform the acquisition date comparison of tax-deductible goodwill to book goodwill. If settlement would result in a tax-deductible asset (other than goodwill), then the recorded amount of the contingency is added to the tax basis of such asset. However, any tax effect is reflected as part of the income statement [profit or loss].	Apply the same treatment as "upon adjustment" if settled at an amount different than previously recorded.
Nontaxable transaction			
Deferred tax treatment **Contingencies**	If settlement would result in a tax deduction or tax-deductible asset (other than goodwill), then a deferred tax asset should be recorded.	If settlement would result in a tax-deductible asset (other than goodwill), the analysis is the same as on the acquisition date.	Apply the same treatment as "upon adjustment" if settled at an amount different than previously recorded.

Topic	At acquisition date	Upon adjustment	Upon settlement
Nontaxable transaction			
Deferred tax treatment **Contingent consideration**	Initially there would not be a temporary difference. If settlement would result in an increase in the tax basis of the shares (i.e., outside basis), then the recorded amount of the contingency would be added to the tax basis. However, this amount would also be recorded as part of the book basis (goodwill) and therefore no temporary difference arises.	Subsequently a temporary difference may arise. If settlement would result in an increase in the tax basis of the shares (i.e., outside basis), then deferred taxes should be considered. This would be based on the subsequent adjustment to the book and tax bases.	Apply the same treatment as "upon adjustment" if settled at an amount different than previously recorded.

See BCG 5.6 for further information on the effects of income tax uncertainties.

5.4.4.1 Contingencies and contingent consideration—taxable transactions

In a taxable business combination, the settlement of a contingency or contingent consideration will often impact the ultimate amount of tax-deductible goodwill. Following the first approach described in BCG 5.4.4, the recorded amount of the contingency or contingent consideration is added to the tax-deductible goodwill balance as if it were settled at the acquisition date. A deferred tax asset should be recorded if the amount of that hypothetical tax-deductible goodwill (as adjusted for the contingency) exceeds the amount of book goodwill. Because the deferred tax asset is related to goodwill, an iterative calculation is required to determine the amount of the deferred tax asset. However, no deferred tax liability is recorded if book goodwill exceeds the hypothetical tax goodwill [ASC 805-740-25-9; IAS 12.32A,15(a)]. See BCG 5.7 for further information on recording deferred taxes on goodwill.

Example 5-3 illustrates the described approach for determining deferred tax balances related to contingent consideration at the acquisition date in a taxable business combination.

EXAMPLE 5-3

Acquisition date deferred taxes related to contingent consideration in a taxable business combination

Assume contingent consideration is valued on the acquisition date in a taxable business combination at CU1,000. Goodwill for book purposes (including the initial recording of contingent consideration) is CU3,000. Tax-deductible goodwill is CU1,800, which excludes the initial recording of contingent consideration. The applicable tax rate for all periods is 40%. When the contingent consideration is settled, it will be included in tax-deductible goodwill.

Analysis

To determine deferred taxes at the acquisition date, consider the tax consequence that will result if the contingent consideration is settled for the book basis. Since the amount of contingent consideration would be added to tax-deductible goodwill when settled, the amount of contingent consideration is added to the balance of tax-deductible goodwill to determine whether there is an excess of tax or book goodwill. The goodwill balances are analysed as follows:

Book goodwill	CU 3,000
Tax-deductible goodwill	1,800
Contingent consideration	1,000
Tax-deductible goodwill (as adjusted)	2,800
Excess of book over tax-deductible goodwill	CU 200

If book goodwill exceeds tax-deductible goodwill, no deferred taxes are recognised. However, if the tax-deductible goodwill exceeds book goodwill, a deferred tax asset is recognised. For example, assuming the same facts as above, except that the contingent consideration was valued at CU1,500 at the acquisition date, the tax-deductible goodwill (as adjusted) would have been CU3,300. The excess of the tax-deductible goodwill (as adjusted) over the book goodwill of CU300 would have resulted in a deferred tax asset. See BCG 5.7.2 for further information on how the deferred tax asset is calculated.

This approach to measuring deferred taxes is also applicable to contingent liabilities in a taxable business combination.

Adjustments to contingencies and contingent consideration in subsequent periods that are not measurement period adjustments generally are recorded for financial reporting purposes in earnings [profit or loss] [ASC 805-30-35-1; IFRS 3.45,58]. See BCG 2.6.4 for further information on accounting for contingent consideration. The appropriate deferred tax treatment related to these adjustments is determined by considering the expected tax consequence, assuming the item is settled at its book basis. Deferred taxes are adjusted if the adjustment to the contingency or contingent consideration would cause a tax consequence (e.g., increase or decrease a tax-deductible expense or asset).

The acquisition date comparison of book goodwill to tax-deductible goodwill should not be reperformed subsequent to the acquisition date unless there is a measurement period adjustment. The Standards treat pretax adjustments to contingencies and contingent consideration that are not measurement period adjustments as being outside of acquisition accounting with no adjustment to book goodwill. Therefore, the tax effect of adjustments to contingencies and contingent consideration should also be reflected outside of acquisition accounting.

For example, a deferred tax asset should be recognised or adjusted along with the related income tax expense or benefit when contingent consideration is increased subsequent to the acquisition date for a change in fair value, and the settlement of the contingent consideration would increase tax-deductible goodwill. This is true even if no deferred tax asset was recorded at the date of acquisition (i.e., tax goodwill did not exceed book goodwill at the acquisition date).

Similarly, consider an example where a contingent consideration liability is decreased subsequent to the acquisition date due to a change in fair value. A decrease in the contingent consideration liability subsequent to the acquisition date causes a decrease in the tax-deductible goodwill as if the contingent consideration is settled. This decrease in the contingent consideration liability, which will result in a decrease in the tax-deductible goodwill when settled, will be recorded by either (1) recording a deferred tax liability (i.e., when book goodwill exceeded tax-deductible goodwill at the acquisition date), or (2) reducing a deferred tax asset (i.e., when tax-deductible goodwill exceeded book goodwill at the acquisition date).

Example 5-4 illustrates this approach for determining deferred tax balances related to an adjustment to contingent consideration in a taxable business combination.

EXAMPLE 5-4

Deferred taxes related to a contingent consideration adjustment in a taxable business combination

Assume contingent consideration is valued on the date of acquisition in a taxable business combination at CU1,000 and is increased in year two to CU1,700. The contingent consideration is eventually settled in year three. At the acquisition date, goodwill for book purposes (including the initial recording of contingent consideration) is CU3,000. Tax-deductible goodwill is CU1,800, which excludes the initial recording of contingent consideration. The applicable tax rate for all periods is 40 percent. For simplicity, the effects of amortisation of tax goodwill are excluded from the example. Once the contingent consideration is settled, it will be included in tax-deductible goodwill. At the acquisition date, book goodwill of CU3,000 was in excess of tax-deductible goodwill of CU2,800 (including the expected additional basis to be recognised when settled); therefore, no deferred tax asset was recorded for contingent consideration. See Example 5-3 for an illustration of recording deferred taxes related to contingent consideration at the acquisition date.

Analysis

In year two, the fair value of the contingent consideration increases by CU700 to CU1,700. The adjustment, when settled, will result in additional tax-deductible goodwill.[1] Therefore, a deferred tax asset related to the adjustment should be recorded, even though no deferred tax asset related to tax-deductible goodwill was recorded at the acquisition date. That is because the acquisition date comparison of book to tax goodwill is not revisited under this approach.

The following entry would be recorded:

Expense	CU700	
Deferred tax asset	CU280[2]	
Contingent consideration		CU700
Deferred tax expense		CU280

[1] In some jurisdictions, a portion of the contingent consideration may be treated as tax-deductible interest. For simplicity, this example does not address that fact pattern.

[2] (CU700 x 40%).

There is no impact on the effective tax rate because the pretax expense related to the increase in contingent consideration has a corresponding deferred tax benefit.

The same treatment would apply if there is a decrease in the contingent consideration. For example, if the contingent consideration had decreased by CU700, a deferred tax liability of CU280 would have been recorded. When resolved, the adjustment to the contingent consideration would result in a decrease in tax-deductible goodwill (i.e., a decrease in a tax deduction).

Year three:

Contingent consideration is settled at CU1,700. Since the item is settled for the amount previously recorded, there is no further impact on earnings or deferred taxes. The deferred tax asset is not adjusted because the contingent consideration was settled at the recorded amount for book purposes, but it has not yet been deducted for tax purposes (i.e., the deduction will occur over time as goodwill is amortised).

The following entry is recorded:

Contingent consideration	CU1,700	
Cash		CU1,700

The same treatment would apply for a contingent liability in a taxable business combination.

A contingent consideration arrangement that is equity-classified is not remeasured based upon subsequent changes in fair value. The ultimate settlement is accounted for within equity [ASC 805-30-35-1;IFRS 3.58].

Example 5-5 illustrates the tax accounting for equity-classified contingent consideration that is settled for more than its carrying amount.

EXAMPLE 5-5

Accounting for tax effects from the settlement of equity-classified contingent consideration

Assume an equity-classified contingent consideration arrangement is valued and measured on the date of acquisition in a taxable business combination at CU100,000. The contingent consideration will be settled by issuing company shares to the seller when certain performance metrics are met, at which time the settlement value will be included in tax-deductible goodwill. At acquisition, book goodwill exceeds tax goodwill by CU100,000, and therefore, no deferred tax is recorded for the equity-classified contingent consideration. The fair value of the contingent consideration increases by CU50,000 to CU150,000 in year two when it is settled for CU150,000 (the fair value of the shares issued to the seller at the time of settlement).

Analysis

The settlement is accounted for as a reclassification within equity at the recorded value of CU100,000. However, the settlement results in additional tax basis in goodwill of CU50,000 to be amortised (in addition to the CU100,000) in future periods. The tax benefit from the additional tax basis, net of any valuation allowance if required, should be recognised in equity [ASC 740-20-45-11(g); IAS 12.61A(b)]. The guidance in ASC 740-20-45-11(g) requires that the tax effects of all changes in tax bases of assets and liabilities caused by transactions among or with shareholders be included in equity. The issuance of company shares to the seller in full settlement of equity-classified contingent consideration should be regarded as a transaction with a shareholder. The guidance in IAS 12.61A(b) requires that current and deferred taxes related to items recognised in equity should also be recognised in equity. Therefore, the related tax benefit from the additional tax-deductible goodwill is recognised in equity under both standards.

5.4.4.2 Contingencies and contingent consideration—nontaxable transactions

The amount paid to settle a contingent liability assumed in a nontaxable business combination may result in a tax deduction. A deferred tax asset should be recorded in acquisition accounting for the acquired contingency if the applicable tax laws would allow for a deduction when the contingent liability is settled. This concept is illustrated in Example 5-6.

EXAMPLE 5-6

Deferred tax impact of contingent liabilities in a nontaxable business combination

Assume a contingent liability is recorded at fair value of CU1,000 on the date of acquisition in a nontaxable business combination. The tax basis in the contingent liability is zero. When the liability is settled, the company will receive a tax deduction for the amount paid. The tax rate is 40%.

Analysis

The contingent liability is a temporary difference at the acquisition date, because it has a zero tax basis and when the liability is settled, it will result in a tax deduction. The following entry would be recorded at the acquisition date:

DTA	CU400	
Goodwill	CU600	
Contingent liability		CU1,000

The deferred tax asset should be adjusted in subsequent periods as the amount of the contingent liability changes.

The settlement of contingent consideration in a nontaxable business combination often will be added to the outside tax basis as part of the amount paid for the acquiree. At the acquisition date no temporary difference would arise.

If the settlement would result in an increase in tax basis of the shares (i.e., outside basis), then the recorded amount of the contingency would be added to the tax basis. However, this amount would also be recorded as part of the book basis (goodwill) and therefore no temporary difference arises. Subsequently a temporary difference may arise. If settlement would result in an increase in the tax basis of the shares (i.e., outside basis), then deferred taxes should be considered. This would be based on the subsequent adjustment to the book and tax bases. Subsequent changes in the amount of contingent consideration could impact an entity's effective tax rate because it is likely that the pretax effect of changes in contingent consideration would be recorded in the income statement without a corresponding tax effect. See BCG 5.4.3 for further information on recording deferred taxes on outside basis differences.

Example 5-7 illustrates this approach for determining deferred tax balances related to contingent consideration in a nontaxable business combination.

EXAMPLE 5-7

Deferred tax impact of contingent consideration in a nontaxable business combination

Assume contingent consideration is valued on the acquisition date in a nontaxable business combination at CU1,000. In year two, the fair value of the contingent consideration increases by CU1,200 to CU2,200 and is settled for cash in year three at CU2,200. The applicable tax rate for all periods is 40%. Once the contingent consideration is settled, for tax purposes it will be added to the basis of the shares acquired (i.e., outside basis). No deferred tax liability is recorded on the outside basis temporary difference in the shares acquired.

Analysis

To determine the deferred taxes at the acquisition date, consider the resulting tax consequence if the contingent consideration is settled for its book basis. The contingent consideration, when settled, will be added to the basis of the acquired shares for tax purposes. Therefore, deferred taxes will not be recorded since the resolution of the contingent consideration will affect only the outside tax basis of the shares.

At the date of acquisition, the following entry would be recorded:

Goodwill	CU1,000	
Contingent consideration		CU1,000

Year two:

The CU1,200 adjustment to fair value of the contingent consideration is recognised in earnings [profit or loss]. However, there is no corresponding tax effect recorded at that time, because the resolution of the contingent consideration will affect only the outside tax basis of the shares, on which no deferred taxes are being recorded. In this case, adjustment of the contingent consideration will impact the effective tax rate because there is a pretax expense item without a corresponding tax effect. The effect on the rate can be demonstrated as follows (assuming income before tax and contingent consideration of CU10,000 and no other permanent or temporary items):

Income before tax and contingent consideration	CU10,000
Less additional contingent consideration	(1,200)
Income before tax	CU8,800
Income tax before contingent consideration	CU4,000
Tax effect of contingent consideration	0
Total income tax	CU4,000
Effective tax rate	45.5%

Year three:

Contingent consideration is settled at CU2,200.

The following entry would be recorded:

Goodwill	CU2,200	
Cash		CU2,200

In year three, there is no further impact on earnings [profit or loss] or the effective tax rate because the contingent consideration was settled for the amount previously recorded. No deferred tax entry is required since the contingent consideration is added to the tax basis in the shares and deferred taxes are not being provided on the outside basis difference.

5.4.5 Deferred taxes related to research and development activities

Research and development activities (R&D) acquired in a business combination will be capitalised as tangible or intangible assets based on their nature. The capitalised in-process R&D (IPR&D) activities are accounted for as indefinite-lived [not available for use] intangible assets, subject to **impairment** testing until completion or abandonment of the projects. The acquirer estimates the **useful life** of the asset once each project is complete [ASC 805-20-35-5].

Deferred tax liabilities related to indefinite-lived [not available for use] assets typically are not used as a source of income to support realisation of deferred tax assets in jurisdictions where tax attributes expire (e.g., jurisdictions where net operating loss carryforwards expire) unless the DTL is expected to reverse prior to the expiration of the tax attribute. The acquirer should determine whether the deferred tax liability related to R&D will reverse in a period that would allow realisation of the deferred tax assets.

Example 5-8 illustrates the approach for considering whether a DTL for R&D activities should be considered a source of income for realising DTAs.

EXAMPLE 5-8

Whether a deferred tax liability for R&D activities should be considered a source of income for realising deferred tax assets

Company A acquires Company B in a nontaxable business combination. Company A recognises an acquired R&D intangible asset for CU100 and records an associated DTL of CU40. Under the Standards, the R&D intangible asset is classified as indefinite-lived [not available for use] until the project is either abandoned or completed, at which time a useful life will be determined. Company A plans to file a consolidated tax return with Company B. Company A had a pre-existing DTA of CU30 for NOLs that will expire in 10 years (for simplicity, assume this is the Company's only DTA). Prior to the acquisition, Company A had a valuation allowance against [had not recognised] the DTA.

Analysis

Company A must estimate both when the R&D project will be completed and the expected useful life of the resulting intellectual property intangible asset in order to determine whether the DTL related to the R&D intangible asset can be used as a source of taxable income. If Company A expects the project to be completed within two years and expects the useful life of the intangible asset to be three years, then the DTL should be used as a source of income in assessing the realisation of the DTA because the DTL is expected to reverse (over years three to five) before the NOL carryforward expires. Any benefit recognised if Company A reverses all or a portion of its valuation allowance [initially recognises all or a portion of the DTA] is recorded outside of acquisition accounting in continuing operations.

5.4.6 Deferred taxes related to acquisition-related costs

Acquisition-related costs are not part of the fair value of the consideration that is transferred. Such acquisition costs are expensed as incurred by the acquirer [ASC 805-10-25-23; IFRS 3.53]. However, acquisition-related costs may be treated one of several ways for tax purposes depending on the tax jurisdiction and the type of costs. For example, these costs could be expensed as incurred, capitalised as a separate intangible asset, included in the basis of the shares acquired, included in the basis of other assets, or included in tax-deductible goodwill.

If the acquisition costs are not immediately deductible for tax purposes, a potential temporary difference is created. We believe there are two acceptable alternatives for determining the appropriate deferred tax treatment for acquisition costs.

One alternative is to consider whether the acquisition costs would result in a future tax deduction if the business combination was not consummated. If so, then the acquisition costs represent a tax-deductible temporary difference for which a deferred tax asset should be recognised when the costs are expensed for financial reporting. This approach is considered acceptable because the consummation of a business combination is generally not anticipated for accounting purposes. When the acquisition is consummated, companies will need to revisit the appropriate accounting for the temporary difference and consider whether the deferred tax asset should be reversed. Depending on how the acquisition costs are treated for tax purposes (e.g., added to the outside basis of the shares), it may no longer be appropriate to record deferred taxes on such acquisition costs. Reversal of a deferred tax asset would be reflected in the income statement and would affect the effective tax rate in the period the acquisition is consummated.

Another alternative is to consider the expected ultimate tax consequence of the costs. The acquirer may expect the costs to be included in the outside basis of the shares for tax purposes, as is typically the case in a nontaxable business combination. In this case, no deferred tax asset would be established related to the acquisition costs unless the acquirer expects to record deferred taxes on the outside basis temporary difference. Therefore, the acquisition costs would be expensed with no corresponding tax effect, which would affect the effective tax rate in the period the acquisition-related costs are expensed. Deferred taxes would be provided on the acquisition costs if those costs are expected to be included in a tax-deductible asset (e.g., tax-deductible goodwill). This approach is considered acceptable because it is appropriate to consider the expected tax consequence of the reversal of the temporary difference in the recognition and measurement of deferred taxes [ASC 740-10-25-20; IAS 12.5]. This approach requires a continuous evaluation of expectations at each reporting date and recognition of deferred tax adjustments consistent with revised expectations.

Tax-deductible goodwill is compared to book goodwill at the acquisition date to determine whether a deferred tax asset should be recorded. Under either approach described above, acquisition costs are not included in the tax goodwill amount for purposes of the comparison of tax-deductible goodwill to book goodwill, because the acquisition costs are not included in book goodwill. See BCG 5.7 for further information on recording deferred taxes on goodwill.

Since these costs will not be reflected in acquisition accounting for financial reporting purposes, associated deferred taxes that are recorded or later reversed will be reflected in the income statement.

For U.S. GAAP, the costs to issue debt or equity securities are recognised in accordance with other applicable GAAP [ASC 805-10-25-23]. For IFRS, the costs to issue debt or equity securities shall be recognised in accordance with IAS 32 and IAS 39 [IFRS 3.53]. Costs to issue debt or equity securities are not part of acquisition accounting. Any associated tax effect will be reflected in the income statement or directly in equity, but not in acquisition accounting.

5.4.7 Identifying the applicable tax rate to calculate deferred tax assets and liabilities

An acquirer should consider the effects of the business combination when determining the applicable tax rate for each jurisdiction (and in some cases for individual temporary differences). This may be important in jurisdictions with graduated rates because the combined business's operations may require the application of a different statutory rate [ASC 740-10-30-8 through 30-9; IAS 12.47]. See BCG 5.5.7 for further information on recording the impact of an expected change in the applicable tax rate on the acquirer's deferred tax balances.

The applicable rate is determined based on enacted tax rates, even if the parties included apparent or expected changes in tax rates in their negotiations. ASC 740 requires that rate changes be reflected in the period when enacted. IAS 12 allows changes in tax rates to be reflected when substantively enacted. This may result in certain differences in the measurement of deferred taxes under IFRS and U.S. GAAP. Further, a change in enacted or substantively enacted rates subsequent to the acquisition date may result in an immediate positive or negative impact on the tax provision in the postcombination period [ASC 740-10-45-15; IAS 12.48].

Companies that file financial statements with the SEC may be required to apply pushdown accounting, whereby the parent's basis in the investment is pushed down to the legal entities acquired. Regardless of whether pushdown accounting is applied, the applicable tax rate(s) used to measure deferred taxes should be determined based on the relevant rate(s) in the jurisdictions where the acquired assets are recovered and the assumed liabilities are settled, as discussed in Example 5-9.

EXAMPLE 5-9

Applicable tax rate

A holding company acquires (in a "nontaxable" transaction) 100% of the shares of another business. The holding company is incorporated in a jurisdiction that does not impose income taxes, and the acquired business is in a jurisdiction where income is subject to income taxes. The holding company identifies temporary differences between the fair value (as determined under the Standards) for financial reporting purposes and the tax bases of the individual assets acquired and liabilities assumed.

Analysis

The consolidated financial statements should include deferred taxes related to the book versus tax basis differences of the acquired net assets. The deferred taxes should be measured at the enacted income tax rate(s) (or substantively enacted rates under IFRS) applicable to the acquired business. The tax rate applied should consider the jurisdiction in which the acquired assets are recovered and the assumed liabilities are settled, even if the parent's basis in the investment has not been pushed down to the separate financial statements of the acquired business.

5.5 Identify acquired tax benefits

The acquirer should determine whether there are any net operating loss, credit, or other carryforwards to record as part of acquisition accounting. The discussion in this section does not consider the fact that certain tax uncertainties could be embedded in the net operating loss, credit, or other carryforwards [ASC 805-740-25-2; IFRS 3.25]. Under IFRS, a deferred tax asset is recorded if it is probable that sufficient taxable profit will be available against which the tax-deductible temporary difference can be utilised. Under U.S. GAAP, generally a deferred tax asset is recorded in full, but then is reduced by a valuation allowance if it is more likely than not that some or all of the deferred tax asset will not be realised [ASC 740-10-30-5(e); IAS 12.36].

5.5.1 Realisation test for acquired tax benefits

ASC 740 and IAS 12 generally have similar methodologies for determining the realisability of deferred tax assets based on the availability of future taxable income. Both methodologies likely will yield a similar net result. A buyer would not recognise a DTA unless it is "more likely than not" [probable] the DTA will be realised. If a DTA is recognised in acquisition accounting it would generally result in an increase in the amount of recognised goodwill. This analysis should be done on a tax jurisdictional basis as required by ASC 740 [IAS 12].

Excerpt from ASC 740-10-30-18

Future realisation of the tax benefit of an existing deductible temporary difference or carryforward ultimately depends on the existence of sufficient taxable income of the appropriate character (for example, ordinary income or capital gain) within the carryback, carryforward period available under the tax law. The following four possible sources of taxable income may be available under the tax law to realise a tax benefit for deductible temporary differences and carryforwards:

a. Future reversals of existing taxable temporary differences

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

c. Taxable income in prior carryback year(s) if carryback is permitted under the tax law

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

    1. Accelerate taxable amounts to utilise expiring carryforwards

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

    3. Switch from tax-exempt to taxable investments.

Evidence available about each of those possible sources of taxable income will vary for different tax jurisdictions and, possibly, from year to year. To the extent evidence about one or more sources of taxable income is sufficient to support a conclusion that a valuation allowance is not necessary, other sources need not be considered. Consideration of each source is required, however, to determine the amount of the valuation allowance that is recognised for deferred tax assets.

Excerpt from IAS 12

.36 An entity considers the following criteria in assessing the probability that taxable profit will be available against which the unused tax losses or unused tax credits can be utilised:

a. whether the entity has sufficient taxable temporary differences relating to the same taxation authority and the same taxable entity, which will result in taxable amounts against which the unused tax losses or unused tax credits can be utilised before they expire;

b. whether it is probable that the entity will have taxable profits before the unused tax losses or unused tax credits expire;

c. whether the unused tax losses result from identifiable causes which are unlikely to recur; and

d. whether tax planning opportunities (see paragraph 30) are available to the entity that will create taxable profit in the period in which the unused tax losses or unused tax credits can be utilised.

To the extent that it is not probable that taxable profit will be available against which the unused tax losses or unused tax credits can be utilised, the deferred tax asset is not recognised.

An acquirer that will include the acquiree in a consolidated tax return should consider the tax attributes and future taxable income of the combined business when assessing whether acquired deferred tax assets are realisable. For example, deductible differences or carryforwards of the acquiree may be realisable because (1) they may be offset by the acquirer's tax attributes under the applicable tax laws, (2) the acquirer has sufficient taxable temporary differences that will generate future taxable income, or (3) the acquirer anticipates having sufficient other future taxable income to ensure realisation. These new sources of future taxable income from the perspective of the combined business may make it possible to recognise deferred tax assets for the combined business at the date of acquisition.

Combined tax attributes or income may also provide evidence as to the realisability of the acquirer's own deferred tax assets at the date of acquisition. However, changes in the assessment of realisability of the acquiring company's deferred tax assets are not included in acquisition accounting. See BCG 5.5.7 for further information on changes in the acquirer's deferred tax balances related to acquisition accounting.

5.5.2 Evaluating future combined results subsequent to the business combination

To determine the need for a valuation allowance [whether a deferred tax asset should be recognised] at the date of acquisition, it is necessary to consider all available evidence. In jurisdictions where a consolidated tax return will be filed (i.e., acquiring and acquired business consolidated), it may be necessary to consider the expected future taxable income of the combined business.

To perform the evaluation, past results as well as expected future results should be considered. It will be necessary to adjust past results of the acquired business to reflect depreciation and amortisation based on the amounts assigned in acquisition accounting. This may, at first, seem inappropriate for a business acquired in a nontaxable acquisition because its future taxable income will be measured based on its carryover tax basis. But the objective of this analysis is to provide some indication of the future earnings power of the combined business. Temporary differences at the date of acquisition will be measured based on the differences between the carryover tax basis (in a nontaxable acquisition) and the fair values assigned in acquisition accounting. If the fair values are higher, the reversals of resulting taxable differences may themselves ensure realisation of future tax benefits. Such pro forma results for the most recent prior year tend to be the most meaningful. However, results for periods more than one or two years prior to the consummation of the business combination also should be considered. Judgment will have to be applied in reviewing the available evidence and to adequately consider historical results to arrive at a meaningful outcome.

5.5.3 Considering the acquirer's taxable differences as a source of realisation

The acquirer's own deferred tax liabilities may provide a source for the realisation of deferred tax assets acquired in a business combination and, therefore, may be an important component in assessing the need for a valuation allowance [whether a deferred tax asset should be recognised] for the deferred tax assets that arise from the acquisition. As a result, the acquirer may need to determine its temporary differences at the date of acquisition, which may be difficult if the acquisition occurs at an interim date. The acquirer's temporary differences on the date of the acquisition should be determined in each jurisdiction and may be computed using one of the three approaches described below:

- Assume that, as of the acquisition date, the acquirer files a short-period tax return. In some jurisdictions, the tax laws govern how annual deductions, such as depreciation, are allowed in a short-period return. The existing book bases of the assets and liabilities would then be compared with these pro forma tax bases to determine the temporary differences.

- Assume that temporary differences arise evenly throughout the year. That is, if the beginning temporary difference is CU100 million and the projected ending temporary difference is CU220 million, the temporary difference is assumed to increase by CU10 million a month as the year progresses.

- Assume that temporary differences arise in the same pattern that pretax accounting income is earned. That is, if pretax income is earned 10, 20, 30, and 40 percent in the first through fourth quarters, respectively, then temporary differences would increase or decrease on that basis as well. That is, if the beginning temporary difference is CU100 million and the projected ending temporary difference is CU220 million, the expected annual increase of CU120 million is assumed to occur in proportion to the pretax income (i.e., 10, 20, 30, and 40 percent in the first through fourth quarters, respectively).

The acquirer should determine the approach most suitable to its facts and circumstances.

5.5.4 Limitation of tax benefits by law

In certain business combination transactions, the acquired business and its tax attributes may be integrated into the consolidated tax returns and positions of the acquirer. However, depending on the specific tax jurisdiction, there may be various limitations on the use of acquired tax benefits. Some examples of these limitations include:

- Utilisation of certain attributes, such as NOLs or tax credits, may be limited due to a change in corporate ownership, structure, or a significant change in business operations. These limitations might be expressed as an absolute amount, a formula-based limitation (e.g., annually changing percentage of the acquired tax benefit), or a relationship to taxable income (e.g., 30 percent of taxable income can be offset by acquired NOLs).

- Use of acquired loss carryforwards may be limited to postacquisition taxable income of the acquired business.

- The acquired business may be subject to tax in a different jurisdiction or may file a separate return in the same jurisdiction as the acquirer. Thus, use of the acquired tax benefits may be limited based on the results of the acquiree's own operations.

All restrictions are considered in assessing whether the deferred tax assets for acquired tax benefits are recognisable or realisable (e.g., which future expected taxable income is relevant, or the impact of expiration periods in case of limited annual use).

5.5.5 Changes to the acquired deferred tax assets after the business combination

The recoverability of deferred tax assets is reassessed at each reporting date. The valuation allowance recorded under U.S. GAAP is reduced or eliminated (i.e., partially or fully released), or the respective deferred tax assets are recognised under IFRS if it is more likely than not [probable] that part or all of deferred tax assets will eventually be utilised [ASC 805-740-45-2; IAS 12.37].

Measurement period adjustments to acquired assets and assumed liabilities are reflected retrospectively (i.e., as of the acquisition date) in the financial statements. In general, any changes to an acquiring company's DTAs that result directly from measurement period adjustments should also be retrospectively recorded. Example 5-10 illustrates this guidance.

EXAMPLE 5-10

Measurement period adjustments related to deferred taxes

Company A acquired Company B in a nontaxable business combination in the first quarter of 20X0. One of Company B's more significant assets was an office building that had no remaining tax basis. Company A recorded the office building at a provisional fair value of CU1,000 and recorded a corresponding DTL of CU400 (40% rate) at the acquisition date. Company A had pre-existing DTAs of CU600, for which there was a full valuation allowance [no recognition of a DTA] in prior periods. Solely as a result of the business combination and the existence of acquired DTLs, Company A released CU400 of its valuation allowance [thus recognising CU400 of the DTAs] and recognised the benefit in the income statement at the acquisition date.

In the second quarter of 20X0, Company A completed its measurement of the acquisition date fair value of the office building when it received a third-party appraisal report. The appraisal indicated that the fair value of the building at the acquisition date was CU700, resulting in a DTL of CU280 (and not the CU400 previously recorded). Accordingly, the acquirer's valuation allowance reversal [initial recognition of a DTA] in the first quarter was overstated by CU120.

Analysis

The accounts should be retrospectively adjusted to reflect the final valuation of the building, the resulting revised depreciation, and the corresponding tax effects, including the adjustment of CU120 to the valuation allowance.

Under U.S. GAAP, the release of a valuation allowance that does not qualify as a measurement period adjustment is reflected in income tax expense (or as a direct adjustment to equity), subject to the normal intraperiod allocation rules. Under IFRS, the initial recognition of acquired deferred tax assets that does not qualify as a measurement period adjustment is reflected in income tax expense (or as a direct adjustment to equity), subject to the backwards tracing rules. The release of a valuation allowance [or under IFRS, the initial recognition of acquired deferred tax assets] within the measurement period resulting from new information about facts and circumstances that existed at the acquisition date is reflected first as an adjustment to goodwill, then as a bargain purchase [ASC 805-740-45-2; IAS 12.68].

The acquirer should consider whether changes in the acquired deferred tax balances are due to new information about facts and circumstances that existed at the acquisition date or are due to events arising in the postcombination period. Changes resulting from discrete events or circumstances that arise within the measurement period and that did not exist at the acquisition date generally would not be recorded in acquisition accounting [ASC 805-10-25-13 through 25-14; IFRS 3.45].

For example, the impact of a subsequent business combination occurring during the measurement period of a prior acquisition would likely not qualify as a measurement period adjustment. The subsequent business combination would typically not represent new information about facts and circumstances that existed at the acquisition date, but would rather be an event arising in the postcombination period. Therefore, if a subsequent business combination triggers the release of a valuation allowance [initial recognition] established in a prior acquisition, such release would typically be recorded as a decrease in income tax expense. The guidance in the Standards related to measurement period adjustments to acquired deferred tax balances is consistent with the guidance for changes in other acquired assets and liabilities. See BCG 2.9 for further information on measurement period adjustments.

The guidance related to the release of a valuation allowance (ASC 740) or recognition of deferred tax assets (IAS 12) subsequent to the date of acquisition also applies to business combinations consummated prior to the effective date of the Standards [ASC 805-10-65-1(b); IFRS 3.67]. See BCG 2.13.1 for further information on the transition provisions of the Standards.

Example 5-11 illustrates the application of the measurement period guidance to a change in valuation allowance [initial recognition].

EXAMPLE 5-11

Measurement period guidance applied to a change in valuation allowance [initial recognition]

Company A acquires Company B on 1 July. Company B's normal business activities are construction and demolition. A full valuation allowance [no recognition of net deferred tax assets] related to Company B's acquired deferred tax assets is recorded in acquisition accounting. A natural disaster occurs after the acquisition date, but prior to 30 June of the following year (i.e., within the measurement period). The natural disaster directly results in Company B obtaining a major new cleanup contract. The company has not provided any natural disaster cleanup services in the past and providing such services was not a factor in determining the acquisition date value of Company B.

Analysis

The increase in taxable earnings from the natural disaster cleanup contract could not be foreseen and was not part of the acquirer's assumptions in establishing the valuation allowance [no recognition] at the acquisition date. Therefore, the resulting change in the valuation allowance [initial recognition] would not be recorded as a measurement period adjustment, but rather would be recorded in earnings [profit or loss].

5.5.6 Effects of postacquisition elections

Business combinations often involve a considerable amount of business, legal, and tax planning. Tax effects can arise from events ranging from tax-specific elections to more complex reorganisations and business integration actions. These events may alter the income taxes expected to be incurred on recovery of acquired temporary differences. When such events relate to actions contemplated by the acquirer at or prior to the acquisition date, careful analysis is required to determine whether the tax effects should be included as part of acquisition accounting or should be accounted for outside of acquisition accounting. The fair value accounting guidance in the Standards is based upon market-participant assumptions which exclude the effects of buyer-specific decisions and transactions. However, the Standards identify income taxes as an exception to the fair value measurement principles. The acquirer should record all deferred tax assets, liabilities, and valuation allowances in accordance with ASC 740 or IAS 12 [ASC 805-20-25-16 through 25-17, ASC 805-740-25-2, and ASC 805-740-30-1; IFRS 3.24 and 3.25].

The Standards do not directly address whether the tax effects of postacquisition elections or transactions that are part of an acquirer's tax planning strategies should be included in acquisition accounting. This determination requires consideration of specific facts and circumstances, and the relevant tax laws, to determine whether the tax effects of a particular event should be recognised as part of, or outside of, acquisition accounting.

The determination might be straightforward when, for example, the seller and buyer agree to make a tax election to treat a share purchase as an asset purchase for tax purposes, thus providing a step-up in the inside tax bases of acquired assets. The buyer is thus able to acquire, through the acquisition transaction negotiations, assets with stepped-up tax bases and should account for the tax election effects in acquisition accounting. However, there are circumstances where the determination is not straightforward and may require significant judgment and analysis. These judgments and analyses can be complex, and practice in this area is evolving.

We believe the following factors should generally be considered:

- Whether the election or transaction is available and contemplated as of the acquisition date, or within the measurement period though based on information and facts that existed at the acquisition date.
- Whether the election or transaction is primarily within the acquirer's control with no significant complexities or uncertainties as to whether the transaction will actually be completed.
- Whether the acquirer is required to make a payment (separate from consideration exchanged for the business) or forgo tax attributes to obtain the tax benefits; in this regard, the mere realization or settlement of an acquired deferred tax liability is not considered a separate payment.
- Whether other significant costs will be incurred to implement the transaction.

For further guidance to consider when assessing whether postacquisition tax elections or transactions should be included in acquisition accounting or accounted for outside of acquisition accounting, refer to Chapter 10 of PwC's *Income tax guide* and Chapters 13 and 25 of PwC's *IFRS Manual of Accounting*.

5.5.7 Changes in the acquirer's deferred tax balances related to acquisition accounting

The impact on the acquiring company's deferred tax assets and liabilities caused by an acquisition is recorded in the acquiring company's financial statements outside of acquisition accounting. Such impact is not a part of the fair value of the assets acquired and liabilities assumed.

For example, in jurisdictions with a graduated tax rate structure, the expected postcombination results of the company may cause a change in the tax rate expected to be applicable when the deferred tax assets and liabilities reverse. The impact on the acquiring company's deferred tax assets and liabilities is recorded as a change in tax rates and reflected in earnings under U.S. GAAP and in profit or loss or equity, as applicable, under IFRS [ASC 740-10-45-15; IAS 12.60].

Additionally, the acquirer's financial statements may have included a valuation allowance before the transaction for its deductible differences or loss carryforwards and other credits (U.S. GAAP) or had not recognised these items previously (IFRS). After considering the transaction, the projected combined results, and available taxable temporary differences from the acquired business, the acquirer may be able to release all or part of its valuation allowance (U.S. GAAP), or recognise all or some of these deferred tax assets (IFRS). While this adjustment is a result of the acquisition, the Standards require that the benefits be recognised in income or equity, as applicable, and not as a component of acquisition accounting. This benefit is related to the acquirer's existing assets and should not be considered in the determination of the fair values of the assets acquired and liabilities assumed [ASC 805-740-30-3; IAS 12.67].

If a valuation allowance is required (U.S. GAAP) or the previously recorded deferred tax assets are no longer recognisable (IFRS) by the acquirer as an indirect result of the acquisition, this immediate charge should be reflected in the income statement [profit or loss] at the date of the acquisition. The concept is similar to the one discussed above; these tax charges are specific to the acquirer's existing assets and should not be considered in the application of acquisition accounting.

Acquired deferred tax liabilities could be a source of income to support recognition of acquired deferred tax assets or the acquirer's existing deferred tax assets, or both. As discussed above, only to the extent acquired deferred tax liabilities support the acquirer's existing deferred tax assets is the effect of releasing any related valuation allowance [recognising deferred tax assets] reflected in earnings (i.e., outside of acquisition accounting). Accordingly, in circumstances in which some but not all of the combined deferred tax assets are supported by acquired deferred tax liabilities, the acquirer will need to apply an accounting policy to determine which balances are being supported. We believe there are two acceptable accounting policies. One policy is to consider the recoverability of deferred tax assets acquired in the acquisition before considering the recoverability of the acquirer's existing deferred tax assets. Another policy is to consider relevant tax law ordering rules for utilisation of tax assets to determine whether the acquired or pre-existing deferred tax assets are considered realisable.

Example 5-12 illustrates the application of each alternative accounting policy on valuation allowance considerations in acquisition accounting [note that IAS 12 does not make use of a valuation allowance but rather deferred tax assets are recognised only to the extent they are deemed realisable].

EXAMPLE 5-12

Accounting policy for considering whether acquired deferred tax liabilities support realisation of acquired or acquirer's deferred tax assets

Company X and Company Y each have CU2,000 of DTAs related to net operating loss (NOL) carryforwards generated in the last four years. Other deferred tax assets and liabilities are de minimis. Company X has historically maintained a valuation allowance against its DTAs. In the current period, Company X acquires the shares of Company Y in a nontaxable transaction and the combined business will file a consolidated tax return. As part of the acquisition, assume DTLs of CU1,500 related to Company Y are recorded, and the combined entity cannot rely on future taxable income for realisation of DTAs. However, the acquired DTLs will reverse prior to any NOL expirations and are, therefore, a source of future taxable income for realisation of DTAs. There are no tax law limitations on future realisation of the NOL carryforwards. Consequently, Company X determines it needs a valuation allowance [should not recognise DTAs] of CU2,500 (combined DTAs of CU4,000 less reversing DTLs of CU1,500).

Analysis

Deferred taxes are recorded in acquisition accounting for the acquired entity's temporary differences and operating loss/credit carryforwards [ASC 805-740-25-2; IFRS 3.24]. However, any changes in the acquirer's deferred taxes as a result of a business combination should be recorded currently in income [ASC 805-740-30-3; IAS 12.67].

In the fact pattern described above, we believe there are two alternative methods to account for the benefit that can be recognised in Company X's financial statements:

View A—The DTLs should first be considered as a source of taxable income in relation to the acquired company's deferred tax assets, with any residual amount applied to the acquirer's deferred tax assets. This view is premised on the sequence of events, starting with the acquisition, followed by the consideration of impacts on the acquirer. Under ASC 740, a CU500 valuation allowance would be recorded in acquisition accounting (i.e., CU1,500 of the CU2,000 acquired DTAs are expected to be realised), and the existing valuation allowance against the acquirer's DTAs (CU2,000) would not change. Under IAS 12, a CU1,500 DTA would be recorded in acquisition accounting.

View B—Realisation of the DTAs should be based on underlying tax law ordering for the jurisdiction (e.g., looking first to older NOLs if that is consistent with the tax law in the relevant jurisdiction). The objective would be to determine the reversal pattern of tax attributes and tax-deductible temporary differences under the tax law. However, where the order in which tax attributes and tax-deductible temporary differences will be used is not determinable, the entity should develop a systematic, rational, and consistent methodology for allocating the benefit resulting from the DTLs.

Either View A or View B is acceptable as an accounting policy election provided the policy is applied consistently to acquisitions with appropriate financial statement disclosure, including specific disclosure of any benefits or expenses recognised for changes in the acquirer's valuation allowance [ASC 805-740-50-1; IAS 12.81(j)].

5.5.8 Business combinations achieved in stages

An acquirer sometimes obtains **control** of an acquiree in which it held an **equity interest** prior to the acquisition date. In a **business combination achieved in stages**, the acquirer shall remeasure its **previously held equity interest** in the acquiree at its acquisition date fair value and recognise the resulting gain or loss (i.e., the difference between its fair value and carrying value) in earnings [profit or loss]. If changes in the fair value of the equity interest were previously recorded in other comprehensive income (OCI), the amount of unrealised gains or losses should be reclassified from OCI and included in the measurement of the gain or loss on the acquisition date [ASC 805-10-25-10; IFRS 3.42]. The recognition of a gain or loss at the acquisition date represents the recognition of the economic gain or loss that is present in the previously held equity interest [FAS 141(R).B387; IFRS 3.BC 387].

Prior to obtaining control, deferred taxes would have been based on the difference between the carrying amount of the investment in the financial statements and the tax basis in the shares of the investment (i.e., outside basis difference). Unless a current tax is triggered, remeasuring the previously held equity interest to fair value will increase the book basis with no corresponding increase in the tax basis, thus changing the outside basis difference and associated deferred tax. Since the acquirer's gain or loss from remeasuring the acquirer's previously held investment is reflected in net income, the corresponding tax effect of the change in outside basis difference caused by such gain or loss should be reflected in the acquirer's income tax expense from continuing operations. The gain or loss associated with a previously held equity interest might include the effects of reclassifying amounts from accumulated other comprehensive income to net income (e.g., unrealised gains or losses on AFS securities and CTA). Generally, the corresponding reclassification adjustment from OCI to net income will also include any related income tax expense or benefit that was previously recognised in OCI.

Example 5-13 illustrates the impact on the outside basis difference from remeasuring a previously held investment to fair value.

EXAMPLE 5-13

Impact on outside basis difference from remeasuring a previously held investment

Company A has a 20% equity-method investment in Company B with a carrying value of CU1,000 and a tax basis of CU800. Company A has recorded a corresponding deferred tax liability of CU80 (CU1,000 – CU800 x 40%). Company A acquires the remaining 80 percent of Company B. The fair value of Company A's previously held investment in Company B is CU1,500 at the acquisition date.

Analysis

Company A would remeasure its investment in Company B to CU1,500 and record a gain of CU500 for financial reporting purposes. Company A's book versus tax basis difference in the previously owned shares of Company B would increase from CU200 (CU1,000 – CU800) to CU700 (CU1,500 – CU800) at the acquisition date. Assuming a 40% tax rate, Company A would record the following tax entry to increase the deferred tax liability from CU80 to CU280:

Deferred tax expense	CU200[1]	
Deferred tax liability		CU200

[1] Increase in outside basis difference of CU500 x 40% tax rate.

Upon obtaining control, the acquirer may no longer need to recognise deferred taxes on the outside basis of the investment due to the provisions of ASC 740 and IAS 12 (e.g., there is a means for tax-free recovery of the investment). In these cases, the accounting for the deferred tax related to the previously held investment differs under IFRS and U.S. GAAP. Under U.S. GAAP, the treatment depends on whether the subsidiary is foreign or domestic.

Under IFRS, for both foreign and domestic subsidiaries, if the deferred tax on the outside basis difference is no longer required, then the deferred tax related to the entire outside basis difference on the previously held investment is reversed. The effect of reversing the deferred tax is recorded in the acquirer's income tax expense from continuing operations and does not impact acquisition accounting. As discussed above, the gain or loss associated with a previously held equity interest will include the effects of reclassifying amounts from accumulated other comprehensive income to net income (e.g., unrealised gains or losses on AFS securities and CTA). Generally, the corresponding reclassification adjustment to other comprehensive income will also include any related income tax expense or benefit that was recognised in OCI.

Under U.S. GAAP, if the subsidiary is domestic and the parent has the intent and ability under the tax law to recover its investment in a tax-free manner, then the entire deferred tax liability related to the outside basis difference on the previously held investment is reversed. The effect of reversing the deferred tax is recorded in the acquirer's income tax expense from continuing operations and does not impact acquisition accounting. The gain or loss associated with a previously held equity interest might include the effects of reclassifying amounts from accumulated other comprehensive income to net income (e.g., unrealised gains or losses on AFS securities and CTA). Generally, the corresponding reclassification adjustment to OCI will also include any related income tax expense or benefit that was recognised in OCI.

If the subsidiary is foreign, then generally a portion of the DTL related to the outside basis difference on the previously held investment must be retained. U.S. GAAP requires that a DTL continue to be recorded for the temporary difference related to the investor's share of the undistributed earnings of a foreign investee prior to the date it becomes a subsidiary. The DTL should remain as long as dividends from the subsidiary do not exceed the parent company's share of the subsidiary's earnings subsequent to the date it became a subsidiary [ASC 740-30-25-16]. Effectively, the DTL at the acquisition date for the outside basis temporary difference caused by undistributed earnings of the foreign investee is "frozen" until that temporary difference reverses.

Outside basis differences can arise from activities other than from undistributed earnings (e.g., currency translation adjustments). In such cases, it is unclear as to what portion of the deferred tax liability should be retained.

One view is that upon gaining control of an equity- or cost-method investee, the DTL for the entire outside basis difference, including any basis difference resulting from adjusting the investment to fair value, is frozen until that temporary difference reverses. A second view is that only the portion of the DTL that relates to undistributed earnings of the investee as of the date control is obtained is frozen. The approach selected is an accounting policy choice that should be applied consistently from acquisition to acquisition. However, in some jurisdictions, the recovery of an investment in a foreign equity investee does not have tax consequences to the investor. In such circumstances, a DTL for holding gains would not be recognised (and then frozen) when control is obtained as such gains would never be taxable and therefore do not constitute temporary differences.

Upon gaining control of the investee, the acquirer will apply acquisition accounting and recognise the assets acquired and liabilities assumed, including goodwill. The acquirer must then identify and measure associated deferred tax assets and liabilities. Consider a situation where the acquiring company obtains a step-up tax basis in the net assets acquired for the portion most recently purchased, but does not obtain a step-up tax basis for the portion previously held (i.e., carryover tax basis related to the previously held investment). The method for calculating tax bases would result in larger inside book-over-tax-basis differences as a result of the acquirer's previously held investment, which, in turn, would impact the amount of goodwill recorded in acquisition accounting. Example 5-14 illustrates this concept.

EXAMPLE 5-14

Impact on inside basis differences from a previously held investment

Company A has a 20% equity-method investment in Company B, with a carrying value of CU1,000 and a tax basis of CU800. Company A acquires the remaining 80% of Company B for CU8,000 and elects, under the tax law, to obtain a step-up of the inside tax bases of the net assets acquired for the 80% purchased (i.e., elected to treat the transaction as taxable). The fair value of the previously held 20% investment at the acquisition date is CU2,000.

Analysis

The resulting inside tax bases would be a combination of the 20% carryover tax basis and the 80 percent fair value (CU800 + CU8,000 = CU8,800).

For financial reporting, the net assets acquired are recorded at fair value (as prescribed by the Standards). The net assets acquired, including goodwill, are recorded at CU10,000.[1]

The book bases exceed the tax bases by CU1,200 (CU10,000 – CU8,800). The excess is attributable to the carryover inside tax bases resulting from the 20% previously held investment.[2] Therefore, a deferred tax liability generally would be recorded as part of acquisition accounting.[3]

In a taxable transaction where the acquirer did not have a prior investment in the acquiree, the inside tax bases would equal the consideration transferred at the date of acquisition. Consequently, no book and tax inside basis differences generally exist and, therefore, no deferred taxes would be recorded on the acquisition date.

[1] CU2,000 fair value of 20% previously held investment plus CU8,000 consideration transferred for the remaining 80 %.

[2] Fair value of 20% previously held investment less carryover tax bases (CU2,000 – CU800 = CU1,200).

[3] Consideration would need to be given to the prohibition against recording a deferred tax liability on excess book over tax-deductible goodwill. See BCG 5.7 for further information on recording deferred taxes relating to goodwill.

Deferred taxes related to inside basis differences are recorded in acquisition accounting. Deferred taxes are one element of the acquired assets and assumed liabilities. The Standards require the acquirer to recognise and measure deferred taxes arising from the net assets acquired and other temporary differences of the acquiree that exist at the acquisition date, or arise as a result of the acquisition in accordance with ASC 740 and IAS 12 [ASC 805-740-25-2, ASC 805-740-30-1; IFRS 3.24,25]. The resulting deferred taxes arise from recording the individual assets acquired and liabilities assumed in the acquisition and should therefore be recorded in acquisition accounting. The deferred taxes related to the net assets acquired would impact goodwill.

5.6 Consider the treatment of tax uncertainties

An acquirer may take positions in a taxable business combination (e.g., in allocating the acquisition price and in filing subsequent tax returns) that it expects the taxing authority to challenge. Similarly, there may be uncertainties about the tax basis of individual assets or the preacquisition tax returns of the acquired business in nontaxable business combinations. Both situations are uncertain tax positions for which there is different guidance under U.S. GAAP and IFRS.

5.6.1 Recording tax uncertainties

An uncertain tax position is an income tax position taken in a previously filed tax return, or a position expected to be taken in a future tax return by an entity for which there is uncertainty as to whether the applicable taxing authority would, upon examination, deny some or all of the tax benefit claimed or to be claimed by the entity. When some or all of an uncertain tax position does not meet the requirements for recognition, some or all of the related uncertain tax benefit must be reduced.

Accounting for income tax related uncertainties under U.S. GAAP, including the related uncertain tax benefits acquired in a business combination, requires an entity to first determine whether an uncertain tax benefit qualifies for recognition. Recognition is permitted only if it is at least “more likely than not” (i.e., greater than

50 percent) that the entity's tax filing position would be sustained upon challenge by the relevant taxing authorities. The determination of the likelihood that a tax filing position will be sustained is based purely on its technical merits and does not include consideration of the likelihood that the taxing authority is likely to identify the tax uncertainty.

If the tax filing position does not have at least a "more likely than not" chance of being sustained, none of the benefit associated with that tax position is recognised. If it is determined that the tax filing position will "more likely than not" be sustained, the tax benefit is measured using a cumulative probability approach. Under this approach, the amount of the uncertain tax benefit that has a cumulative probability of realisation in excess of 50 percent is the amount recognised. [ASC 740-10-25-6, ASC 740-10-30-7]. See TX 16 for more discussion of accounting for tax uncertainties under U.S. GAAP.

While uncertain tax positions are not addressed explicitly by either IFRS 3 or IAS 12, two approaches have emerged in practice: uncertain tax positions in a business combination are either accounted for as a contingent liability using the guidance in IFRS 3 and recorded at fair value, or accounted for under IAS 12. If IAS 12 is followed, a liability is recognised when it is probable that a position taken will not be sustained on examination by the taxing authority. The liability is measured using either an expected-value (weighted-average probability) approach or a single best estimate of the most likely outcome. The current tax liability would be the aggregate liability in connection with current taxes and other uncertain tax positions [IAS 12.46].

5.6.1.1 Income tax indemnifications

A seller may indemnify the acquirer for tax uncertainties that arose prior to the business combination. The Standards provide guidance on the recognition and measurement of an indemnification asset. The indemnified party recognises an indemnification asset at the same time that it recognises the indemnified item, and measures the asset on the same basis as the indemnified item [ASC 805-20-25-27 through 25-28; IFRS 3.27, 28]. An indemnification asset related to an uncertain tax position is recognised at the same time and measured on the same basis as the related liability, subject to collectability or contractual limitations on the indemnified amount [ASC 805-20-35-4; IFRS 3.57]. Indemnification assets recognised on the acquisition date continue to be measured on the same basis as the related indemnified item until they are collected, sold, cancelled, or expire.

The Standards generally assume that the terms of the indemnification arrangement fully cover the related exposure. Where that is not the case, there can be accounting differences, such as in the following scenarios:

- An income tax uncertainty relates to the timing of a deduction. For example, a tax deduction was claimed in year 1, but there is risk that the deduction should be taken over 15 years. Where the indemnification covers the implied interest cost associated with spreading the deduction over a longer period, the indemnification asset would not equal the related liability. Rather, in this case, the indemnification receivable would presumably equal only the outstanding interest accrual.

- The indemnification covers any tax exposure that exceeds a specified dollar amount. In this situation, the mirror image will apply only to the excess over the specified amount.

There also may be scenarios where the terms of the indemnification fully cover the tax exposure, but the related amounts recorded for accounting purposes appear to differ, such as in the following scenarios:

- A company does not classify interest and penalties in the same line as the liability for an income tax exposure. In this situation, mirror image accounting may apply (assuming that interest and penalties are covered by the indemnification); however, the indemnification asset would mirror the total of the tax liability and the related interest and penalty accruals.

- The company records a reserve against the indemnification asset due to collection risk.

There also may be scenarios where the seller provides a blanket indemnification for taxes owed in prior years, but no specific tax positions are reserved. No indemnification asset should be recognised if no liability is required under the uncertain tax position guidance in ASC 740, IFRS 3, or IAS 12.

From a U.S. tax perspective, there are typically no consequences from indemnification payments regardless of whether the acquisition was taxable or nontaxable. For example, assume that an uncertain tax position is not sustained and that the buyer (or acquired company) pays CU100 to the taxing authority and collects CU100 from the seller. The amount paid to the taxing authority and the amount collected from the seller would generally offset, with no net impact on taxable earnings, tax-deductible goodwill or stock basis. As a result, in most cases the indemnification receivable recorded in acquisition accounting would not be expected to have a deferred tax effect.

An indemnification asset should not be netted against the related liability. Adjustments to the indemnification asset should be recorded in pre-tax income [profit before income tax], not as part of income tax expense [ASC 740 and IAS 12 narrowly define the term "income taxes" as domestic and foreign taxes based on income (taxable profits) [ASC 740-10-20; IAS 12.2]]. Recoveries under an indemnification agreement do not appear to fit within the scope of this definition. Therefore, although dollar-for-dollar changes in the income tax liability and the related indemnification asset (subject to the limitations of the indemnity and collectability) will offset on an after-tax basis, pre-tax income [profit before income tax] and income tax expense will move directly as the amount of the income tax liability and related indemnification asset change].

Companies should ensure that liabilities for unrecognised tax benefits, regardless of whether covered by an indemnification agreement, are included in the company's annual disclosures. That is, the disclosures required by ASC 740-10-50-15 would reflect the unrecognised tax benefits with no offset or netting for an indemnification. For example, the company would need to include the tax position in its disclosure of gross amounts of increases and decreases in unrecognised tax benefits and amounts that, if recognised, would affect the effective tax rate. However, it may often be necessary to provide additional disclosure in regard to the terms of any indemnification arrangements so that financial statement readers can appropriately assess the net economic exposure to the entity.

See BCG 2.5.14 for further information on indemnifications.

5.6.2 Subsequent resolution of tax uncertainties in a business combination

Adjustments to uncertain tax positions made subsequent to the acquisition date are recognised in earnings [profit or loss], unless they qualify as measurement period adjustments. Measurement period adjustments are recorded first as an adjustment to goodwill, then as a bargain purchase.

For example, during the initial due diligence, the acquirer may have identified uncertain tax positions of the acquiree and made a preliminary estimate of the amount, if any, of the related liability. That preliminary estimate is recorded in acquisition accounting. If, during the measurement period, the acquirer performs a more detailed analysis of information that existed at the acquisition date and determines that an adjustment is necessary, the adjustment should be recorded retrospectively in acquisition accounting. Similarly, if, during the measurement period, the acquirer discovers an uncertain tax position that was not identified in its due diligence but which existed at the acquisition date, the accounting for that position should be recorded retrospectively in acquisition accounting.

ASC 740-10-25-14 provides that subsequent changes in judgment that lead to changes in an uncertain tax position should be recognised in the period in which the change in facts occurs. Changes in judgment about an uncertain tax position should result from *new information*. "New information," in this context, represents a change in circumstances, and the resulting adjustment from the change in judgment would not be a measurement period adjustment.

If the adjustment arises from an identifiable postacquisition event, then it should be recorded outside of acquisition accounting (even if still within the measurement period). On the other hand, if the adjustment results from the discovery of facts and circumstances that existed at the acquisition date, then it should be recorded as part of acquisition accounting.Unlike the general transition provisions of ASC 805, the guidance for recognition of adjustments to acquired income tax uncertainties also applies to existing uncertainties arising in a business combination consummated *prior* to the effective date of ASC 805 (ASC 805-10-65-1(b)).

5.7 Deferred taxes related to goodwill

Goodwill for financial reporting purposes is a residual amount. Acquired goodwill for financial reporting purposes is recognised as an asset and is not amortised. Some business combinations, particularly taxable business combinations, can generate goodwill that is deductible for tax purposes (also referred to as "tax-deductible goodwill").

The amount assigned to goodwill for book and tax purposes could differ, due to different valuation and allocation rules and differences in determining the amount of consideration transferred (e.g., different treatment of contingencies or costs incurred for the transaction). ASC 740 describes the separation of goodwill into components to assist in determining the appropriate deferred tax accounting related to goodwill at the acquisition date. Although the concept of having separate components of goodwill is not explicitly described in IFRS, we believe that the principles can be applied by analogy. The first component (component-1) equals the lesser of (1) goodwill for financial reporting or (2) tax-deductible goodwill. The second component (component-2) equals the remainder of each, that is, (1) the remainder, if any, of goodwill for financial reporting in excess of tax-deductible goodwill or (2) the remainder, if any, of tax-deductible goodwill in excess of the goodwill for financial reporting [ASC 805-740-25-8].

Figure 5-2 displays the concept of component-1 and component-2 goodwill.

5.7.1 Excess of tax-deductible goodwill over book goodwill

An excess of tax-deductible goodwill over goodwill for financial reporting is a temporary difference for which a deferred tax asset is recognised [ASC 805-740-25-9; IAS 12.21A-B].

In a nontaxable transaction where the historical tax bases of the acquired business carry over to the acquirer, there may be tax-deductible goodwill from prior acquisitions of the acquiree that carries over in the current acquisition. In this instance, a question arises as to how to treat the carryover tax-deductible goodwill in determining deferred taxes. In general, we believe that the carryover tax-deductible goodwill should be compared to the book goodwill arising in the current transaction for purposes of determining whether a recognisable temporary difference exists. See BCG 5.7.2 for further information on the recognition of a deferred tax asset for excess tax-deductible goodwill.

In analysing component-1 and component-2 goodwill, the expected impact on tax-deductible goodwill of contingent consideration and contingent liabilities should be considered. See BCG 5.4.4 for further information on the relationship between the comparison of book goodwill to tax-deductible goodwill and contingent liabilities or contingent consideration. See BCG 5.4.6 for further information on the treatment of acquisition-related costs and the comparison of book goodwill to tax-deductible goodwill.

5.7.2 Recognition of a deferred tax asset for excess tax-deductible goodwill

The Standards prescribe the recognition of a deferred tax benefit resulting from tax-deductible goodwill that is in excess of book goodwill. The tax benefit of the excess tax goodwill is recognised as a deferred tax asset at the acquisition date, which increases the values assigned to the acquired net assets and correspondingly decreases book goodwill. This, however, further increases (1) the difference between book goodwill and tax-deductible goodwill and (2) the corresponding deferred tax balance [ASC 805-740-55-9 through 55-13; IAS 12.32A]. To deal with this iterative process, the computation of the deferred tax asset can be reduced to the following equation:

(Tax rate / (1 – tax rate)) x preliminary temporary difference (PTD) = DTA

The resulting amount of deferred tax asset reduces book goodwill. If book goodwill is reduced to zero, any additional amounts recognised will result in a bargain purchase gain. Example 5-15 provides an example of the iterative calculation.

EXAMPLE 5-15

Recording a deferred tax asset for excess tax-deductible goodwill, no bargain purchase gain

A taxable acquisition results in initial book goodwill of CU450 million. A separate determination for taxes results in tax-deductible goodwill of CU600 million. The gross PTD between book and tax goodwill is CU150 million. Assume an applicable tax rate of 40%.

Analysis

The deferred tax asset for the excess tax-deductible goodwill is (CUs in millions):

(40% / (1 – 40%)) x CU150 = DTA of CU100

The acquirer would record a deferred tax asset for CU100 million with a corresponding decrease in book goodwill. Therefore, final goodwill for financial reporting purposes would be CU350 million, and a deferred tax asset of CU100 million would be established. The resulting deferred tax asset appropriately reflects the temporary difference related to goodwill, as illustrated below:

(Tax goodwill – book goodwill) x 40% = DTA
(CU600 – CU350) x 40% = CU100

Example 5-16 illustrates a situation where the formula used to determine the deferred tax asset related to excess tax-deductible goodwill requires modification.

EXAMPLE 5-16

Recording a deferred tax asset for excess tax-deductible goodwill with bargain purchase gain

A taxable acquisition results in initial book goodwill of CU200 million. A separate determination for taxes results in tax-deductible goodwill of CU600 million. The gross PTD between book and tax goodwill is CU400 million. Assume an applicable tax rate of 40%.

Analysis

When the initial calculation of the DTA related to goodwill exceeds the amount of book goodwill, the total DTA to be recognised will be equal to the tax effect of tax-deductible goodwill (i.e., tax-deductible goodwill less book goodwill of zero). Therefore, the company will record a DTA of CU240 million (i.e., CU600 million tax goodwill less CU0 book goodwill x 40%). A portion of the DTA recognised in acquisition accounting will reduce initial book goodwill to zero. The remaining amount of the DTA is recorded as a bargain purchase gain. The following demonstrates the recognition of a DTA for excess tax-deductible goodwill with a bargain purchase gain based upon the facts described above.

The initial calculation of the deferred tax asset for excess tax-deductible goodwill is (CUs in millions):

(40% / (1 – 40%)) x CU400 = DTA of CU267

However, the DTA is in excess of book goodwill. Recording a DTA of CU267 million would result in a complete elimination of the book goodwill and a tax benefit of CU67 million. In that case, the DTA would not appropriately reflect the temporary difference related to goodwill, as illustrated below:

(Tax goodwill – book goodwill) x 40% = DTA
(CU600 – CU0) x 40% = CU240, which does not equal the CU267 DTA as previously calculated

The following formula can be used to determine the amount of PTD required to eliminate all book goodwill:

(40% / (1 – 40%)) x PTD = CU200 (book goodwill)
Solving for PTD = CU300

A deferred tax asset is recorded and goodwill is adjusted to the extent of the calculated limit of PTD, calculated as follows:

(40% / (1 – 40%)) x CU300 = CU200[1]

[1] Recorded as a DTA and as an adjustment to goodwill.

The remaining amount of deferred tax asset is recorded as a bargain purchase gain. The following formula can be used to determine the amount of the gain:

(PTD original result – PTD revised limit) x 40% = gain
(CU400 – CU300) x 40% = CU40[2]

[2] Recorded as a DTA and as a bargain purchase gain.

The following entry would be recorded (in millions):

DTA	CU240	
Goodwill		CU200
Bargain purchase gain		CU40

The resulting deferred tax asset appropriately reflects the temporary difference related to goodwill, as illustrated below:

(Tax goodwill – book goodwill) x 40% = DTA
(CU600 – CU0) x 40% = CU240

Measurement period adjustments are recorded retrospectively and, therefore, may affect goodwill [ASC 805-10-25-17; IFRS 3.49]. If, after the measurement period adjustments, tax-deductible goodwill exceeds book goodwill, the associated deferred tax asset should be recorded or adjusted. This adjustment will be recorded against goodwill.

5.7.3 Situations in which the iterative formula may not apply

Use of the equation described in BCG 5.7.2 is not appropriate in every situation. Complexities may arise that require modification of the formula and, in some cases, preclude its use altogether. These complexities may include either of the following situations:

- The formula uses a single statutory tax rate. However, there may be situations where the temporary differences arising in the acquisition would be tax-effected at different rates (i.e., where there are different rates in a carryback period or a rate change has been enacted for future years, or where the temporary differences give rise to more than one type of taxable income). In these situations, successive calculations may be required to determine the deferred tax asset.

- To the extent that a valuation allowance is required (U.S. GAAP) or the deferred tax assets are not recognised (IFRS) for all or part of the tax-deductible temporary differences, there may be no or only a partial iterative effect on goodwill. Again, successive calculations may be required to determine the deferred tax asset.

5.7.4 *Excess of book goodwill over tax-deductible goodwill*

When there is an excess of book over tax goodwill, as of the acquisition date, no deferred tax liability is recorded for the excess book goodwill. Establishing a deferred tax liability would increase further the amount of goodwill, as it would decrease the value of the net assets acquired. This would, in turn, require an increase in the deferred tax liability, which would again increase goodwill, etc. As a consequence, this approach is not followed, as it would result in the grossing up of goodwill and the deferred tax liability. Implicit in this treatment of goodwill is an assumption that its carrying amount will be recovered on an after-tax basis.

5.7.5 *Business combinations in multiple jurisdictions*

Business combinations may involve multiple jurisdictions. Tax-deductible goodwill in each jurisdiction will need to be compared to book goodwill allocated to each jurisdiction to determine the related temporary differences. ASC 740-10-30-5 and IAS 12.15 require that deferred taxes, including goodwill, be determined separately for each tax-paying component in each jurisdiction.

Example 5-17 illustrates this guidance.

Example 5-17

Comparison of book goodwill to tax-deductible goodwill involving multiple jurisdictions

Company A buys Subsidiary B in a nontaxable business combination. Subsidiary B has operations in the U.S. and Germany. As a result of the transaction, Company A recorded a total amount of CU600 book goodwill. CU500 of that total amount is associated with U.S. operations, while the remaining CU100 is associated with German operations. Carryover tax-deductible goodwill acquired in the transaction totals CU500; CU200 is associated with legal entities in the U.S., and CU300 is associated with legal entities in Germany.

Analysis

The comparison of book to tax-deductible goodwill at a jurisdictional level yields the following results:

	U.S. goodwill			German goodwill	
	Book	**Tax**		**Book**	**Tax**
Component-1	CU200	CU200	**Component-1**	CU100	CU100
Component-2	300	—	**Component-2**	—	200
Total goodwill	CU500	CU200	**Total goodwill**	CU100	CU300

At the acquisition date, the acquirer would not record a DTL for goodwill associated with the U.S. jurisdiction because book goodwill exceeds the tax-deductible goodwill. However, for goodwill associated with the German jurisdiction, the acquirer would record a DTA in acquisition accounting because tax-deductible goodwill exceeds book goodwill.

For the calculation and recognition of the deferred tax asset, the same methodology as illustrated in Example 5-16 should be applied.

5.7.6 Recognition of deferred tax liabilities related to tax-deductible goodwill subsequent to the acquisition date

Accounting for deferred taxes related to tax-deductible goodwill in periods subsequent to the acquisition is described differently under U.S. GAAP and IFRS, but the concepts are similar.

From a U.S. GAAP perspective, component-2 goodwill may result from an excess of book goodwill over tax-deductible goodwill. However, changes in the temporary difference for the component-2 book goodwill are disregarded. Deferred taxes are provided only for differences arising between the book and tax basis of component-1 goodwill (e.g., due to amortisation for tax purposes or impairment for book purposes) [ASC 805-740-25-9]. When component-2 goodwill in an excess of tax-deductible goodwill over book goodwill, changes in the entire temporary difference (i.e., component-1 and component-2) are recorded. For example, amortisation of component-2 tax-deductible goodwill will reduce the corresponding deferred tax asset until the tax basis is equal to the book basis, and create a deferred tax liability for the basis difference created by tax amortisation thereafter. See BCG 11.5 for further information on goodwill impairments.

Under IFRS, no deferred tax liability is recognised for the initial recording of book goodwill in excess of tax-deductible goodwill, nor for subsequent changes in that unrecognised taxable temporary difference. For example, a goodwill **impairment loss** may reduce the taxable temporary difference related to the initial recognition of goodwill, but no deferred tax would be recorded for the decrease in the unrecognised deferred tax liability attributable to component-2 goodwill that is an excess of book over tax goodwill. However, deferred taxes would be recorded for the portion of the impairment loss attributable to component-1 goodwill. Additionally, consistent with U.S. GAAP, other temporary differences that arise subsequent to the initial recognition of goodwill, for example, the amortisation for tax purposes of tax-deductible goodwill, should be recognised [IAS 12.21A-B].

5.7.7 Deferred tax liabilities related to tax-deductible goodwill and indefinite-lived intangible assets—source of taxable income

Under U.S. GAAP and IFRS, a deferred tax liability related to goodwill may be created in periods subsequent to an acquisition, as described in BCG 5.7.6. Deferred tax liabilities related to an asset with an **indefinite useful life** (goodwill and indefinite-lived intangible assets) in jurisdictions where there is a finite loss carryforward period will ordinarily not serve as a source of income for the realisation of deferred tax assets, because the deferred tax liability will not reverse until some indefinite future period when the asset is sold or written down due to impairment. Therefore, a company may need to record a full valuation allowance on its deferred tax assets (ASC 740) or not recognise the deferred tax assets (IAS 12) and report a net deferred tax liability. In situations where there are indefinite carryforward periods, these deferred tax liabilities would generally be considered to be a source of taxable income. This should be evaluated on a facts and circumstances basis.

5.7.8 Disposal of goodwill

In many jurisdictions, goodwill is associated with the shares of a specific legal entity, whereas for book purposes goodwill is associated with a reporting unit [cash generating unit (CGU) or group of CGUs]. The reporting unit or CGU may include several legal entities or be limited to a portion of a legal entity. This can result in differences between the book and tax accounting for goodwill upon the disposal of a business. If the disposed business is a legal entity, any tax-deductible goodwill associated with that entity would be included in the determination of the taxable gain or loss. If the disposed operations are a business, ASC 350-20-35-52 and IAS 36.86 require the allocation of a reporting unit's [CGU's] goodwill to (1) the business [operation] that was disposed of and (2) the remaining parts of the reporting unit [CGU], based on their relative fair values on the date of disposal. [In some rare circumstances, IFRS will permit another method of allocating the goodwill if such method better reflects the goodwill of the operation disposed of]. Once goodwill is characterised as component-1 or component-2, it retains this characterisation as long as a reporting entity retains that goodwill. Therefore, upon disposal of a business that includes some or all of a reporting entity's goodwill, a deferred tax adjustment would generally be required for disposal of component-1 but not for disposal of component-2 goodwill. Examples 5-18 and 5-19 illustrate the disposal of a business, including a portion of component-1 goodwill, resulting in a deferred tax adjustment to the reporting entity. Example 5-20 illustrates the disposal of a business, including a portion of component-2 goodwill, resulting in no deferred tax adjustment to the reporting entity.

EXAMPLE 5-18

Disposal of tax-deductible goodwill with retention of book goodwill

Entity A acquired Entity B in a taxable business combination (i.e., Entity A treated the purchase as an asset acquisition for tax purposes), which gave rise to book and tax-deductible goodwill in equal amounts of CU100. The business of Entity B and the associated goodwill are fully integrated into one of Entity A's reporting units [CGUs]. In a later period, Entity A decides to dispose of the shares of Entity B, including Entity B's operations. For tax purposes, the entire remaining tax-deductible goodwill of CU70 (CU100 initial basis less assumed tax amortisation of CU30) is included in the disposal. For book purposes, goodwill of CU20 is allocated on a relative fair value basis to the disposed operation. As a result, CU80 of the book goodwill is retained by the surviving reporting unit [CGU] within Entity A (CU100 initial value less CU20 included in the disposed operation).

Analysis

The disposal will result in a basis difference in the goodwill retained by Entity A, with book goodwill exceeding tax-deductible goodwill by CU80. This gives rise to a deferred tax liability for the entire CU80 taxable basis difference (i.e., Entity A compares nil tax-deductible goodwill to book goodwill of CU80).

EXAMPLE 5-19

Disposal of book goodwill with retention of tax-deductible goodwill

Entity A from the above example instead disposes of a significant portion of its operations but not its shares in Entity B. For tax purposes, the goodwill associated with the shares of Entity B would remain with Entity A. For book purposes, CU80 of goodwill is allocated to the disposed operations on a relative fair value basis and included in the determination of the disposal gain or loss. Book goodwill of CU20 remains in the reporting unit [CGU].

Analysis

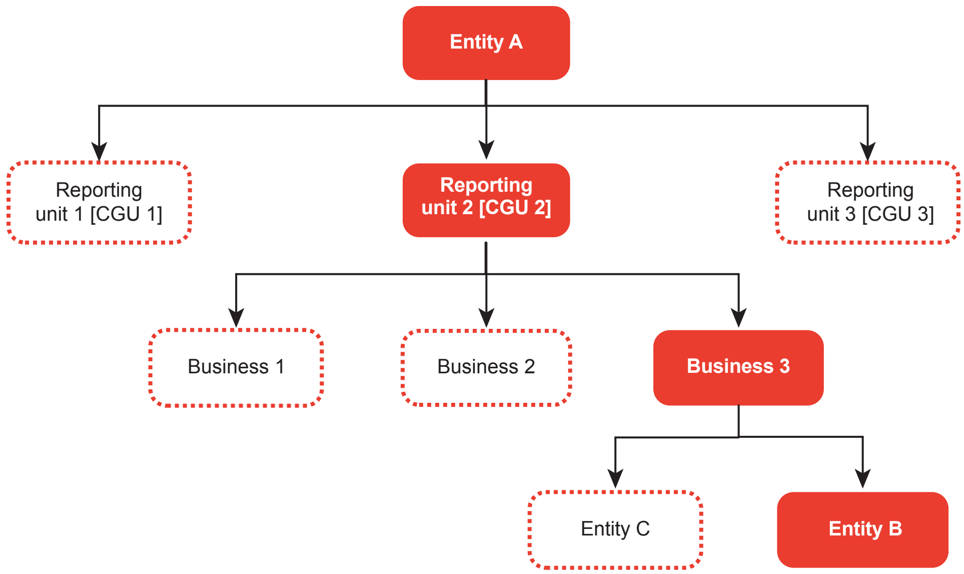
The disposal of component-1 goodwill will result in a basis difference in goodwill retained by Entity A, consisting of the remaining tax goodwill (CU70) exceeding book goodwill (CU20) by CU50, which will give rise to a deferred tax asset (subject to the measurement criteria of ASC 740 and IAS 12).

EXAMPLE 5-20

Evaluating deferred tax assets for temporary differences on component-2 goodwill after disposition of the entity that generated the goodwill

Entity A acquired Entity B in a nontaxable business combination. For tax purposes, the transaction resulted in a carryover basis in Entity B's assets and liabilities. Because the tax basis carried over and Entity B's assets for tax purposes did not contain any tax-deductible goodwill, all of the goodwill recorded in purchase accounting was component-2 book goodwill. See BCG 5.7 for information on recording deferred taxes related to goodwill. Entity B was subsequently integrated into Reporting Unit 2 [CGU 2], and as a result, Entity B's goodwill was combined with the rest of Reporting Unit 2's [CGU 2's] goodwill.

Entity A's structure is as follows:



In the current year, Entity A sold Business 3, which includes Entity B. The goodwill in Reporting Unit 2 [CGU 2] was allocated to Business 3, based on the relative fair value of Business 3 and the retained operations of Reporting Unit 2 [CGU 2], pursuant to ASC 350-20-35-53 and IAS 36.86. This resulted in only a small amount of book goodwill being allocated to Business 3. Entity A had a significantly larger tax basis in Business 3, in large part due to Entity A's acquisition cost for Entity B's shares. The difference between the book and tax goodwill included in the measurement of the book and tax gain or loss produces a small gain for book purposes and a significant loss for tax purposes. The current tax benefit from the transaction has a disproportionate impact on the current-year effective tax rate.

Analysis

No deferred tax liability should be recognised in this instance. If for book purposes there is goodwill with no tax basis, a deferred tax liability would not be recorded, pursuant to ASC 740-10-25-3(d) and IAS 12.15(a). On the date Entity A acquired Entity B, the entire amount of book goodwill was classified as component-2 goodwill as there was no tax goodwill in the transaction, and no deferred tax liability was recorded. The fact that only a portion of that goodwill was subsequently attributed to Entity B when it was disposed of does not change that characterisation. Thus, the goodwill remaining in Reporting Unit 2 [CGU 2] after the sale of Entity B continues to be component-2 goodwill for which no deferred tax liability would be recorded.

5.7.9 Bargain purchase

Bargain purchase refers to a situation where the fair value of the net assets acquired exceeds the fair value of consideration transferred. Such excess is sometimes referred to as "negative goodwill." In these situations, the acquirer must reassess whether it has correctly identified all of the assets acquired and liabilities assumed and review the procedures used to measure the components of the acquisition to ensure all available evidence as of the acquisition date has been considered. The aggregate amount of fair value assigned to the acquired net assets may, after this review, still exceed the acquisition consideration and result in a bargain purchase gain [ASC 805-30-25-2; IFRS 3.34,36].

The tax rules for each separate jurisdiction may require a different treatment for bargain purchases than that required under the Standards. Tax rules often require the allocation of negative goodwill to certain assets through the use of the residual method, resulting in decreased tax bases. In the United States, for example, for tax purposes, the acquisition price is assigned to assets categorised in seven distinct asset classes, first to the assets in Class I and then successively through to Class VII. The consideration transferred is not allocated to a successive class until it has been allocated to the assets in the previous class based on their full fair values. This methodology can result in several classes of assets without tax bases and in temporary differences for a significant portion of all assets. The allocation of negative goodwill to reduce the tax bases of acquired net assets causes the book bases to exceed their respective tax bases, resulting in the recognition of deferred tax liabilities. The recognition of deferred tax liabilities then results in a reduction in the bargain purchase gain for financial reporting, and may result in the recognition of goodwill. Example 5-21 illustrates the recording of deferred tax balances in a bargain purchase situation.

EXAMPLE 5-21

Recording deferred tax balances in a bargain purchase (U.S. tax jurisdiction)

Company A acquires Company B in a taxable acquisition. Total acquisition consideration amounted to CU230 million, and the acquired fair value of the net assets equal CU290 million, which results in the following allocation (in millions). Assume an applicable tax rate of 40%.

Analysis

	Fair value	Tax basis
Class I – cash	CU50	CU50
Class II – CDs	10	10
Class III – accounts receivable	60	60
Class IV – inventory	80	80
Class V – tangible property	50	30
Class VI – intangibles	40	0
Class VII – goodwill	0	0
	CU290	CU230

Further, assuming tangible property consists of three pieces of equipment, their new tax bases would be determined as follows (in millions):

Equipment A	CU10	CU6
Equipment B	15	9
Equipment C	25	15
	CU50	CU30

For financial statement purposes, this transaction is a bargain purchase. Therefore, the assets are recorded at their fair value determined under the Standards, and the bargain element of the transaction is recorded in earnings [profit or loss] [ASC 805-30-25-2; IFRS 3.34]. The differences between the book and tax bases of the net assets acquired result in the recognition of deferred tax liabilities of CU24 million ((CU290 – CU230) x 40% tax rate). Therefore, the total amount of net assets recorded in acquisition accounting is CU266 million (CU290 – CU24). The bargain purchase gain would be calculated as follows (in millions):

Fair value of net assets acquired	CU266
Less: consideration transferred	(230)
Bargain purchase gain	CU36[1]

[1] The bargain purchase gain is reflected in earnings [profit or loss] in a single line in pretax income from continuing operations.

5.8 Recording the tax effects of transactions with noncontrolling shareholders

Once a parent controls a subsidiary, changes can occur in the ownership interests in that subsidiary that do not result in a loss of control by the parent. If changes occurring in a parent's ownership interest after control is obtained do not result in a change in control of the subsidiary, those changes should be accounted for as equity transactions [ASC 810-10-45-23; IAS 27R.30].

A **noncontrolling interest** (NCI) is the portion of equity (net assets) in a subsidiary not attributable, directly or indirectly, to the parent. In a transaction that results in a change in the parent's ownership interest while the parent retains its controlling financial interest, the carrying amount of the NCI is adjusted to reflect the change in its ownership interest in the subsidiary's net assets. Any difference between the fair value of the consideration received or paid and the amount by which the NCI is adjusted is recognised in equity attributable to the parent [ASC 810-10-45-23; IFRS 10.B96].

The parent's ownership interest in a subsidiary may change as a result of a variety of transactions while the parent retains its controlling financial interest. For example, a parent may purchase some of the subsidiary's shares or sell some of the shares that it holds, a subsidiary may reacquire some of its own shares, or a subsidiary may issue additional shares. See BCG 6 for further information on the accounting for transactions with noncontrolling shareholders.

The direct tax effect of a transaction with noncontrolling shareholders that does not cause a change in control generally is recorded in equity [ASC 740-20-45-11(c); IAS 12.61]. However, care should be taken to distinguish between direct and indirect tax effects, because the treatment in the financial statements may differ for each, and sometimes the tax effect of a transaction comprises both direct and indirect components. For purposes of this section of the Guide, direct effects are those resulting from application of the relevant tax law to the transaction. Direct effects do not include those resulting from a change in an accounting assertion, election, or assessment, even though such a change may have been undertaken by the reporting entity in contemplation of the transaction. The remainder of this section discusses the accounting for direct and indirect tax effects of transactions with noncontrolling shareholders.

5.8.1 Direct tax impact of a transaction with noncontrolling shareholders

The direct tax effect, net of any related valuation allowance (U.S. GAAP) of a transaction with noncontrolling shareholders that does not cause a change in control, is generally recorded in equity [ASC 740-20-45-11(c); IAS 12.61]. Subsequent release of the related valuation allowance [initial recognition of the tax benefit] would also be recorded in equity. Example 5-22 illustrates the recording of a direct tax effect of a transaction with noncontrolling shareholders.

EXAMPLE 5-22

Recording the direct tax effect of a transaction with noncontrolling shareholders

Parent owns 100 percent of Company B, which has net assets of CU200 million. Parent's tax basis in its investment in Company B is CU200 million (equal to the book basis). Company B issues additional shares to Company C, an unaffiliated third party, for cash of CU80 million. The issuance of the additional shares dilutes Parent's interest to 80 percent. After issuance of the additional shares, the ownership interests in the net assets of Company B are as follows (CUs in millions). Assume an applicable tax rate of 40%.

Analysis

	Total net assets	Ownership interest	Net assets attributable
Parent - consolidated	CU280[1]	80%	CU224
Company C	CU280	20%	CU56
		100%	CU280

[1] CU200 + CU80 proceeds = CU280.

The transaction would result in the following impact in the consolidated financial statements, before consideration of income taxes (in millions):

Cash	CU80	
NCI		CU56
Equity		CU24

Assume the transaction is not a current taxable event to Parent. The transaction caused a CU24 million increase in the book basis of Parent's investment in Company B, but no change in the tax basis, thus creating a taxable temporary difference.

Unless Parent can establish its intent and ability to indefinitely delay reversal of the difference, Parent would record a deferred tax liability for the taxable temporary difference. Since the transaction is recorded directly in equity, the tax effect of the transaction, assuming a 40 percent tax rate, is also recorded directly in equity, as follows (in millions):

Equity	CU9.6[2]	
Deferred tax liability		CU9.6

[2] CU224 book basis – CU200 tax basis x 40% = CU9.6.

5.8.2 *Indirect tax impacts of a transaction with noncontrolling shareholders*

It is important to distinguish between direct and indirect tax effects because the treatment in the financial statements may differ for each. For example, the purchase by a parent company of an additional interest in a controlled subsidiary may allow the parent for the first time to file a consolidated tax return. The ability to file a consolidated tax return may allow the company to change its assessment regarding its ability to realise existing deferred tax assets, causing the company to release all or a portion of its valuation allowance [recognise previously unrecognised DTAs]. Even though a transaction with noncontrolling shareholders may have caused the change in circumstances that allows the parent to realise (or conclude it may not realise) its deferred tax assets in the future, the change in valuation allowance [initial recognition] results from a change in management's assessment regarding the realisation of deferred tax assets and is, therefore, an indirect effect of the transaction. The tax effect of a change in judgment about the realisation of deferred tax assets in future years generally is reflected in earnings [profit or loss], but it is subject to the intraperiod allocation requirements [ASC 740-20-45-8(a); IAS 12.58].

Some transactions may cause a direct and an indirect tax effect. Example 5-23 illustrates the recording of the direct and indirect tax effects of a transaction with noncontrolling shareholders.

EXAMPLE 5-23

Recording the tax effects of a transaction with noncontrolling shareholders

Parent owns and controls 100 percent of Company B, which is domiciled in a foreign jurisdiction. Parent's book basis and tax basis in its investment in Company B is CU300 million and CU200 million, respectively. The difference between the book basis and tax basis is attributable to the undistributed earnings of Company B. Parent has not historically recorded a deferred tax liability on the taxable temporary difference because of its intent and ability to indefinitely delay reversal of the difference. Parent sells 20% of Company B for CU250 million. The sale of Parent's investment is taxable at a rate of 40%.

Analysis

The transaction would result in the following impact in the consolidated financial statements, before consideration of income taxes (in millions):

Cash	CU250	
NCI		CU60[1]
Equity		CU190

[1] Book basis of CU300 x 20% = CU60.

Parent's current tax consequence from the tax gain on the sale of its investment in Company B is CU84 million ((CU250 selling price – (CU200 tax basis x 20% portion sold)) x 40% tax rate). The total tax consequence of CU84 million comprises two components:

1. CU8 million, which is the difference between the book basis and the tax basis (i.e., undistributed earnings of Company B) of the portion sold ((CU300 book basis – CU200 tax basis) x 20% portion sold x 40% tax rate). This component is an indirect tax effect of the transaction. The tax consequence results from a change in assertion regarding the indefinite delay of the reversal of the outside basis difference, which is triggered by the decision to sell a portion of the investment in Company B. The outside basis difference is attributable to

undistributed earnings of Company B, and the tax effect of the change in assertion related to the outside basis difference is recorded in earnings [profit or loss] [ASC 740-30-25-19; IAS 12.58].

2. CU76 million, which is the difference between the selling price and the book basis for the portion sold ((CU250 selling price – (CU300 book basis x 20% portion sold)) x 40% tax rate). This second component represents the economic gain on the sale and is a direct tax effect of the transaction. Because the difference between fair value and carrying amount of NCI is recorded in equity, the direct tax effect should also be recorded in equity.

The tax consequences are recorded as follows (in millions):

Income tax expense	CU8[2]	
Equity	CU76[3]	
Current tax payable		CU84[4]

[2] (CU300 book basis – CU200 tax basis) x 20% x 40% = CU8.

[3] (CU250 selling price – CU60 book basis) x 40% = CU76.

[4] (CU250 selling price – CU40 tax basis) x 40% = CU84.

The change in assertion related to the indefinite delay of the reversal of the outside basis difference will impact the effective tax rate in the period in which the change occurs.

Recording a tax related to unremitted earnings of the foreign subsidiary is a change in assertion regarding indefinite reinvestment and is generally recorded in continuing operations. In fact, the tax liability related to the unremitted earnings of the subsidiary may be required to be recorded in a period preceding the actual sale transaction, because the liability should be recorded when the company's assertion regarding indefinite reinvestment changes.

In light of the disposal of a portion of the Parent's investment in Company B, Parent should also reassess its intent and ability to indefinitely delay reversal of the remaining outside basis difference in the portion retained and assess whether a deferred tax liability should be recorded on such difference.

5.9 Other considerations

Other transactions requiring special considerations include asset acquisitions and transfering assets other than cash as part of the consideration transferred in a business combination.

5.9.1 Asset acquisitions and nonmonetary exchanges

The purchase of an asset or group of assets that does not meet the definition of a business is accounted for as an asset acquisition. Such assets may be acquired through a monetary or nonmonetary exchange transaction. Typically in a monetary exchange, the book and tax bases of the assets acquired are equal at the transaction date. Therefore, there is no deferred tax to recognise. Even if there is an acquired temporary difference (i.e., the book and tax bases differ at the transaction date) there would generally be no immediate income tax expense [ASC 740-10-25-51; IAS 12.22(c)]. For example, consider an asset acquired by purchasing the shares of an entity (not a business) in which the tax basis of the asset is lower than the price paid to acquire the shares and carries over to the acquirer. The resulting deferred tax liability is recognised under U.S. GAAP by increasing the recorded amount of the asset. This accounting increases the deferred tax liability, which further increases the asset. To address the iterative effect, the deferred tax liability can be determined by using a "simultaneous equations method" [ASC 740-10-25-51]. Under IFRS, no deferred tax liability would be recognised at the purchase date in an asset acquisition assuming the initial recognition exemption applies [IAS 12.15(b)].

Assets acquired through a nonmonetary exchange may result in a temporary difference, generally giving rise to a deferred tax liability due to differences in book and tax bases. For example, consider a transaction whereby the tax law provides for the acquirer's tax on the exchange transaction to be deferred and the acquirer's tax basis in the asset disposed carries over to be the tax basis of the asset received (e.g., a like-kind exchange or rollover relief). A deferred tax liability should be recorded because the basis difference does not arise from the acquired asset's initial recognition, but instead arises because of the deferral of the tax on the asset disposed. As a result, the tax effect flows through the income statement in the same period as the accounting gain.

Example 5-24 illustrates the income tax accounting for a tax-free exchange of nonmonetary assets.

EXAMPLE 5-24

Income tax accounting for a tax-free exchange of nonmonetary assets

Entity X acquires Asset B in exchange for Asset R. The fair value of Asset B is CU150. The carrying value of Asset R is CU100 and the tax basis is CU80, resulting in an existing deferred tax liability of CU8 (assuming a 40 percent tax rate). For tax purposes, the transaction is structured such that Entity X can defer the taxable gain on the exchange. The tax basis in Asset R of CU80 will become the tax basis in Asset B. Assume that the nonmonetary exchange has commercial substance, and is not an exchange transaction to facilitate sales to customers. Therefore, the exchange is measured at fair value.

Analysis

Entity X records a gain of CU50 on disposal of Asset R (based on the difference in the fair values of Asset B and Asset R) and a corresponding deferred tax liability of CU20 on the gain.

Entity X records the following entries on the transaction date:

Asset B	CU150	
Income tax expense	CU20[1]	
Asset R		CU100
Gain on sale		CU50
Deferred tax liability		CU20

[1] Gain on sale of CU50 x 40% = CU20.

The total deferred tax liability related to Asset B is CU28 ((CU150 book basis – CU80 tax basis) x 40% = CU28). The above entry increases the deferred tax liability from CU8 to CU28.

See BCG 9 for further information on the accounting for asset acquisitions that are not business combinations.

5.9.2 *Exchanges of assets between companies—U.S. GAAP*

An acquirer may transfer assets other than cash as part of the consideration transferred in a business combination. The difference between the fair value and the carrying value of the transferred asset is recognised as a gain or loss in earnings unless the assets remain in the combined group [ASC 805-30-30-8]. See BCG 2.6.3.2 for further information on the accounting for consideration transferred that includes other assets and liabilities of the acquirer. The tax consequences to the acquirer from transferring assets as part of consideration paid are recorded in the acquirer's financial statements outside of acquisition accounting. However, sometimes the transfer is tax-free, in which case no income tax effect is recorded. Example 5-25 illustrates the income tax accounting for a tax-free transfer of an equity interest in exchange for control of a subsidiary.

EXAMPLE 5-25

Income tax accounting for a tax-free transfer of an equity interest in exchange for control of a subsidiary

Entity X owns 15 percent of Entity Y, which is a private enterprise. Entity X appropriately accounts for its investment by using the cost method. The two companies enter into an agreement whereby Entity Y exchanges a wholly owned subsidiary (Sub S) in return for Entity X's 15 percent ownership interest in Entity Y.

Both the carrying value and the tax basis of Entity X's investment in Entity Y is CU300. The fair value is CU1,000. The fair value of Sub S is less than the fair value of the Entity Y shares held by Entity X. Therefore, Entity Y infuses cash into Sub S just prior to the exchange to equalise the value. After the cash infusion, the fair value of Sub S is CU1,000. The fair value of Sub S's identifiable assets and liabilities is CU700. The tax bases of the assets and liabilities are equal to CU500.

The exchange of Entity X's investment in Entity Y for Entity Y's investment in Sub S is tax-free. Entity X's tax basis in its investment in Entity Y (CU300) will become Entity X's tax basis in its investment in Sub S. Assume that there is no uncertainty relative to the tax-free nature of the transaction.

After the transaction, Entity X will have the intent and ability to recover its investment in Sub S in a tax-free liquidation; therefore will not record a deferred tax liability for any resulting book-over-tax outside basis difference in its investment in Sub S. Entity X's tax rate is 40 percent.

Analysis

Entity X recorded the following entries in acquisition accounting:

Net assets	CU700[1]	
Goodwill	CU380[2]	
Deferred tax liability		CU80[3]
Gain on investment		CU700[4]
Investment in entity Y		CU300[5]

[1] Fair value of the identifiable assets and liabilities of Sub S.

[2] Goodwill is calculated as the residual after recording the identifiable net assets acquired and associated deferred tax assets and liabilities (CU1,000 – (CU700 – CU80)).

[3] The deferred tax liability is calculated as the difference between the book bases of the identifiable net assets acquired and the carryover tax bases at the applicable tax rate ((CU700 – CU500) x 40%).

[4] The gain on investment is the difference between the fair value and the carrying value of Entity X's investment in Entity Y (CU1,000 – CU300).

[5] Carrying value of Entity X's investment in Entity Y.

There is no tax consequence from exchanging Entity X's investment in Entity Y for Entity Y's investment in Sub S. Therefore, the gain from transferring the investment in Entity Y will impact Entity X's effective tax rate.

Chapter 6: Partial acquisitions, step acquisitions, and accounting for changes in the noncontrolling interest

6.1 Chapter overview

A **noncontrolling interest (NCI)** is the **equity interest** in a **subsidiary** that is not attributable, directly or indirectly, to a **parent**. This chapter discusses the accounting associated with **partial acquisitions, step acquisitions**, and changes in a company's NCI pursuant to ASC 810-10 and IFRS 10. NCI valuation considerations are discussed in BCG 7. Discussion of transition issues, disclosures, and presentation of the NCI Standards is found in FSP 5.

The accounting for partial acquisitions and step acquisitions is generally the same under U.S. GAAP and IFRS, although there are some differences. The primary difference relates to the initial measurement of the NCI. Companies that follow IFRS can choose to measure NCI at **fair value** (the **fair value method**) or at the proportionate share of the **acquiree's identifiable** net assets at the **acquisition date** (the **proportionate share method**). U.S. GAAP companies are required to recognise any new NCI at fair value at the acquisition date. Thus, the initial measurement for the noncontrolling interest will differ between IFRS companies that choose the proportionate share method and U.S. GAAP companies.

The examples provided in this chapter assume a simple equity structure (i.e., one class of common shares). Other issues may arise if a subsidiary has a complex equity structure.

The IASB issued IFRS 10, *Consolidated Financial Statements* (IFRS 10), IFRS 11, *Joint Arrangements* (IFRS 11), and IFRS 12, *Disclosures of Interests in Other Entities* (IFRS 12) in May 2011. IFRS 10, 11, and 12 include the presentation and disclosure requirements for interests in a subsidiary, joint arrangement, an associate, or a structured entity. IFRS 10, 11, and 12 are effective for annual periods beginning on or after 1 January 2013, although earlier application was permitted. This chapter of the Guide reflects the guidance of IFRS 10, 11, and 12.

The key takeaways from this chapter are:

- **Noncontrolling interest is classified as equity.** Noncontrolling interest is the equity interest in a subsidiary that is not attributable, directly or indirectly, to a parent. Noncontrolling interest is reported as part of equity in the consolidated financial statements and is presented separately from the controlling interest's equity.

- **Initial measurement of the noncontrolling interest may be different for U.S. GAAP companies and IFRS companies.** In a business combination, U.S. GAAP companies measure any new noncontrolling interest at fair value at the acquisition date. IFRS companies, on the other hand, may measure the noncontrolling interest at either its fair value (fair value method) or at the proportionate share of the acquiree's identifiable net assets at the acquisition date (proportionate share method). The difference between the two methods is that goodwill is not recognised for the noncontrolling interest under the proportionate share method. IFRS companies may choose between the two methods on a transaction-by-transaction basis.

- **All U.S. GAAP companies and the IFRS companies that elect the fair value method for valuing the noncontrolling interest recognise 100 percent of the goodwill and identifiable net assets in a partial acquisition.** Acquisitions of a controlling interest in less than 100 percent of a business result in the recognition of 100 percent of the goodwill and 100 percent of the identifiable assets and liabilities of the partially acquired business.

- **Gains or losses may be recognised in the income statement when control is obtained or lost.** Under U.S. GAAP, any equity interest that is currently held and is the result of a previous transaction is remeasured at fair value and any resulting gain or loss is recognised in the income statement when an acquirer gains control. Under U.S. GAAP, any gain or loss on the interest sold and on any retained noncontrolling investment (remeasured at fair value) is recognised in the income statement when an acquirer loses control. Under IFRS, these same principles apply, except for the option to designate equity securities not for trading on initial recognition. This option allows an entity to make an initial irrevocable election to present subsequent changes in the fair value of the equity interest in other comprehensive income.

- **Changes in ownership interest are treated as equity transactions, if control is maintained.** Additional acquisitions of ownership interests after control is obtained and disposals of an ownership interest that do not result in a company losing control are treated as equity transactions.

- **Net income or loss and comprehensive income or loss are attributed to the controlling and noncontrolling interests.** U.S. GAAP and IFRS do not prescribe a method for attributing net income or loss and other comprehensive income or loss between the controlling interest and the noncontrolling interest. The attribution of earnings specified by contractual arrangements should be considered if the arrangements are substantive. If there are no such contractual arrangements, the relative ownership interests in the entity should generally be used.

- **Losses are allocated to the noncontrolling interest regardless of the balance in the noncontrolling interest.** This could result in the noncontrolling interest having a deficit balance, even though the noncontrolling interest has no obligation or commitment to fund the losses.

6.2 Definition and classification of the noncontrolling interest

Noncontrolling interest is the equity (net assets) in a subsidiary not attributable, directly or indirectly, to a parent [ASC 810-10-20; IFRS 10.A]. The noncontrolling interest is (1) reported as part of equity of the **consolidated group**, (2) recorded separately from the parent's interests, and (3) clearly identified and labelled (e.g., noncontrolling interest in subsidiaries) to distinguish it from other components of the parent's equity. A company with a noncontrolling interest in more than one subsidiary may aggregate its various noncontrolling interests in the **consolidated financial statements** [ASC 810-10-45-16; IFRS 10.22].

Financial instruments, which may be either freestanding or embedded, can be treated as a noncontrolling interest in the consolidated financial statements if issued by a subsidiary and classified as equity for financial reporting purposes in both the parent's consolidated financial statements and subsidiary's financial statements [ASC 810; IFRS 10, IAS 32]. The parent may, in some circumstances, issue financial instruments on behalf of a subsidiary. If such financial instruments qualify for equity classification in both the parent's consolidated financial statements and subsidiary's financial statements they should, similar to an equity-classified financial instrument issued by a subsidiary, be treated as noncontrolling interest in the consolidated financial statements. Guidance under U.S. GAAP also clarifies that a financial instrument issued by a parent or a subsidiary for which the payoff to the counterparty is based, in whole or in part, on the shares of a consolidated subsidiary, that is considered indexed to the entity's own shares in the consolidated financial statements of the parent, is also treated as a noncontrolling interest [ASC 815-40-15-5C].

A financial instrument that a subsidiary classifies as a liability is not a noncontrolling interest in the consolidated financial statements. For example, a subsidiary's mandatorily redeemable financial instruments that are classified as liabilities under ASC 480 or IAS 32 are not considered a noncontrolling interest because they are not ownership interests [ASC 810-10-45-17]. Also, financial instruments classified as liabilities in the parent's consolidated financial statements under IAS 32 are not considered a noncontrolling interest, even if classified as equity in the subsidiary's financial statements. The guidance in ASC 480 or IAS 32 is used to determine the classification of a financial instrument as a liability or equity [ASC 810-10-45-17].

Further, U.S. GAAP companies with redeemable securities that are subject to the guidance in ASC 480 must apply that guidance in determining the classification and measurement of those securities (see BCG 2.6.5.1). This includes presenting redeemable securities outside of permanent equity and accreting the reported amount of those securities to their redemption value. Financial instruments issued by a subsidiary and classified as mezzanine equity in the subsidiary's financial statements are classified as mezzanine equity in the consolidated financial statements and are generally considered a noncontrolling interest.

See BCG 6.12 for further information on the classification of a financial instrument as a noncontrolling interest.

6.2.1 Measurement of the noncontrolling interest—fair value method

The NCI is recognised and measured at fair value on the acquisition date by the **acquirer** for all U.S. GAAP companies, and IFRS companies that choose the fair value method of measuring the NCI [ASC 805-20-30-1; IFRS 3.19]. The NCI is not remeasured in subsequent periods. However, the NCI will be allocated its share of net income or loss and its respective share of each component of other comprehensive income [ASC 810-10-45-20; IFRS 10.B94].

6.2.2 *Measurement of the noncontrolling interest—proportionate share method—IFRS*

IFRS companies have the option of measuring the NCI at fair value or at its proportionate share of the recognised amount of the acquiree's identifiable net assets at the acquisition date, as measured in accordance with the Standards [IFRS 3.19]. This accounting can be elected on a transaction-by-transaction basis and does not require an IFRS company to make an accounting policy choice. The NCI is not remeasured in subsequent periods. The NCI will be allocated its share of profit or loss and its share of each component of other comprehensive income in subsequent periods [IFRS 10.B94].

The option of measuring noncontrolling interest under the proportionate share method applies only to components of noncontrolling interests that are present ownership instruments and entitle their holders to a proportionate share of the entity's net assets in the event of liquidation. Other noncontrolling interests should be measured at fair value unless another measurement basis is required by IFRS. Preference shares, employee share options, and the equity element of convertible debt are examples of instruments measured at other than fair value under IFRS.

Example 6-1 demonstrates the application of the proportionate share method and measurement of other noncontrolling interest.

EXAMPLE 6-1

Measurement of noncontrolling interest including preference shares-IFRS

Company B has issued 1,000 common shares and 100 preference shares (nominal value of CU1 per preference share). The preference shares are appropriately classified within equity. The preference shares give their holders a right to a preferential dividend in priority to the payment of any dividend to the holders of common shares. Upon liquidation of Company B, the holders of the preference shares are entitled to receive CU1 per share in priority to the holders of the common shares. The holders of the preference shares do not have any further rights on liquidation.

Company A acquires 800 common shares of Company B, resulting in Company A controlling Company B. The acquisition date fair value of a preference share is CU1.2 per share.

Analysis

Company A can choose to measure the noncontrolling interests that relate to the 200 common shares either at fair value or at the proportionate share of Company B's identifiable net assets.

The noncontrolling interest that relates to Company B's preference shares should be measured at fair value. The preference shares do not entitle their holders to a proportionate share of Company B's net assets in the event of liquidation. Company A must measure the preference shares at their acquisition date fair value of CU120 (100 preference shares x CU1.2 per share).

IFRS companies that choose the proportionate share method typically record the NCI at an initial value that is lower than the value that would be used under the fair value method. Therefore, subsequent purchases of the NCI for these companies may result in a larger percentage reduction of the controlling interest's equity on the subsequent acquisition date. This is demonstrated in Examples 6-9 through 6-16 in BCG 6.5.

6.3 Accounting for changes in ownership interest

A partial acquisition occurs when a company obtains control of a **business** through the acquisition of less than 100 percent of the equity interests of an entity. Step acquisitions occur when a company acquires blocks of equity interests in a business over a period of time in a series of transactions through which the company eventually obtains control of the business.

When a company obtains additional interests in a business, or sells a portion of its interest in a business, the accounting results vary depending upon whether the company continues to control the business.

A summary of the types of changes in ownership interest, the accounting result, and the impact on the financial statements is included in Figure 6-1. Each is described in more detail in BCG 6.4–6.6.

Figure 6-1
Summary of accounting for changes in ownership interest

Change in ownership interest	Result	Impact
Partial acquisition:control is obtained, but less than 100 percent of business is acquired	Consolidate as of date control is obtained Recognise the NCI in equity	Recognise 100 percent of identifiable assets and liabilities Fair value method (all U.S. GAAP companies and IFRS companies, if chosen): □ Recognise the NCI at fair value □ Recognise 100 of goodwill Proportionate share method (only IFRS companies, if chosen): □ Recognise the NCI at its proportionate share of the recognised amount of the identifiable net assets, excluding goodwill □ Recognise goodwill attributable to controlling interest

Change in ownership interest	Result	Impact
Step acquisition:control is obtained where there is a previously held equity interest	Change classification and measurement of previously held equity interest Consolidate as of date control is obtained Recognise a gain or loss on a previously held equity interest in the income statement If less than 100 percent acquired, recognise the NCI in equity	Recognise 100 percent of identifiable assets and liabilities Remeasure the previously held equity interest to fair value and recognise any difference between fair value and carrying value as a gain or loss in the income statement Recognise 100 percent of goodwill if all equity interests are acquired If less than 100 percent interest is acquired: □ Fair value method (all U.S. GAAP companies and IFRS companies, if chosen): o Recognise the NCI at fair value o Recognise 100 percent of goodwill □ Proportionate share method (only IFRS companies, if chosen): o Recognise the NCI at its proportionate share of the recognised amount of identifiable net assets, excluding goodwill o Recognise goodwill attributable to controlling interest
Additional interest obtained:control is maintained	Account for as an equity transaction	Do not recognise a gain or loss in the income statement Recognise the difference between the fair value of the consideration paid and the related carrying value of the NCI acquired in the controlling entity's equity Reclassify the carrying value of the NCI obtained from the NCI to the controlling entity's equity

Change in ownership interest	Result	Impact
Reduction in parent's ownership interest: control is maintained[1]	Account for as an equity transaction	Do not recognise a gain or loss in the income statement Recognise the difference between the fair value of the consideration received and the related carrying value of the controlling interest sold in the controlling entity's equity Reclassify the carrying value of the controlling interest sold from the controlling entity's equity to the NCI
Reduction in parent's ownership interest: control to noncontrolling investment[2]	Change classification and measurement of investment Cease consolidation accounting and begin accounting for investment under other applicable guidance Recognise gain or loss on disposal and gain or loss on the retained noncontrolling investment in the income statement	Deconsolidate investment Remeasure any retained noncontrolling investment at fair value Recognise gain or loss on interest sold and gain or loss on the retained noncontrolling investment in the income statement

[1] Reduction in a parent's ownership interest may occur by different methods, including (1) a parent sells part of its interest in its subsidiary or (2) the subsidiary issues shares, thereby reducing the parent's ownership in the subsidiary [ASC 810-10-45-22].

[2] Loss of control by a parent may occur in different ways, including (1) a parent sells all or part of its interest in its subsidiary; (2) a contractual agreement that gave control of the subsidiary to the parent expires; (3) control is obtained by another party through a contract; (4) the subsidiary issues shares, thereby reducing the parent's ownership in the subsidiary; or (5) the subsidiary becomes subject to the control of a government, court, administrator, or regulator [ASC 810-10-40-4, ASC 810-10-55-4A; IFRS 10.B37].

6.4 Accounting for partial and step acquisitions

Each acquisition of equity interests is accounted for as an additional investment under the applicable literature for step acquisitions until control is achieved. The purchase of the additional interest in which the company obtains control is accounted for as a **business combination** if it meets the requisite criteria. See BCG 1 for further information.

6.4.1 Fair value method

If a partial acquisition or a step acquisition in which control is obtained is considered a business combination, then all U.S. GAAP companies and IFRS companies choosing the fair value method will recognise the following at the acquisition date:

- 100 percent of the identifiable net assets, as measured in accordance with the Standards

- NCI at fair value
- Goodwill as the excess of (a) over (b) below:

  a. The aggregate of (1) the **consideration transferred**, as measured in accordance with the Standards, which generally requires acquisition-date fair value, (2) the fair value of any noncontrolling interest in the acquiree, and (3) in a **business combination achieved in stages**, the acquisition-date fair value of the acquirer's **previously held equity interest** in the acquiree; less

  b. The net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed, as measured in accordance with the Standards [ASC 805-30-30-1; IFRS 3.32]

As discussed in BCG 2, the identifiable assets acquired and liabilities assumed are generally measured at fair value. The Standards provide for limited exceptions for certain assets and liabilities to be recognised in accordance with other GAAP [ASC 805-20-25-16; IFRS 3.21–31].

If no consideration is transferred, goodwill will be measured by reference to the fair value of the acquirer's interest in the acquiree, determined using an appropriate valuation technique [ASC 805-30-30-3; IFRS 3.33]. See BCG 7 for further information on valuation techniques.

Under the fair value method, 100 percent of the goodwill of the acquiree is recognised, not just the portion attributable to the controlling interest acquired. For IFRS companies, if the company chooses to use the proportionate share method instead of the fair value method, only the controlling interest's portion of goodwill is recognised.

Example 6-2 in BCG 6.4.3 illustrates the full amount of goodwill that would be recognised in a partial acquisition by all U.S. GAAP companies and IFRS companies electing the fair value method.

6.4.2 Remeasurement of previously held equity interest and recognition of gains and losses

A step acquisition occurs when a shareholder obtains control over an entity by acquiring an additional interest in that entity. Under U.S. GAAP, the acquirer's previously held equity interest is remeasured to fair value at the date the controlling interest is acquired. Under U.S. GAAP, any difference between the carrying value and the fair value of the previously held equity interest is recognised as a gain or loss in the income statement [ASC 805-10-25-10; IFRS 3.42]. This remeasurement is likely to result in the recognition of gains, since companies are required to periodically evaluate their investments for **impairment**. Under IFRS, these same principles apply, except for the option to designate equity securities not for trading on initial recognition. This option allows an entity to make an initial irrevocable election to present subsequent changes in the fair value of the equity interest in other comprehensive income [IFRS 9.5].

When calculating the gain or loss to be recognised in the income statement, the acquirer should reclassify and include any gains or losses associated with the previously held equity interest it had recognised in other comprehensive income in prior reporting periods [ASC 805-10-25-10; IFRS 3.42]. See BCG 6.4.4 for further information on the considerations in valuing the previously held equity interest.

In a step acquisition in which control is obtained, but the acquirer does not purchase all of the remaining ownership interests, an NCI is created at the acquisition date. The NCI is recorded in equity at fair value for U.S. GAAP companies. For IFRS companies, the NCI is recorded in equity at fair value under the fair value method or its proportionate share of the recognised amount of the acquiree's identifiable net assets under the proportionate share method.

6.4.3 Examples of the fair value method

Examples 6-2 through 6-4 demonstrate the acquisition date calculations for a partial acquisition and a step acquisition in which control is obtained and the fair value method is used to value the NCI.

EXAMPLE 6-2

Accounting for a partial acquisition: fair value method

Company A acquires Company B by purchasing 60% of its equity for CU150 million in cash. The fair value of the noncontrolling interest is determined to be CU100 million.[1] The net aggregate value of the identifiable assets and liabilities, as measured in accordance with the Standards, is determined to be CU50 million.

Analysis

The acquirer recognises at the acquisition date (1) 100% of the identifiable net assets, (2) NCI at fair value, and (3) goodwill as the excess of (a) over (b) below:

a. The aggregate of (1) the consideration transferred, as measured in accordance with the Standards, which generally requires acquisition-date fair value; (2) the fair value of any noncontrolling interest in the acquiree; and (3) in a business combination achieved in stages, the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree; less

b. The net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed, as measured in accordance with the Standards [ASC 805-30-30-1; IFRS 3.32].

The journal entry recorded on the acquisition date for the 60% interest acquired is as follows (in millions):

Identifiable net assets	CU 50[2]	
Goodwill	CU200[3]	
Cash		CU150[4]
NCI[1]		CU100[5]

[1] As more fully described in BCG 6.4.4 and BCG 7, the fair value of the NCI may not merely be an extrapolation of the consideration transferred for the controlling interest; therefore, the fair value of the NCI may have to be independently derived.

[2] The value of 100% of the identifiable net assets of Company B is recorded, as measured in accordance with the Standards.

[3] The full amount of goodwill is recorded (in millions):

Fair value of consideration transferred	CU150
Fair value of the NCI	100
Fair value of previously held equity interest	n/a*
Subtotal (a)	250
Recognised value of 100 percent of the identifiable net assets, as measured in accordance with the Standards (b)	(50)
Goodwill recognised (a-b)	CU200

* Not applicable in this example.

[4] Cash paid for the 60% interest acquired in Company B.

[5] Fair value of the 40% NCI is recognised in equity.

EXAMPLE 6-3

Accounting for step acquisition when control is obtained: fair value method

Company A has a 40% previously held equity interest in Company B. The carrying value of the previously held equity interest is CU20 million. Company A purchases the remaining 60% interest in Company B for CU300 million in cash. The fair value of the 40% previously held equity interest is CU200 million.[1] The net aggregate value of the identifiable assets and liabilities, as measured in accordance with the Standards, is determined to be CU440 million. (For illustrative purposes, the tax consequences on the gain have been ignored.)

Analysis

The acquirer recognises at the acquisition date (1) 100% of the identifiable net assets, (2) NCI at fair value, and (3) goodwill as the excess of (a) over (b) below:

a. The aggregate of (1) the consideration transferred, as measured in accordance with the Standards, which generally requires acquisition-date fair value; (2) the fair value of any noncontrolling interest in the acquiree; and (3) in a business combination achieved in stages, the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree; less

b. The net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed, as measured in accordance with the Standards [ASC 805-30-30-1; IFRS 3.32].

Any gain or loss on the previously held equity interest is recognised in the income statement [ASC 805-10-25-10; IFRS 3.42].

The journal entry recorded on the acquisition date is as follows (in millions):

Identifiable net assets	CU440[2]	
Goodwill	CU60[3]	
Cash		CU300[4]
Equity investment		CU20[5]
Gain on equity interest[1]		CU180[6]

[1] As more fully described in BCG 6.4.4 and BCG 7, the fair value of the previously held equity interest may not merely be an extrapolation of the consideration transferred for the controlling interest; therefore, the fair value of the previously held equity interest may have to be independently derived.

[2] The value of 100% of the identifiable net assets of Company B is recorded, as measured in accordance with the Standards.

[3] The full amount of goodwill is recorded (in millions):

Fair value of consideration transferred	CU300
Fair value of the NCI	n/a*
Fair value of previously held equity interest	200
Subtotal (a)	500
Recognised value of 100% of the identifiable net assets, as measured in accordance with the Standards (b)	(440)
Goodwill recognised (a-b)	CU60

* Not applicable in this example.

[4] Cash paid for the remaining 60% interest acquired in Company B.

[5] Elimination of the carrying value of the 40% previously held equity interest.

[6] The gain on the 40% previously held equity interest is recognised in the income statement: fair value of the previously held equity interest less the carrying value of the previously held equity interest = CU200 – CU20.

EXAMPLE 6-4

Accounting for partial acquisition when control is obtained but less than 100% is acquired: fair value method

Company A has a 40% previously held equity interest in Company B, with a carrying value of CU20 million. Company A purchases an additional 50% interest in Company B for CU250 million in cash. The fair value of Company A's 40% previously held equity interest is determined to be CU200 million.[1] The fair value of the NCI is determined to be CU50 million.[1] The net aggregate value of the identifiable assets and liabilities, as measured in accordance with the Standards, is determined to be CU440 million. (For illustrative purposes, the tax consequences on the gain have been ignored.)

Analysis

The acquirer recognises at the acquisition date (1) 100% of the identifiable net assets, (2) NCI at fair value, and (3) goodwill as the excess of (a) over (b) below:

a. The aggregate of (1) the consideration transferred, as measured in accordance with the Standards, which generally requires acquisition-date fair value; (2) the fair value of any noncontrolling interest in the acquiree; and (3) in a business combination achieved in stages, the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree; less

b. The net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed, as measured in accordance with the Standards [ASC 805-30-30-1; IFRS 3.32].

Any gain or loss on the previously held equity interest is recognised in the income statement [ASC 805-10-25-10; IFRS 3.42].

The journal entry recorded on the acquisition date for the 50% controlling interest acquired is as follows (in millions):

Identifiable net assets	CU440[2]	
Goodwill	CU 60[3]	
Cash		CU250[4]
Equity investment		CU20[5]
Gain on equity interest[1]		CU180[6]
NCI[1]		CU 50[7]

[1]As more fully described in BCG 6.4.4 and BCG 7, the fair value of the NCI and the previously held equity interest may not merely be an extrapolation of the consideration transferred for the controlling interest; therefore, the fair value of the NCI and the previously held equity interest may have to be independently derived.

[2] The value of 100% of the identifiable net assets of Company B is recorded, as measured in accordance with the Standards.

[3] The full amount of goodwill is recorded:

Fair value of consideration transferred	CU250
Fair value of the NCI	50
Fair value of previously held equity interest	200
Subtotal (a)	500
Recognised value of 100% of the identifiable net assets, as measured in accordance with the Standards (b)	(440)
Goodwill recognised (a-b)	CU60

[4] Cash paid for the 50% interest acquired in Company B.

[5] Elimination of the carrying value of the 40% previously held equity interest.

[6] The gain on the 40% previously held equity interest is recognised in the income statement: fair value of the previously held equity interest less the carrying value of the previously held equity interest = CU200 – CU20.

[7] Fair value of the 10% NCI is recognised in equity.

6.4.4 Fair value considerations

The fair value of the noncontrolling interest can be measured on the basis of market prices for the equity shares not held by the acquirer if the noncontrolling interest consists of publicly traded securities. The acquirer must measure the fair value of the noncontrolling interest using other valuation techniques if the securities are not publicly traded [ASC 805-20-30-7; IFRS 3.B44]. The fair value of the previously held equity interest may also need to be similarly measured.

On a per-share basis, the fair value of the acquirer's interest in the acquiree and the noncontrolling interest may differ. This difference may be due to 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 in the per-share fair value of the noncontrolling interest [ASC 805-20-30-8; IFRS 3.B45].

A control premium represents the amount paid by a new controlling shareholder for the benefits resulting from synergies and other potential benefits derived from controlling the acquired company. Control premiums and minority interest discounts should not be applied without considering whether the noncontrolling interest will benefit in ways similar to the acquirer. For example, certain operational synergies will often impact the cash flows of the acquiree as a whole, including the noncontrolling interest in the acquiree. In such a case, deducting those operational synergies (control premium) to value the noncontrolling interest may not be appropriate. BCG 7 contains further discussion on valuation techniques and methods.

6.4.5 Consideration of goodwill when noncontrolling interest exists—U.S. GAAP

In a partial acquisition, consideration needs to be given to the attribution of goodwill to controlling and noncontrolling interests in the event that goodwill is later impaired.

When goodwill is impaired, ASC 350-20 requires that the impairment loss be attributed to the parent and the NCI on a rational basis [ASC 350-20-35-57A]. One rational approach would be to attribute the impairment loss to the controlling interest and the NCI using their relative interests in the carrying value of goodwill. See BCG 11 for further information on impairment testing of goodwill for U.S. GAAP companies.

6.4.6 Consideration of goodwill when noncontrolling interest exists—IFRS

The impairment model for goodwill is different under IFRS than for U.S. GAAP. Any impairment charge is allocated between the controlling and noncontrolling interests on the basis of their relative profit shares [IAS 36.C6] if the fair value method was used to measure the noncontrolling interest on the acquisition date. The impairment charge is allocated to the controlling interest if the proportionate share method was used to measure the noncontrolling interest on the acquisition date. See BCG 12 for further information on impairment testing of goodwill for IFRS companies.

6.4.7 Bargain purchase in a partial or step acquisition—U.S. GAAP companies and IFRS companies choosing the fair value method

Occasionally, an acquirer will make a bargain purchase, a business combination in which (a) the acquisition-date amounts of the identifiable net assets acquired and the liabilities assumed, as measured in accordance with the Standards, exceeds (b) the aggregate of (1) the consideration transferred, as measured in accordance with the Standards, which generally require acquisition-date fair value; (2) the fair value of any noncontrolling interest in the acquiree; and (3) in a business combination achieved in stages, the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree [ASC 805-30-25-2; IFRS 3.34].

Similar to a bargain purchase in an acquisition of 100 percent of the equity interests, the acquirer shall reassess whether it has identified all of the assets acquired and liabilities assumed. The acquirer shall also review its valuation procedures used to measure the amounts recognised for the identifiable net assets, the NCI, the previously held equity interest, and the consideration transferred. If a bargain purchase is still indicated, the acquirer recognises a gain in the income statement on the acquisition date [ASC 805-30-25-2, ASC 805-30-25-4; IFRS 3.34,36].

In a bargain purchase, the bargain element realised by the controlling interests in the transaction is not allocated to the NCI. Therefore, the NCI is recognised at its fair value.

Example 6-5 demonstrates the accounting for a bargain purchase in a partial acquisition.

EXAMPLE 6-5

Accounting for a bargain purchase in a partial acquisition

Company A acquires Company B by purchasing 70% of its equity for CU150 million in cash. The fair value of the NCI is determined to be CU69 million.[1] The net aggregate value of the identifiable assets and liabilities, as measured in accordance with the

Standards, is determined to be CU220 million. (For illustrative purposes, the tax consequences on the gain have been ignored.)

Analysis

The bargain purchase gain is calculated as the excess of (a) the recognised amount of the identifiable net assets acquired, as measured in accordance with the Standards; over (b) the fair value of the consideration transferred plus the fair value of the NCI and, in a step acquisition, the fair value of the previously held equity interest [ASC 805-30-25-2; IFRS 3.34].

Recognised value of 100% of the identifiable net assets, as measured in accordance with the Standards (a)	CU 220
Fair value of consideration transferred	(150)
Fair value of the NCI	(69)
Fair value of previously held equity interest	n/a*
Less: subtotal (b)	(219)
Bargain purchase gain (a – b)	CU 1

* Not applicable in this example

The recognised amount of the identifiable net assets is greater than the fair value of the consideration transferred plus the fair value of the NCI, and there was no previously held equity interest in Company B to value. Therefore, a bargain purchase gain of CU1 million is recognised in the income statement.

The journal entry recorded on the acquisition

Identifiable net assets	CU220[2]	
Cash		CU150[3]
Gain on bargain purchase		CU1[4]
NCI[1]		CU69[5]

[1] As more fully described in BCG 6.4.4 and BCG 7, the fair value of the NCI may not merely be an extrapolation of the consideration transferred for the controlling interest; therefore, the fair value of the NCI may have to be independently derived.

[2] The value of 100% of the identifiable net assets of Company B is recorded, as measured in accordance with the Standards.

[3] Cash paid for the 70% interest acquired in Company B.

[4] Gain recognised on bargain purchase: recognised amount of the identifiable net assets less fair value of consideration transferred plus the fair value of the NCI and the fair value of previously held equity interest = CU220 – (CU150 + CU69 + N/A).

[5] Fair value of the 30% NCI is recognised in equity.

Because the NCI is required to be recorded at fair value, a bargain purchase gain is recognised only for CU1 million. The NCI is recognised at fair value, which includes embedded goodwill of CU3 million: Fair value of NCI – NCI's share of identifiable assets = CU69 – (CU220 x 30%). Although the NCI value includes embedded CU3 million of goodwill, the consolidated financial statements do not contain a separate goodwill line item.

6.4.8 Partial acquisition and step acquisition—proportionate share method—IFRS

Application of the proportionate share method under IFRS is the same as the fair value method, except that NCI is recognised at its proportionate share of the recognised amount of the identifiable net assets. The acquirer measures 100 percent of the identifiable assets and liabilities, but recognises only the goodwill associated with the controlling interest. When the proportionate share method is used, goodwill is recognised at the acquisition date as the difference between (a) and (b) below:

a. The aggregate of (1) the consideration transferred, as measured in accordance with IFRS 3, which generally requires acquisition-date fair value; (2) the amount of any noncontrolling interest in the acquiree (measured as the noncontrolling interest's proportionate share of the acquiree's identifiable net assets); and (3) in a business combination achieved in stages, the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree; less

b. The net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed, as measured in accordance with IFRS 3 [IFRS 3.19,32].

If no consideration is transferred, goodwill is measured by reference to the fair value of the acquirer's interest in the acquiree, as determined using an appropriate valuation technique [IFRS 3.33]. See BCG 7 for further information on valuation techniques.

Examples 6-6 and 6-7 demonstrate the calculation on the acquisition date for cases in which the proportionate share method is used to value the NCI in a partial acquisition or a step acquisition where control is obtained.

EXAMPLE 6-6

Accounting for a partial acquisition—IFRS company electing proportionate share method

Company A acquires Company B by purchasing 60% of its equity for CU150 million in cash. The net aggregate value of the identifiable assets and liabilities measured in accordance with the Standards is determined to be CU50 million. Company A chooses to measure the NCI using the proportionate share method for this business combination.

Analysis

The acquirer recognises 100% of the identifiable net assets on the acquisition date. NCI is recorded at its proportionate share of the recognised amount of the identifiable net assets [IFRS 3.19]. Goodwill is recognised at the acquisition date as the excess of (a) over (b) below:

a. The aggregate of (1) the consideration transferred, as measured in accordance with the Standards, which generally requires acquisition-date fair value; (2) the amount of any noncontrolling interest in the acquiree (measured as the noncontrolling interest's proportionate share of the acquiree's identifiable net assets); and (3) in a business combination achieved in stages, the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree; less

b. The net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed, as measured in accordance with the Standards [IFRS 3.32].

The journal entry recorded on the acquisition date for the 60% interest acquired is as follows (in millions):

Identifiable net assets	CU 50[1]	
Goodwill	CU120[2]	
Cash		CU150[3]
NCI		CU 20[4]

[1] The value of 100% of the identifiable net assets of Company B is recorded, as measured in accordance with the Standards.

[2] Since NCI is recorded at its proportionate share of Company B's identifiable net assets, goodwill is recognised only for the controlling interest's portion. (That is, goodwill is not recognised for the NCI.) Goodwill is calculated as follows:

Fair value of consideration transferred	CU150
Proportionate share of the NCI (CU50 x 40%)	20
Fair value of previously held equity interest	n/a*
Subtotal (a)	170
Recognised value of 100% of the identifiable net assets, as measured in accordance with the Standards (b)	(50)
Goodwill recognised (a-b)	CU120

* Not applicable in this example.

[3] Cash paid for the 60% interest acquired in Company B.

[4] Recognition of the 40% NCI at its proportionate share of the identifiable net assets = CU50 x 40%.

EXAMPLE 6-7

Accounting for a partial acquisition when control is obtained but less than 100% is acquired—IFRS company choosing proportionate share method

Company A has a 40% previously held equity interest in Company B, with a carrying value of CU20 million. Company A purchases an additional 50% interest in Company B for CU250 million in cash. The fair value of the 40% previously held equity interest is determined to be CU200 million.[1] The net aggregate value of the identifiable assets and liabilities, as measured in accordance with the Standards, is determined to be CU440 million. Company A chooses to measure NCI using the proportionate share method for this business combination. (For illustrative purposes, the tax consequences on the gain have been ignored.)

Analysis

The acquirer recognises 100% of the identifiable net assets on the acquisition date. NCI is recorded at its proportionate share of the recognised amount of the identifiable net assets [IFRS 3.19]. Goodwill is recognised at the acquisition date as the excess of (a) over (b) below:

a. The aggregate of (1) the consideration transferred, as measured in accordance with the Standards, which generally requires acquisition-date fair value; (2) the amount of any noncontrolling interest in the acquiree (measured as the noncontrolling interest's proportionate share of the acquiree's identifiable net assets); and (3) in a business combination achieved in stages, the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree; less

b. The net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed, as measured in accordance with the Standards [IFRS 3.32].

Any gain or loss on the previously held equity interest is recognised in the income statement [IFRS 3.42].

The journal entry recorded on the acquisition date is as follows (in millions):

Identifiable net assets	CU440[2]	
Goodwill	CU 54[3]	
Cash		CU250[4]
Equity investment		CU 20[5]
Gain on investment[1]		CU180[6]
NCI		CU 44[7]

[1] As more fully described in BCG 6.4.4 and BCG 7, the fair value of the previously held equity interest may not merely be an extrapolation of the consideration transferred for the controlling interest; therefore, the fair value of the previously held equity interest may have to be independently derived.

[2] The value of 100% of the identifiable net assets of Company B is recorded, as measured in accordance with the Standards.

[3] Since NCI is recorded at its proportionate share of Company B's identifiable net assets, goodwill is recognised only for the controlling interest's portion. (That is, goodwill is not recognised for the NCI.) Goodwill is calculated as follows:

Fair value of consideration transferred	CU250
Proportionate share of the NCI (CU440 x 10%)	44
Fair value of previously held equity interest	200
Subtotal (a)	494
Recognised value of 100% of the identifiable net assets, as measured in accordance with the Standards (b)	(440)
Goodwill recognised (a-b)	CU54

[4] Cash paid for the 50% interest acquired in Company B.

[5] Elimination of the carrying value of the 40% previously held equity interest.

[6] The gain on the 40% previously held equity interest is recognised in the income statement: fair value of the previously held equity interest less the carrying value of the previously held equity interest = CU200 – CU20.

[7] Recognition of the 10% NCI at its proportionate share of the identifiable net assets = CU440 x 10%.

6.4.9 Bargain purchase in a partial or step acquisition—proportionate share method—IFRS

The process to determine a bargain purchase under the proportionate share method is the same as the fair value method. The acquirer compares (a) 100% of the identifiable net assets, as measured in accordance with IFRS 3, and (b) the fair value of the consideration transferred, plus the recognised amount of the NCI (at its proportionate share) and, in a step acquisition, the fair value of the previously held equity interest. A bargain purchase gain is recognised for the excess of (a) over (b) [IFRS 3.34].

Prior to recognising a bargain purchase gain, the acquirer should reassess whether it has identified all of the assets acquired and liabilities assumed. The acquirer shall also review its valuation procedures used to measure the amounts recognised for the identifiable net assets, previously held equity interest, and consideration transferred. If a bargain purchase is still indicated, the acquirer recognises a gain in the income statement on the acquisition date [IFRS 3.36].

Example 6-8 demonstrates the calculation on the acquisition date when the proportionate share method is used to value the NCI in a bargain purchase.

EXAMPLE 6-8

Accounting for a bargain purchase—an IFRS company chooses the proportionate share method for valuing the NCI

Company A acquires Company B by purchasing 70% of its equity for CU150 million in cash. The net aggregate value of the identifiable assets and liabilities, as measured in accordance with the Standards, is determined to be CU220 million. Company A chooses to measure NCI using the proportionate share method for this business combination. (For illustrative purposes, the tax consequences on the gain have been ignored.)

Analysis

This method calculates the bargain purchase the same as under the fair value method, except that the NCI is measured as the proportionate share of the identifiable net assets. The gain is the excess of (a) the recognised amount of the identifiable net assets acquired, as measured in accordance with the Standards, over (b) the fair value of the consideration transferred, plus the recognised amount of the NCI (proportionate share of the identifiable net assets) and the fair value of the previously held equity interest [IFRS 3.34].

Recognised value of 100% of the identifiable net assets, as measured in accordance with the Standards (a)	CU220
Fair value of consideration transferred	(150)
Amount of the NCI recognised (at proportionate share) (CU220 x 30%)	(66)
Fair value of previously held equity interest	n/a*
Less: subtotal (b)	(216)
Bargain purchase gain (a – b)	CU 4

* Not applicable in this example.

Because the recognised amount of the identifiable net assets is greater than the fair value of the consideration transferred, plus the recognised amount of the NCI (at proportionate share), and there was no previously held equity interest in Company B to fair value, a bargain purchase gain of CU4 million is recognised in the income statement.

The journal entry recorded on the acquisition date for the 70% interest acquired is as follows (in millions):

Identifiable net assets	CU220[1]	
Cash		CU150[2]
Gain on bargain purchase		CU 4[3]
NCI		CU 66[4]

[1] The value of 100% of the identifiable net assets of Company B is recorded, as measured in accordance with the Standards.

[2] Cash paid for the 70% interest acquired in Company B.

[3] Gain recognised on bargain purchase: recognised amount of the identifiable net assets, less the fair value of the consideration transferred, plus the recognised amount of the NCI (at proportionate share) and the fair value of the previously held equity interest = CU220 – (CU150 + (CU220 x 30%) + N/A).

[4] Recognition of the 30% NCI at its proportionate share of the recognised amount of the identifiable net assets = CU220 x 30%.

Under the proportionate share method, NCI is recorded at its proportionate share of the identifiable net assets, and not at fair value. Therefore, the bargain purchase gain recognised under the proportionate share method may be higher than the gain recognised under the fair value method.

6.5 Accounting for changes in ownership interest that do not result in loss of control

Changes in a parent's ownership interest that do not result in a change in control of the subsidiary are accounted for as equity transactions. Thus, if the parent maintains control, it will recognise no gain or loss in earnings [profit or loss] upon selling shares of a subsidiary. Similarly, the parent will not record any additional acquisition adjustments to reflect its subsequent purchases of additional shares in a subsidiary if there is no change in control. Instead, the carrying amount of the NCI will be adjusted to reflect the change in the NCI's ownership interest in the subsidiary. Any difference between the amount by which the NCI is adjusted and the fair value of the consideration paid or received is recognised in equity and attributed to the equity holders of the parent [ASC 810-10-45-23; IFRS 10.B96].

NCI is recorded at fair value [or proportionate share for IFRS companies, if chosen] only at the date of the business combination. Subsequent purchases or sales of ownership interests when control is maintained are recorded at the NCI's proportionate share of the net assets, including goodwill.

A subsidiary may issue shares to a third party, thereby diluting the controlling interest's ownership percentage. Additional instruments of the subsidiary, such as preferred shares, warrants, puts, calls, and options may also dilute the controlling interest's ownership percentage when issued or exercised. If this dilution does not result in a change in control, it is accounted for as an equity transaction.

Examples 6-9 through 6-16 demonstrate changes in ownership interest where control of a business does not change.

IFRS companies that elect the proportionate share method will record the NCI initially at a lower value than if they had elected the fair value method. Therefore, subsequent purchases of the NCI for these companies may result in a larger percentage reduction of the controlling interest's equity on the transaction date. This is illustrated in Examples 6-12 and 6-13.

EXAMPLE 6-9

Change in controlling ownership interest—initial acquisition of controlling interest—fair value method used to measure the NCI in a business combination

Company A acquires Company B by purchasing 60% of its equity for CU300 million in cash. The fair value of NCI is determined to be CU200 million.[1] The net aggregate value of the identifiable assets and liabilities, as measured in accordance with the Standards, is determined to be CU370 million.

Analysis

The acquirer recognises at the acquisition date (1) 100% of the identifiable net assets, (2) NCI at fair value, and (3) goodwill as the excess of (a) over (b) below:

a. The aggregate of (1) the consideration transferred as measured in accordance with the Standards, which generally require acquisition-date fair value; (2) the fair value of any noncontrolling interest in the acquiree; and (3) in a business combination achieved in stages, the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree; less

b. The net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed, as measured in accordance with the Standards [ASC 805-30-30-1; IFRS 3.32].

The journal entry recorded on the acquisition date for the 60% interest acquired is as follows (in millions):

Identifiable net assets	CU370[2]	
Goodwill	CU130[3]	
Cash		CU300[4]
NCI[1]		CU200[5]

[1] As more fully described in BCG 6.4.4 and BCG 7, the fair value of the NCI may not merely be an extrapolation of the consideration transferred for the controlling interest ; therefore, the fair value of the NCI may have to be independently derived.

[2] The value of 100% of the identifiable net assets of Company B is recorded, as measured in accordance with the Standards.

[3] The full amount of goodwill is recorded:

Fair value of consideration transferred	CU300
Fair value of the NCI	200
Fair value of previously held equity interest	n/a*
Subtotal (a)	500
Recognised value of 100% of the identifiable net assets, as measured in accordance with the Standards (b)	(370)
Goodwill recognised (a-b)	CU130

[*] Not applicable in this example.

[4] Cash paid for the 60% interest acquired in Company B.

[5] Fair value of the 40% NCI is recognised in equity.

EXAMPLE 6-10

Change in controlling ownership interest that does not result in loss of control—acquisition of additional shares

Two years after the transaction in Example 6-9, Company A purchases the outstanding 40% interest from the subsidiary's noncontrolling shareholders for CU300 million in cash. The goodwill of CU130 million from the acquisition of the subsidiary is assumed to not have been impaired. The carrying value of the 40% NCI is CU260 million (original value of CU200 million, plus CU60 million, assumed to be allocated to the NCI over the past two years for its share in the income of the subsidiary and its share of accumulated other comprehensive income).

Analysis

A change in ownership interests that does not result in a change of control is considered an equity transaction. The identifiable net assets remain unchanged and any difference between the amount by which the NCI is adjusted, and the fair value of the consideration paid is recognised directly in equity/APIC (additional paid-in capital) and attributed to the controlling interest [ASC 810-10-45-23; IFRS 10.B96].

The journal entry recorded for the 40% interest acquired is as follows (in millions):

NCI	CU260[1]	
Equity/APIC	CU 40[2]	
Cash		CU300[3]

[1] Elimination of the carrying value of the 40% NCI on Company A's books.

[2] Difference in NCI: consideration paid less the carrying value of NCI = CU300 – CU260.

[3] Cash paid for the 40% interest acquired in the subsidiary.

EXAMPLE 6-11

Change in controlling ownership interest that does not result in loss of control—sale of shares, control is maintained

Three years after the transaction in Example 6-10, Company A sells a 20% interest in the subsidiary to outside investors for CU200 million in cash. Company A still maintains an 80% controlling interest in the subsidiary. The carrying value of the subsidiary's net assets is CU600 million, including goodwill of CU130 million from the initial acquisition of the subsidiary.

Analysis

A change in ownership interests that does not result in a change of control is considered an equity transaction. The identifiable net assets remain unchanged and any difference between the amount by which the NCI is recorded, and the fair value of the consideration received, is recognised directly in equity and attributed to the controlling interest [ASC 810-10-45-23; IFRS 10.B96]. NCI is recognised at fair value only at the date of the business combination. For subsequent changes in ownership interest that do not result in a change of control, the change in the NCI is recorded at its proportionate interest of the carrying value of the subsidiary.

The journal entry recorded on the disposition date for the 20% interest sold is as follows (in millions):

Cash	CU200[1]	
NCI		CU120[2]
Equity/APIC		CU 80[3]

[1] Cash received for the 20% interest sold.

[2] Recognition of the 20% NCI at its proportionate interest in the carrying value of the subsidiary = CU600 x 20%.

[3] Fair value of the consideration received less the recorded amount of the NCI = CU200 – (CU600 x 20%).

EXAMPLE 6-12

Change in controlling ownership interest—initial acquisition of controlling interest—proportionate share method used to measure the NCI in a business combination—IFRS

Company A acquires Company B by purchasing 60% of its equity for CU300 million in cash. The net aggregate value of the identifiable assets and liabilities, as measured in accordance with the Standards, is determined to be CU370 million. Company A chooses to measure NCI using the proportionate share method for this business combination.

Analysis

The acquirer recognises 100% of the identifiable net assets on the acquisition date. The NCI is recorded at its proportionate share of the recognised amount of the identifiable net assets [IFRS 3.19]. Goodwill is recognised at the acquisition date as the excess of (a) over (b) below:

a. The aggregate of (1) the consideration transferred, as measured in accordance with the Standards, which generally requires acquisitiondate fair value;
(2) the amount of any noncontrolling interest in the acquiree (measured as the noncontrolling interest's proportionate share of the acquiree's identifiable net assets); and (3) in a business combination achieved in stages, the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree; less

b. The net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed, as measured in accordance with the Standards [IFRS 3.32].

The journal entry recorded on the acquisition date for the 60% interest acquired is as follows (in millions):

Identifiable net assets	CU370[1]	
Goodwill	CU 78[2]	
Cash		CU300[3]
NCI		CU148[4]

[1] The value of 100% of the identifiable net assets of Company B is recorded, as measured in accordance with the Standards.

[2] Since NCI is recorded at its proportionate share of Company B's identifiable net assets, only the controlling interest's portion of goodwill is recognised, and there is no goodwill recognised for the NCI. Goodwill is calculated as follows:

Fair value of consideration transferred	CU300
Proportionate share of NCI (CU370 x 40%)	148
Fair value of previously held equity interest	n/a*
Subtotal (a)	448
Recognised value of 100% of the identifiable net assets, as measured in accordance with the Standards (b)	(370)
Goodwill recognised (a-b)	CU78

* Not applicable in this example.

[3] Cash paid for the 60% interest acquired in Company B.

[4] Recognition of the 40% NCI at its proportionate share of the identifiable net assets = CU370 x 40%.

EXAMPLE 6-13

Change in controlling ownership interest that does not result in loss of control—acquisition of additional shares—proportionate share method used to measure the NCI in a business combination—IFRS

Two years after the transaction in Example 6-12, Company A purchases the outstanding 40% interest from the subsidiary's noncontrolling shareholders for CU300 million in cash. The goodwill of CU78 million from the acquisition of the subsidiary is assumed to not have been impaired. The carrying value of the 40% NCI is CU208 million (original value of CU148 million plus CU60 million assumed to be allocated to the NCI over the past two years for its share in the income of the subsidiary and its share of accumulated other comprehensive income).

Analysis

A change in ownership interests that does not result in a change of control is considered an equity transaction. The identifiable net assets remain unchanged, and any difference between the amount by which the NCI is adjusted and the fair value of the consideration paid is recognised directly in equity and attributed to the controlling interest [IFRS 10.B96].

The journal entry recorded for the 40% interest acquired is as follows (in millions):

NCI	CU208[1]	
Equity/APIC	CU 92[2]	
Cash		CU300[3]

[1] Elimination of the carrying value of the 40% NCI on Company A's books.

[2] Difference in NCI: fair value of the consideration paid less the carrying value of NCI = CU300 – CU208.

[3] Cash paid for the 40% interest acquired in the subsidiary.

Because Company A chose the proportionate share method over the fair value method, it recorded a lower value for the NCI on the acquisition date. This resulted in Company A recording a larger reduction to the controlling interest's equity than under the fair value method when it acquired additional interests. However, the change in total equity (CU300 million) is the same for both methods.

EXAMPLE 6-14

Change in controlling ownership interest that does not result in loss of control—sale of shares, control is maintained—proportionate share method used to measure the NCI in a business combination IFRS

Three years after the transaction in Example 6-13, Company A sells a 20% interest in Company B to outside investors for CU200 million in cash. Company A still maintains an 80% controlling interest in the subsidiary. The carrying value of the subsidiary's net assets is CU548 million. This includes the goodwill of CU78 million from the initial acquisition of the subsidiary.

Analysis

A change in ownership interests that does not result in a change of control is considered an equity transaction. The identifiable net assets remain unchanged, and any difference between the amount by which the NCI is recorded and the fair value of the consideration received is recognised directly in equity and attributed to the controlling interest [IFRS 10.B96].

The journal entry recorded on the disposition date for the 20% interest sold is as follows (in millions):

Cash	CU200[1]	
NCI		CU110[2]
Equity/APIC		CU 90[3]

[1] Cash received for the 20% interest sold.

[2] Recognition of the 20% NCI at its proportionate interest in the carrying value of the subsidiary = CU548 x 20%.

[3] Fair value of the consideration received less the value of the NCI = CU200 – (CU548 x 20%).

The accounting result is different than in Example 6-13 because NCI was originally recorded using the proportionate share method ; therefore, no goodwill was recognised for the NCI (i.e., lower carrying value of the subsidiary in Example 2).

EXAMPLE 6-15

Change in controlling ownership interest that does not result in loss of control—sale of additional shares by subsidiary, dilution of controlling interests ownership percentage, control is maintained

On 31 December, Company A owns 90 shares (90%) of Subsidiary Z. On 1 January, Subsidiary Z sells an additional 20 shares to Company C (an unrelated party) for CU200 million in cash.

Assume the following facts on 31 December and 1 January (CU's in millions):

	31 December (pre-sale)	1 January (post-sale)
Total shares outstanding—subsidiary Z	100 shares	120 shares
Company A's ownership percentage in subsidiary Z	90%[1]	75%[2]
Company A's basis in subsidiary Z	CU370[3]	CU458[4]
Subsidiary Z's net equity	CU411	CU611

[1] 90 shares divided by 100 shares outstanding.

[2] 90 shares divided by 120 shares outstanding.

[3] Subsidiary Z's net equity x 90%.

[4] Subsidiary Z's net equity x 75%.

For purposes of this example, it is assumed that there is no basis difference between Company A's investment in Subsidiary Z and Subsidiary Z's net equity.

Analysis

Company A's ownership percentage of Subsidiary Z has been diluted from 90% to 75%. This is a change in Company A's ownership interest that does not result in a change of control and, therefore, is considered an equity transaction. Any difference between the amount by which the carrying value of Company A's basis in Subsidiary Z is adjusted and the fair value of the consideration received is recognised directly in equity and attributed to the controlling interest [ASC 810-10-45-23; IFRS 10.B96].

In its consolidated accounts, Company A records the following journal entry (in millions):

Cash	CU200[1]	
Equity/APIC		CU88[2]
NCI		CU112[3]

[1] Cash received for the 20 shares sold by Subsidiary Z to Company C.

[2] Company A's share of the fair value of the consideration received (CU200 x 75%) less the change in Company A's basis in Subsidiary Z (CU411 x (90% – 75%)).

[3] The change in the recorded amount of NCI represents:

NCI's share of the fair value of the consideration received (CU200 x 25%)	CU50
Change in NCI's basis in Subsidiary Z (CU411 x 15%)	62
	CU112

Alternatively, the journal entries can be recorded in the separate accounts of Subsidiary Z and Company A as follows (in millions):

Recorded by Subsidiary Z:

Cash	CU200[4]	
Equity		CU200

[4] Cash received for the 20 shares sold to Company C.

Recorded by Company A:

Investment in Subsidiary Z	CU88[5]	
Equity/APIC		CU88[5]

[5] Company A's share of the fair value of the consideration received (CU200 x 75%) less the change in Company A's basis in Subsidiary Z (CU411 x (90% – 75%)).

In consolidation, Company A will eliminate its investment in Subsidiary Z of CU458 million, Subsidiary Z's equity of CU611 million, and recognise the NCI of CU153 million in Subsidiary Z (CU112 + CU41 (10% of the original investment)).

This example assumes that the cash will stay in Subsidiary Z. In other cases, if the cash is transferred to the parent, the accounting for this transaction may be different.

EXAMPLE 6-16

Change in controlling ownership interest that does not result in loss of control—accounting for the indirect decrease in an interest in an investee through the sale of shares of an intermediate subsidiary—proportionate share method used to measure the NCI in a Business Combination—IFRS

Company A owns 100% of Company B, a substantive operating company, which owns 30% of an equity-method investee, Company Z. The carrying amount of Company A's investment in Company B is CU160, which includes the carrying amount of Company B's investment in Company Z of CU60. Company A sells a 40% interest in Company B for CU100 to an unrelated third party, out of which CU40 is allocated to the indirect disposal of an interest in Company Z.

Analysis

A change in ownership interests that does not result in a change in control is considered an equity transaction. The identifiable net assets remain unchanged and any difference between the amount by which the NCI is recorded, and the fair value of the consideration received, is recognised directly in equity and attributed to the controlling interest [ASC 810-10-45-23; IFRS 10.23].

The journal entry recorded on the disposition date for the 40% interest sold is as follows (in millions):

Cash	CU100[1]	
NCI		CU64[2]
Equity/APIC		CU36[3]

[1] Cash received for the 40% interest in Company B sold by Company A to an unrelated third party.

[2] Recognition of the 40% NCI at its proportionate interest in the carrying value of Company B = CU160 x 40%.

[3] Fair value of the consideration received less the recorded amount of NCI = CU100 – (CU160 x 40%).

Alternatively, if Company B was a shell company with no other investments, Company A would effectively own only an equity investment in Company Z. Therefore, if Company A sold a partial interest in Company B it would, in substance, be akin to Company A disposing of a portion of its equity investment in Company Z. In this case, gain recognition in earnings for the difference between the portion of the consideration received attributable to the investment in Company Z and the carrying amount of the disposed interest in Company Z generally would be appropriate [ASC 323-10-40-1; IAS 28.19A].

6.5.1 *Parent company accounting for an equity-classified freestanding written call option on subsidiary's shares*

Equity-classified freestanding written call option on subsidiary's shares issued by parent

A freestanding written call option (including an employee stock option) on a subsidiary's shares issued by a parent that qualifies for equity classification should be accounted for by the parent as noncontrolling interest for the amount of consideration received for the written call option. However, during the period the option is outstanding, the option holder should not be attributed any profit or loss of the subsidiary. The noncontrolling interest remains in existence until the option expires.

If the option is exercised and the parent retains control of the subsidiary, the change in the parent's ownership interest should be accounted for as an equity transaction [ASC 810-10-45-23; IFRS 10.23]. Upon exercise, the newly issued shares should be reported as noncontrolling interest equal to the noncontrolling interest holder's proportionate share of the parent's basis in the subsidiary's equity. Conversely, if the option expires, the carrying amount of the written option should be reclassified from noncontrolling interest to the equity of the controlling interest [ASC 810-10-45-17A; IAS 32].

Example 6-17 illustrates this guidance.

EXAMPLE 6-17

Accounting for a freestanding written call option on a subsidiary's shares issued by a parent

Company A issues a warrant (written call option) to purchase 10% of Subsidiary's shares with an exercise price of CU150 to Investor B for CU60. Before and after Investor B's exercise of the warrant, Company A's carrying amount in Subsidiary, including goodwill, is CU1,000. There are no basis differences between Company A's investment in Subsidiary and Subsidiary's equity. There is no other existing noncontrolling interest.

Analysis

In consolidation, Company A would record the following journal entries:

Cash	CU60	
Noncontrolling interest		CU60
To record the issuance of the warrant		
Cash	CU150	
Noncontrolling interest		CU 40[1]
Additional paid in capital		CU1102

To record the exercise of the warrant

[1] Company A's basis in Subsidiary's equity after exercise of warrant	CU1,000
Investor B's ownership percentage	x 10%
Noncontrolling interest after exercise	100
Less: Noncontrolling interest prior to exercise	(60)
Increase in noncontrolling interest	CU40
[2] Warrant consideration received by Company A	CU60
Plus: Exercise price	150
Total consideration received by Company A	210
Less: 10% of Company A's basis in Subsidiary's equity	(100)
Change in Company A's additional paid in capital	CU110

If the warrant was not exercised but expires, Company A would record the following entry to reclassify the premium received for the warrant [ASC 810-10-45-17A; IAS 32]:

Noncontrolling interest	CU60	
Additional paid in capital		CU60
To account for the expiration of the warrant		

Equity-classified freestanding written call option on subsidiary's shares issued by subsidiary

A freestanding written call option (including an employee stock option) on a subsidiary's shares issued by the subsidiary that qualifies for equity classification should also be accounted for by the parent as noncontrolling interest for the amount of consideration received for the written call option. During the period the option is outstanding, the option holder should not be attributed any profit or loss of the subsidiary. The noncontrolling interest remains in existence until the option expires.

If the option is exercised and the parent maintains control of the subsidiary, the change in the parent's ownership interest should be accounted for as an equity transaction. Upon exercise, the newly issued shares should be reported as noncontrolling interest equal to the noncontrolling interest holder's proportionate share of the parent's investment in the subsidiary's equity. Conversely, if the option expires, the parent should record a reduction in the noncontrolling interest for the parent's proportionate share of the carrying amount of the written option [ASC 810-10-45-23; IFRS 10.23].

Example 6-18 illustrates this guidance.

EXAMPLE 6-18

Accounting for a freestanding written call option (including an employee stock option) on a subsidiary's shares issued by the subsidiary

Subsidiary, which is controlled by Company A, issues a warrant (written call option) to purchase 10% of Subsidiary's shares with an exercise price of CU150 to Investor B for CU60. After Investor B's exercise of the warrant, Subsidiary's equity, including goodwill, is CU1,210 (CU1,000 of net assets plus CU60 of cash received for issuance of the warrant and CU150 received for the exercise price). There are no basis differences between Company A's investment and Subsidiary's equity. There is no other existing noncontrolling interest.

Analysis

In consolidation, Company A would record the following journal entries:

Cash	CU60	
Noncontrolling interest		CU60
To record the issuance of the warrant		
Cash	CU150	
Noncontrolling interest		CU61[3]
Additional paid in capital		CU89[4]
To record the exercise of the warrant		

[3]Company A's basis in Subsidiary's equity after exercise of warrant	CU1,210
Investor B's ownership percentage	x 10%
Noncontrolling interest after exercise	121
Less: Noncontrolling interest prior to exercise	(60)
Increase in noncontrolling interest	CU 61

[4]Subsidiary's carrying amount of net assets after exercise	CU1,210
Company A's ownership percentage after exercise	
Company A's ownership in Subsidiary's net assets after exercise	1,089
Company A's ownership investment in Subsidiary before exercise	(1,000)
Change in Company A's ownership interest	CU 89

If the warrant was not exercised but expires, Company A would record the following entry to reclassify the premium received for the warrant [ASC 810-10-45-17A; IAS 32].

Noncontrolling interest	CU60	
Additional paid in capital		CU60

To account for the expiration of the warrant

Note that the change in interest calculation may be more complex if there is an existing noncontrolling interest prior to the issuance of the option, or if there is a basis difference between the parent's investment in the subsidiary and the equity in the subsidiary's separate financial statements.

6.5.2 *Parent company accounting for employee stock option issued by a subsidiary*

An employee stock option issued by the subsidiary that qualifies for equity classification should be accounted for by the parent as noncontrolling interest (recorded as the option vests) totalling the grant date fair value based measure of the employee stock option. However, during the period the option is outstanding, the noncontrolling interest related to the option holder should not be attributed any profit or loss of the subsidiary. Even though a portion of the profit or loss is compensation expense related to the NCI, until the option is exercised, the noncontrolling interest related to the option is not an actual equity interest in the entity. Therefore, there is no attribution of profit or loss to the NCI.

If the option is exercised and the parent maintains control of the subsidiary, the change in the parent's ownership interest should be accounted for as an equity transaction. Upon exercise, the newly issued shares should be reported as noncontrolling interest equal to the noncontrolling interest holder's proportionate share of the parent's basis in the subsidiary's equity. Subsequent to exercise, the NCI would be attributed profit or loss of the subsidiary. Conversely, if the option expires, the parent should record a reduction in the noncontrolling interest and an increase to controlling equity/APIC for the parent's proportionate share of the carrying amount of the employee stock option [ASC 810-10-45-23; IFRS 10.23].

6.5.3 *Accounting for a transaction in which a noncontrolling interest in a wholly owned subsidiary is exchanged for a controlling interest in another entity*

If an entity exchanges a noncontrolling interest in its wholly owned subsidiary for an interest in an unrelated entity and the interest obtained in the unrelated entity is a controlling interest, the transaction is accounted for as a business combination. The acquiring entity would record 100% of the assets acquired and liabilities assumed of the acquired entity [ASC 805-20-25-1; IFRS 3.10]. As part of the business combination, the acquiring entity would also measure the noncontrolling interest held by the acquiree at its fair value [or at its proportionate share for IFRS companies who choose this option].

As discussed in section 6.5, changes in ownership interests that do not result in loss of control should be accounted for as equity transactions. Therefore, when an entity sells/exchanges a noncontrolling interest in its wholly owned subsidiary, it creates a noncontrolling interest in that subsidiary which should be accounted for as an equity transaction. The noncontrolling interest would be reflected at the noncontrolling interest's proportionate share of the net equity of the subsidiary, and no gain or loss would be recognised by the entity that relinquished the noncontrolling interest in its subsidiary. The acquiring entity's controlling interest in its existing subsidiary may need to be adjusted to reflect the change in ownership interest in the subsidiary.

The noncontrolling interest in the acquiring entity's consolidated financial statements would comprise the sum of the noncontrolling interest's share of the fair value [or proportionate share for IFRS companies who choose this option] in the acquired business and the noncontrolling interest's share in the proportionate interest of the net equity of the subsidiary exchanged in the transaction.

Example 6-19 illustrates this guidance.

EXAMPLE 6-19

Accounting for a transaction in which a noncontrolling interest in a subsidiary is exchanged for a controlling interest in another entity[1]

Company A enters into a venture with Company X where each company will contribute a subsidiary, each representing a business, into a NewCo in a series of planned and integrated transactions. Company A forms the NewCo and transfers an existing subsidiary (Subsidiary A) into the NewCo. NewCo then issues 46% of its common shares to Company X in return for 100% of Company X's subsidiary (Target). Company A maintains control of the NewCo with an ownership interest of 54%, and Company X owns 46%. Economically, this transaction is an exchange of 46% of Company A's interest in Subsidiary A for a 54% controlling interest in Target.

Fair and book values for Target and Subsidiary A are as follows:

Target fair value	CU690
Subsidiary A net equity	CU300
Subsidiary A fair value	CU810

[1] For U.S. GAAP companies and IFRS companies choosing the fair value method.

Analysis

Company A's interest in NewCo would be equal to the sum of (1) 54% of its historical cost of Subsidiary A plus (2) the fair value of 54% of Target (which is also equal to 46% of the fair value of Subsidiary A's business). Company A's retained interest in Subsidiary A's business is recorded at carryover basis. In Company A's consolidated financial statements, all of the assets and liabilities of Target would be recorded and measured in accordance with the Standards. The noncontrolling interest of Newco is the combination of the fair value of the noncontrolling interest in Target and the noncontrolling interest in the net equity of Subsidiary A's business.

Company A would record net assets acquired of CU690 (100% of Target's fair value) and noncontrolling interest of CU455 (46% of Target's fair value of CU690 plus 46% of the net equity of Subsidiary A of CU300).

Company A would record the following journal entry to account for the acquisition:

Target net assets acquired	CU690	
Noncontrolling interest		CU455
APIC—controlling interest		CU235[2]

[2] The change in ownership interest is calculated in accordance with ASC 810-10-45-23 as follows:

NewCo equity before acquisition of Target	CU300
NewCo equity issued to acquire Target	690
Total NewCo equity after acquisition of Target	CU990
Company A's ownership interest in NewCo after acquisition of Target	× 54%
Company A's investment in NewCo after acquisition of Target	CU535
Company A's investment in NewCo before acquisition of Target	(300)
Change in Company A's ownership interest in NewCo	CU235

6.5.4 Accumulated other comprehensive income considerations

Comprehensive income or loss is allocated to the controlling interest and the NCI each reporting period. Upon a change in a parent's ownership interest, the carrying amount of accumulated other comprehensive income (AOCI) is adjusted to reflect the change in the ownership interest in the subsidiary through a corresponding charge or credit to equity attributable to the parent [ASC 810-10-45-24; IFRS 10.B98]. AOCI is reallocated proportionately between the controlling interest and the NCI. For financial statement purposes, the line item titled "Accumulated Other Comprehensive Income" is generally attributed entirely to the controlling interests. AOCI related to the NCI is typically included in the NCI balance.

Changes in ownership interest that do not result in a change of control should be accounted for as equity transactions. Example 6-20 demonstrates the accounting for a reallocation of accumulated other comprehensive income upon a change in ownership that does not result in a change of control.

EXAMPLE 6-20

Reallocation of accumulated other comprehensive income

Company A owns 80% of a subsidiary. Company A acquires an additional 10% of the subsidiary (i.e., 50% of the NCI) for CU35 million in cash. The carrying value of the 20% NCI is CU50 million, which includes CU4 million of accumulated other comprehensive income.

Analysis

A change in ownership interests that does not result in a change of control is considered an equity transaction. The identifiable net assets remain unchanged, and any difference between the amount by which the NCI is adjusted and the fair value of the consideration paid is recognised directly in equity and attributed to the controlling interest [ASC 810-10-45-23; IFRS 10.B96].

The journal entry to record the acquisition of the 10% interest is as follows (in millions):

NCI	CU25[1]	
Equity/APIC	CU10[2]	
Cash		CU35[3]

[1] Elimination of the carrying value of the 10% NCI = CU50 x 50%. This adjustment effectively includes CU2 of accumulated other comprehensive income (CU4 x 50%).

[2] Consideration paid less the change in the carrying value of NCI = CU35 – CU25.

[3] Cash paid for the 10% interest acquired in the subsidiary.

Company A adjusts the carrying value of the accumulated other comprehensive income to reflect the change in ownership through an adjustment to equity (e.g., additional-paid-in capital) attributable to Company A.

Equity/APIC	CU2[4]	
Accumulated other comprehensive income		CU2[4]

[4] Reallocation of accumulated other comprehensive income to the controlling interest = CU4 x 50%.

6.5.4.1 *Accumulated other comprehensive income considerations when the parent disposes of a group of assets in a consolidated foreign entity*

A parent may sell a group of assets that constitute a business within a consolidated foreign entity while retaining ownership of the foreign entity. Alternatively, the group of assets may be sold directly by the foreign entity.

ASC 830-30 provides for the release of the cumulative translation adjustment (CTA) into earnings upon sale or upon complete or substantially complete liquidation of an investment in an entire foreign entity. ASC 810-10 requires a parent to deconsolidate a subsidiary, or derecognise a group of assets that is a business, including CTA, as of the date the parent ceases to have a controlling financial interest in that subsidiary or group of assets. Diversity in practice has developed as a result with regard to the release of CTA into earnings upon sale of a group of assets that is a business in a foreign entity. ASU 2013-05 clarifies that a parent should follow the guidance in ASC 830-30 and release CTA to earnings only when a disposal of a subsidiary or group of assets that constitutes a business within the foreign entity represents a complete or substantially complete liquidation of the foreign entity. The determination of what constitutes a foreign entity is based on the definition found in ASC 830. However, transactions impacting the investment *in* the foreign entity may result in full or partial release of CTA even though complete or substantially complete liquidation of the foreign entity has not occurred.Under IFRS, a parent must reclassify to profit and loss the proportionate share of the cumulative amount of exchange differences recognised in other comprehensive income upon loss of control of a foreign operation through an entire or partial disposal of an interest in a subsidiary [IAS 21.48]. The loss of control provisions of IFRS 10 apply to a group of assets that constitute a business if it is considered to be a foreign operation, as well as to the loss of control of a subsidiary. See BCG 6.6.2 for further information.

Example 6-21 demonstrates the accounting for CTA in a foreign entity under IFRS as well as ASC 830-30 and ASU 2013-05 when a group of assets which qualifies as a business is disposed.

EXAMPLE 6-21

Disposal of a portion of a foreign entity—release of CTA in a foreign entity into earnings

Company A owns 100% of two branches (X and Y). Branch X and Y are individual businesses with different functional currencies and are reported to Company A separately and translated directly into Company A's group consolidation.

Company A's carrying amount of branch X is CU20 exclusive of a credit balance of CU 2 for CTA related to branch X. Company A disposes of branch X for CU24 in cash, which is remitted to Company A.

Analysis

Under both U.S. GAAP and IFRS, a gain is recognized on the disposal of the business for the amount received that is greater than the carrying amount of the business [ASC 360-10-40-5; IAS 16.67-68]. Under ASC 830-30 and ASU 2013-05, as the disposal of the business represents a complete liquidation of the foreign entity, CTA should be released into earnings. Under IAS 21.48, the CTA related to branch X should be released into profit and loss as the branch is a separate foreign operation.

Company A's journal entry to record the disposal of the branch X follows (in millions):

	Dr	Cr
Cash	CU24[1]	
Accumulated other comprehensive income	CU 2[2]	
Disposal group of assets		CU20[3]
Gain on disposal of net assets		CU 6[4]

[1] Cash received for the group of assets disposed of.

[2] CTA attributable to branch X.

[3] Carrying amount of disposal group of assets that constitutes a business, exclusive of CTA.

[4] Sum of the gain on disposal of the group assets (CU24 – CU20 = CU4) and the portion of CTA released into earnings (CU2).

Under U.S. GAAP, if branch X and Y had the same functional currency and therefore considered a single foreign entity based on ASC 830-30 and ASU 2013-05, the disposal of the business would not represent a complete or substantially complete liquidation of the foreign entity (assuming each branch is approximately the same size), as such, no CTA would be released into earnings.

6.5.5 Acquisition of a noncontrolling interest through a business combination

A change in a parent's ownership interest in an entity where control is maintained is accounted for as an equity transaction [ASC 810-10-45-23; IAS27.30-31]. When an additional noncontrolling interest is obtained indirectly through the acquisition of a controlling interest in another entity, which owns the noncontrolling interest, the transaction should be accounted for as two separate transactions.

Example 6-22 demonstrates the accounting for the acquisition of a controlling interest in an entity and indirectly obtaining an additional interest in a controlled entity.

EXAMPLE 6-22

Acquisition of additional noncontrolling interest through a business combination

Company A owns a 90% controlling interest in Subsidiary B. Company C holds the 10% noncontrolling interest with a carrying value of CU70 million in Company A's consolidated financial statements and a fair value of CU100 million. Company A acquires Company C in a business combination for CU1,000 million, which includes the indirect acquisition of the noncontrolling interest in Subsidiary B for CU100 million.

Analysis

The accounting for the acquisition of Company C and the acquisition of the noncontrolling interest in Subsidiary B should be treated as separate transactions. The consideration transferred would be allocated between the business acquired and the purchase of the noncontrolling interest based on their fair values. The fair value of the consideration transferred would be allocated to the fair value of the acquired business of CU900 million and the fair value of the noncontrolling interest in Subsidiary B of CU100 million [ASC 805-50-30-3; IAS 16.24].

Through this transaction, Company A obtained an additional interest in and maintained control of Subsidiary B. A change in ownership interest that does not result in a change of control is considered an equity transaction. The identifiable net assets of Subsidiary B remain unchanged and the CU30 million excess amount paid over the carrying amount of the noncontrolling interest in Subsidiary B in Company A's financial statements is recorded in equity [ASC 810-10-45-23; IFRS 10.23].

Company A also recognises and measures the other identifiable assets acquired and liabilities assumed of Company C at the acquisition date in accordance with the Standards, generally at fair value. In this example, it is assumed that there is no excess between the net value of the assets and liabilities acquired and the consideration paid that would need to be recorded as goodwill or shortfall that would be recorded as a bargain purchase gain.

Company A would record the following journal entry to account for the transaction (in millions):

Identifiable net assets of Company C	CU900[1]	
Noncontrolling interest of Subsidiary B	CU70[2]	
Equity/APIC	CU30[3]	
Cash		CU1,000[4]

[1] The value of 100% of the identifiable net assets of Company C is recorded, as measured in accordance with the standards.

[2] Elimination of the carrying value of the 10% NCI on Company A's books.

[3] Difference in NCI: consideration paid less the carrying value of NCI = (CU100 – CU70).

[4] Cash paid for the 100% interest in Company C.

6.5.6 *Acquisition of additional ownership interests in a variable interest entity—U.S. GAAP*

After initial measurement, the assets, liabilities, and the NCI of a consolidated VIE will be accounted for in the consolidated financial statements as if the entity were consolidated based on voting interests [ASC 810-10-35-3]. A primary beneficiary's acquisition or disposal of additional ownership interests in the VIE (while remaining the primary beneficiary) is accounted for in the same manner as the acquisition or disposal of additional ownership interests (where control is maintained) in a voting interest entity. See BCG 6.5 for further information. Therefore, subsequent acquisitions or sales of additional ownership interests by the primary beneficiary that do not result in a change in the primary beneficiary are accounted for as equity transactions.

A primary beneficiary's acquisition or disposal of additional ownership interests is a reconsideration event that requires a reassessment of whether the entity is a VIE and whether the party designated as the primary beneficiary has changed, because the accounting as described above is applicable only if the primary beneficiary remains the same (i.e., control is maintained).

The carrying amount of the NCI is adjusted to reflect the primary beneficiary's change in interest in the VIE's net assets. Any difference between the amount by which the NCI is adjusted and the fair value of the consideration transferred is recognised in equity (APIC) and attributed to the equity holders of the primary beneficiary.

6.6 Changes in interest resulting in a loss of control

The loss of control of a subsidiary, other than in a nonreciprocal transfer to **owners**, results in the recognition of a gain or loss on the sale of the interest sold and on the revaluation of any retained noncontrolling investment. A loss of control is an economic event, similar to that of gaining control, and therefore is a remeasurement event.

Events resulting in deconsolidation of a subsidiary include the following:

- A parent sells all or part of its ownership interest in its subsidiary, thereby losing its controlling financial interest in its subsidiary
- A contractual agreement that gave control of the subsidiary to the parent expires
- The subsidiary issues shares, thereby reducing the parent's ownership interest in the subsidiary so that the parent no longer has a controlling financial interest in the subsidiary
- The subsidiary becomes subject to the control of a government, court, administrator, or regulator [ASC 810-10-55-4A; IFRS 10.B37]

Question 6-1

When should a parent company, which is not in bankruptcy, deconsolidate a subsidiary that has filed for bankruptcy?

PwC response

A parent deconsolidates a subsidiary as of the date the parent no longer has control of the subsidiary [ASC 810-10-40-4; IFRS 10.B37]. Examples of events that result in deconsolidation of a subsidiary include when a subsidiary becomes subject to the control of a government, court, administrator, or regulator. Normally, once a subsidiary files for bankruptcy protection, a parent no longer has control over the subsidiary (as the bankruptcy court must approve all significant actions), and the subsidiary should be deconsolidated on that date.

6.6.1 Loss of control—U.S. GAAP

The guidance in ASC 810-10 generally applies both to the loss of control of a subsidiary that is a business, and also to the loss of control of a group of assets that constitute a business (i.e. an unincorporated division which meets the definition of a business). This includes transfers of a business to an equity-method investee or joint venture. Sales of in substance real estate and conveyances of oil and gas mineral rights that are subject to specific industry guidance are outside the scope of ASC 810-10.

In December 2011, the FASB issued ASU 2011-10, *Derecognition of in Substance Real Estate—a Scope Clarification* (ASU 2011-10), which updated the guidance in ASC 810-10 and ASC 360-20. ASU 2011-10 clarifies that a parent should follow specific industry guidance when it ceases to have a controlling financial interest in a subsidiary that is in substance real estate as a result of a default on the subsidiary's nonrecourse debt. Generally, a parent would continue to consolidate the subsidiary until legal title to the real estate is transferred, to legally satisfy the debt even if the parent ceases to have a controlling financial interest under ASC 810-10 at an earlier date.

This ASU is to be applied prospectively for public companies for fiscal years and interim periods within those years beginning on or after June 15, 2012, and for non public entities for fiscal years ending after December 15, 2013, with early adoption permitted.

The definition of a subsidiary under U.S. GAAP includes unincorporated entities. If a decrease in ownership occurs in a subsidiary that is not a business, an entity first needs to consider whether the substance of the transaction causing the decrease in ownership is addressed in other authoritative guidance. If no other guidance exists, an entity should apply the guidance in ASC 810-10.

6.6.2 Loss of control—IFRS

The definition of a subsidiary under IFRS includes legal entities and those that are unincorporated (i.e., unincorporated division). Therefore, the loss of control provisions of IFRS 10 apply to a group of assets that constitute a business, as well as to the loss of control of a subsidiary. IFRS 10 is silent as to whether a subsidiary must also be a business. We believe that the loss of control of a legal entity that is not a business is not accounted for under IFRS 10, but rather under the IFRS that would apply to the underlying assets and liabilities.

Further, there are no exclusions from the scope of IFRS 10 related to sales of in substance real estate or conveyances of oil and gas mineral rights.

6.6.3 Accounting for changes in interest if control is lost

If a parent loses control of a subsidiary through means other than a nonreciprocal transfer to owners, it:

- Derecognises the assets (including an appropriate allocation of goodwill) and liabilities of the subsidiary at their carrying amounts at the date control is lost

- Derecognises the carrying amount of any NCI at the date control is lost (including any components of accumulated other comprehensive income attributable to it)

- Recognises the fair value of the proceeds from the transaction, event, or circumstances that resulted in the loss of control

- Recognises any noncontrolling investment retained in the former subsidiary at its fair value at the date control is lost

- Reclassifies to income [profit or loss], or transfers directly to retained earnings if required, in accordance with other U.S. GAAP [IFRS], the amounts recognised in other comprehensive income in relation to that subsidiary

- Recognises any resulting difference as a gain or loss in income [profit or loss] attributable to the parent

The gain or loss is calculated as the difference between:

- The aggregate of:

  - The fair value of the consideration transferred

  - The fair value of any retained noncontrolling investment in the former subsidiary on the date the subsidiary is deconsolidated

  - The carrying amount of any noncontrolling interest in the former subsidiary (including any accumulated other comprehensive income or loss attributable to the NCI) on the date the subsidiary is deconsolidated

- The carrying amount of the former subsidiary's net assets [ASC 810-10-40-5; IFRS 10.25]

The calculation outlined above results in an amount that includes the gain or loss for both the interest sold and the noncontrolling investment retained. However, the NCI Standards require a parent to separately disclose the total gain or loss and the portion of the gain or loss related to the retained noncontrolling investment [ASC 810-10-50-1B; IFRS 12.19]. To obtain the information necessary for disclosure, a second calculation of the portion related to the gain or loss on the retained noncontrolling investment is necessary.

It is also important to identify any gains or losses deferred in accumulated other comprehensive income attributable to the subsidiary. The cumulative amount deferred in other comprehensive income related to that subsidiary is considered part of the carrying amount of the subsidiary and is included in determining the gain or loss on the interest sold and the retained noncontrolling investment [FAS 160.B53]. This includes the parent's and the NCI's share of gains or losses previously recognised in other comprehensive income on foreign exchange differences, cash flow hedges, and other individual assets and liabilities (e.g., available-for-sale financial assets).

Amounts recognized in equity (outside of other comprehensive income) related to changes in ownership interests that did not result in a change in control should not be included in determining the gain or loss on the interest sold and the retained noncontrolling investment. These amounts resulted from transactions among shareholders and are not directly attributable to the NCI. Additionally, under IFRS, amounts recognized in equity for revaluation of assets should not be included in determining the gain or loss on the interest sold and the retained noncontrolling investment. For example, IFRS companies may have recognised gains or losses on the revaluation of fixed and **intangible assets**. These amounts are reclassified from reserves directly to retained earnings and do not form part of the gain or loss recognised.

The effect of applying the steps above when a subsidiary is partially owned prior to the loss of control is that the noncontrolling interests held by third parties are not revalued to fair value. As part of the deconsolidation of the subsidiary, the carrying value of the NCI's portion of the subsidiary's net assets is derecognised against the carrying amount of the NCI, with no gain or loss.

Typically, impairment tests for goodwill and long-lived assets (**asset group**) are needed when a parent expects that it will sell or lose control of a subsidiary (ASC 350-20 and ASC 360-10; IAS 36 and IFRS 5). If the goodwill or long-lived assets (asset group) is impaired, the impairment loss should be recognised in earnings [profit or loss] [IFRS 10.BCZ180].

Examples 6-23 and 6-24 demonstrate the accounting for a change in interest when control is lost.

EXAMPLE 6-23

Accounting for changes in interest of a wholly owned subsidiary if control is lost

Company A owns 100% of a subsidiary. Company A disposes of 60% of its interest in the subsidiary for CU360 million, and loses control of the subsidiary. At the disposal date, the fair value of the retained noncontrolling investment is determined to be CU240 million. The carrying value of the identifiable net assets is CU440 million, excluding goodwill. There is CU60 million of goodwill recorded related to the previously acquired interests in the subsidiary. Company A tested the goodwill and long-lived assets of the subsidiary prior to disposal and there was no impairment. (For illustrative purposes, the tax consequences on the gain have been ignored.)

Analysis

Company A:

- Derecognises the assets (including an appropriate allocation of goodwill) and liabilities of the subsidiary at their carrying amounts

- Derecognises the carrying amount of any NCI (including any components of accumulated other comprehensive income attributable to the NCI)

- Recognises the fair value of the proceeds
- Recognises any retained noncontrolling investment in the former subsidiary at its fair value
- Reclassifies to income [profit or loss], or transfers directly to retained earnings if required/permitted in accordance with other U.S. GAAP [IFRS], the amounts recognised in other comprehensive income in relation to that subsidiary
- Recognises any resulting difference as a gain or loss in income [profit or loss] attributable to the parent [ASC 810-10-40-5; IFRS 10.25]

The journal entry recorded on the disposal date for the 60% interest sold, the gain recognised on the 40% retained noncontrolling investment, and the derecognition of the subsidiary is as follows (in millions):

Cash	CU360[1]	
Equity-method investment	CU240[2]	
Net assets		CU500[3]
Gain on investment		CU100[4]

[1] Cash received for the 60% interest sold.

[2] Fair value of the 40% retained noncontrolling investment is recognised.

[3] Deconsolidation of the subsidiary and removal of 100% of carrying value of the subsidiary's net assets, including an appropriately allocated portion of previously recorded goodwill.

[4] Gain or loss on the interest sold and the retained noncontrolling investment is recognised in earnings [profit or loss]; calculated as follows:

Fair value of consideration	CU360
Fair value of retained noncontrolling investment	240
Carrying value of NCI	n/a*
Subtotal	600
Less: carrying value of former subsidiary's net assets (CU440 net assets excluding goodwill + CU60 goodwill)	(500)
Gain on interest sold and retained noncontrolling investment	CU100

*Not applicable in this example.

The CU100 million gain on the interest sold and the retained noncontrolling investment is recognised in earnings [profit or loss] and is disclosed in the financial statements. Additionally, the NCI Standards require the disclosure of the portion of the gain or loss related to the remeasurement of the retained noncontrolling investment to fair value. This amount is calculated as follows (in millions):

Fair value of retained noncontrolling investment	CU240
Percentage retained of carrying value of subsidiary ((CU440 + CU60) x 40%)	(200)
Gain on retained noncontrolling investment	CU40

EXAMPLE 6-24

Accounting for changes in interest if control is lost—accounting for changes in interest of a partially owned subsidiary if control is lost

Company B owns 80% of a subsidiary. Company B disposes of 50% of the subsidiary for CU300 million, and loses control of the subsidiary. Company B will deconsolidate the subsidiary and account for the remaining 30% interest as an equity-method investment. At the disposal date, the fair value of the retained noncontrolling investment is determined to be CU180 million. The carrying value of the identifiable net assets is CU440 million and there is no goodwill. The carrying value of the 20% noncontrolling interests held by third parties prior to the transaction is CU88 million. (For illustrative purposes, the tax consequences on the gain have been ignored.)

Analysis

Company B:

- Derecognises the assets and liabilities of the subsidiary at their carrying amounts
- Derecognises the carrying amount of any NCI (including any components of accumulated other comprehensive income attributable to the NCI)
- Recognises the fair value of the proceeds
- Recognises any retained noncontrolling investment in the former subsidiary at its fair value
- Reclassifies to income [profit or loss], or transfers directly to retained earnings if required/permitted in accordance with other U.S. GAAP [IFRS], the amounts recognised in other comprehensive income in relation to that subsidiary
- Recognises any resulting difference as a gain or loss in income [profit or loss] attributable to the parent [ASC 810-10-40-5; IFRS 10.25]

The journal entry recorded on the disposal date for the 50% interest sold, the gain recognised on the 30% retained noncontrolling investment, and the derecognition of the subsidiary are as follows (in millions):

Cash	CU300[1]	
Equity-method investment	CU180[2]	
NCI	CU 88[3]	
Net assets		CU440[4]
Gain on investment		CU128[5]

[1] Cash received for the 50% interest sold.

[2] Fair value of the 30% retained noncontrolling investment is recognised.

[3] Derecognition of the carrying value of the NCI.

[4] Deconsolidation of the subsidiary and removal of the carrying value of the subsidiary's net assets.

[5] Gain or loss on the interest sold and the retained noncontrolling investment is recognised in the income statement; calculated as follows:

Fair value of consideration	CU300
Fair value of retained noncontrolling investment	180
Carrying value of NCI	88
Subtotal	568
Less: carrying value of former subsidiary's net assets	(440)
Gain on interest sold and retained noncontrolling investment	CU128

The CU128 million gain on the interest sold and the retained noncontrolling investment is recognised in earnings [profit or loss] and is disclosed in the financial statements. Additionally, the NCI Standards require the disclosure of the portion of the gain or loss related to the remeasurement of the retained noncontrolling investment to fair value. This amount is calculated as follows (in millions):

Fair value of retained noncontrolling investment	CU180
Percentage retained of carrying value of subsidiary (CU440 x 30%)	(132)
Gain on retained noncontrolling investment	CU 48

Question 6-2

Should a parent company, which is not in bankruptcy and has a negative investment in a subsidiary, recognise a gain upon the subsidiary's filing for bankruptcy?

PwC response

Following the guidance in ASC 810-10 and IFRS 10, a parent would derecognise the negative investment and determine the amount of gain or loss to recognise on the date of the bankruptcy filing. The parent should consider the fair value of its retained investment when making this determination. This includes consideration of whether it needs to separately recognise any obligations related to its ownership of the subsidiary, which would reduce the gain or increase the loss on deconsolidation (e.g., the parent has guaranteed, or the court will hold the parent liable for, certain obligations of the subsidiary).

Question 6-3

Is there a difference between (1) the gain recognised when an entity sells 100 percent of a consolidated subsidiary's shares to an equity-method investee and (2) the gain recognised when an entity sells shares of a consolidated subsidiary to an unrelated party but retains an equity interest in the former subsidiary?

PwC response

The two transactions are substantively similar and the accounting result should be similar. This is best understood by analysing the following two scenarios. Assume a parent company owns 30% of Investee A and 100% of Subsidiary B. In one scenario, Parent sells 100% of Subsidiary B to Investee A. Investee A pays cash for 100% of Subsidiary B. Parent indirectly retains a 30% interest in Subsidiary B through its equity holding of Investee A. In another scenario, Parent sells 70% of Subsidiary B to an unrelated third party. In the first scenario, one could argue that a gain should be recognised on only the 70% interest in Subsidiary B that was not retained by Parent. However, even though Parent retains its 30% interest in Investee A, which now owns 100% of Subsidiary B, the Parent would recognise a gain or loss on the sale of the 100% interest sold in Subsidiary B, as there has been a change of control. In the second scenario, the Parent would recognise a gain or loss on the sale of the 70% interest sold, and a gain or loss on the remeasurement of the retained 30% noncontrolling investment in Subsidiary B. As a result, under both scenarios, the gain will be recognised upon the deconsolidation of a subsidiary in accordance with the guidance in ASC 810-10/IFRS 10. Assuming similar facts and circumstances in the scenarios, an equal gain would result.

6.6.4 Retained noncontrolling investment

The retained noncontrolling investment includes the retained equity investment in the subsidiary upon deconsolidation. There may be other interests retained by the investor (parent) in the investee (subsidiary), such as a preferred share investment, debt investment, or other contractual arrangements (e.g., off-market lease contracts) that may need to be considered by the parent company in determining the amount of gain or loss to be recognised upon deconsolidation of the subsidiary. Example 6-25 illustrates this guidance.

EXAMPLE 6-25

Determining the amount of gain or loss to be recognised upon the sale of a controlling interest in a subsidiary

Company A owns 100% of Subsidiary B. Subsidiary B rents an office building from Company A at a nominal cost (i.e., below market rental rate). Company A sells 60% of its ownership in Subsidiary B to an unrelated third party. The lease contract remains unchanged after the sale. Company A deconsolidates Subsidiary B on the sale date.

Analysis

In determining the amount of gain or loss upon deconsolidation of Subsidiary B, Company A should determine what portion of the consideration received from the buyer relates to compensation for Company A continuing to rent to Company D under its unfavourable lease contract, versus consideration for the sale of the 60% ownership in Subsidiary B. The amount ascribed to the off-market lease contract should be recorded at fair value on the balance sheet. This reduces the consideration attributed to the deconsolidation of Subsidiary B and therefore reduces the gain recognised by Company A.

6.6.5 Nonreciprocal transfer to owners

If a U.S. GAAP company loses control of a subsidiary through a nonreciprocal transfer to owners (i.e., distribution of a business to owners in a spin-off), ASC 810-10's guidance for measuring the gain or loss will not apply to the transferred portion [ASC 810-10-40-5]. Rather, the transferred portion will be accounted for under ASC 845, *Nonmonetary Transactions*, specifically ASC 845-10-30-10. Under this guidance, the nonmonetary assets, which meet the definition of a business as discussed in ASC 805-10-20, distributed in the nonreciprocal transfer will be recorded at their carrying value, adjusted for any impairment. If the portion is transferred (1) through a spin-off or other form of reorganisation or liquidation, or (2) under a plan that is, in substance, the rescission of a prior business combination, the distribution should be recorded based on the carrying amount of the nonmonetary assets. This guidance is also applicable to distributions to shareholders of an investee being accounted for under the equity method. Depending upon facts and circumstances, other nonreciprocal transfers of nonmonetary assets to owners may be accounted for at fair value.

A nonreciprocal transfer to owners under IFRS is recorded at the fair value of the net assets to be distributed. The difference between the fair value of the net assets distributed and the carrying amount of the net assets is recorded in profit or loss in accordance with IFRIC 17, *Distributions of Non-cash Assets to Owners* (IFRIC 17). The scope of IFRIC 17 is narrow and applies only to distributions where all owners in the same class of equity are treated equally and to distributions that result in a change in control over the assets distributed. There is no specific guidance under IFRS for transactions outside of the scope of IFRIC 17. Current practice is to use predecessor basis.

6.6.6 Multiple transactions or agreements that result in loss of control

Sometimes a company may lose control of a subsidiary as a result of two or more transactions (e.g., sale of 40 percent of the subsidiary and a second sale of 20 percent of the subsidiary shortly thereafter). Circumstances sometimes indicate that multiple arrangements should be accounted for as a single transaction. In determining whether to account for arrangements as a single transaction, the terms and conditions of the arrangements and their economic effects should be considered [ASC 810-10-40-6; IFRS 10.B97]. If multiple transactions resulting in a loss of control are considered separate transactions, then each transaction should be accounted for separately in accordance with its nature. The transactions that do not result in a loss of control are accounted for as equity transactions and any differences between the amount received and the carrying value of the NCI on these transactions should be recorded in equity and not in the income statement. If a transaction results in a loss of control, it should be recognised in earnings, along with the related gain or loss on the final transaction (including the revalued amount of any retained noncontrolling investment).

Sometimes a company may determine that multiple transactions should be considered as a single transaction that resulted in a loss of control. In these cases, the gains and losses on all of the transactions (including the revaluation of any retained noncontrolling investment) should be recognised in earnings [profit or loss].

The existence of one or more of the following indicators may signal that multiple arrangements should be treated as a single arrangement:

- The arrangements are entered into at the same time or in contemplation of each other.
- The arrangements form a single transaction designed to achieve an overall commercial effect.
- The occurrence of one arrangement is dependent on the occurrence of at least one other arrangement.
- One arrangement considered on its own is not economically justified, but it is economically justified when considered together with other arrangements. An example is when one disposal of shares is priced below market and is compensated for by a subsequent disposal priced above market [ASC 810-10-40-6; IFRS 10.B97].

6.6.6.1 Multiple transactions or agreements that result in gaining control

Sometimes a company may gain control of a business as a result of two or more transactions (e.g., purchase of 40 percent of a business and a second purchase of 20 percent of the business shortly thereafter). The same principles discussed in BCG 6.6.6 for a loss of control may be applied for gaining control of a business in multiple transactions. Companies may consider the factors included in BCG 6.6.6 to assess whether a series of transactions that results in gaining control should be considered as a single transaction.

6.7 Attribution of net income and comprehensive income to controlling and noncontrolling interests

Net income or loss and comprehensive income or loss are attributed to the controlling and noncontrolling interests. The NCI Standards do not specify any particular method for attributing earnings between the controlling interest and the noncontrolling interest [ASC 810-10-45-20; IFRS 10.B94].

If there are contractual arrangements that determine the attribution of earnings, such as a profit-sharing agreement, the attribution specified by the arrangement should be considered if it is determined to be substantive. If there are no such contractual arrangements, the relative ownership interests in the entity should be used if the parent's ownership and the NCI's ownership in the assets and liabilities are proportional. For example, if the controlling interest owns 60 percent of Company A and the NCI owns 40 percent, then 60 percent of the earnings should be allocated to the controlling interest and 40 percent to the NCI. If, however, the parties have a contractual arrangement specifying a 50/50 split of the earnings, 50 percent of the earnings should be allocated to the controlling interest and 50 percent to the NCI, provided the contractual arrangement is substantive.

In some instances, agreements may designate different splits among the parties of profit and loss for financial reporting, taxable profit and loss, distributions of cash from operations, and distributions of cash proceeds on liquidation. And one or more of the splits may change with the lapse of time or the occurrence of specified events. In such circumstances, the accounting for a party's equity in earnings must be considered with care, including the possibility that the split of profit and loss specified in the agreement may be solely for tax purposes or that it may not be substantive.

Furthermore, for U.S. GAAP companies, the parent's and the NCI's relative carrying values in particular assets and liabilities may not be proportional to their relative ownership interests. For example, if an entity acquired 80 percent of the ownership interests in a subsidiary in a single transaction before the effective date of ASC 805, the intangible assets that it recognised in the acquisition would likely have been recorded at 80 percent of their fair value (80 percent fair value for the ownership interest acquired plus 20 percent carryover value for the interest not acquired, which for previously unrecognised intangible assets would have been zero). In this case all of the amortisation expense for previously unrecognised intangible assets would be allocated to the parent's interest [FAS 160.B38].

6.7.1 Attribution of losses to noncontrolling interests in excess of carrying amount of noncontrolling interests

All earnings and losses of a subsidiary should be attributed to the parent and the NCI based on their relative ownership interests in the absence of explicit agreements that designate different splits among the parties. Losses should continue to be attributed to the NCI even if that results in a debit balance in shareholders' equity [ASC 810-10-45-21; IFRS 10.B94].

If prior to adoption of the NCI Standards, a company had stopped attributing losses to the NCI because the losses exceeded the carrying amount of the NCI, upon adoption of the NCI Standards, the company will prospectively attribute losses to the NCI. However, the company should not revise its prior consolidated net income to deduct losses that were attributed to it because the losses exceed the NCI's carrying amount. Rather, on the date of adoption, the NCI should reflect the previous carrying amount for minority interest (i.e., zero). Earnings or losses after that date should be attributed to the NCI. See BCG 2.13 for further information on transition issues.

6.7.2 Attribution of other items to noncontrolling interests in excess of carrying amount of noncontrolling interests

The NCI is considered part of the equity of the consolidated group under the Standards. It participates in both the risk and rewards of ownership in a subsidiary. Therefore, other items, such as an excess distribution, can also result in a debit balance of the NCI.

For example, appreciated property in a real estate subsidiary may be refinanced, and the proceeds from the refinancing are distributed to the owners of the subsidiary. Under the Standards, attributing distributions to the NCI in excess of the carrying amount is consistent with the view that the NCI represents an equity interest in the consolidated group.

6.8 Recognition of gain or loss by investor in a joint venture—IFRS

The new and revised standards on consolidation and joint arrangements (IFRS 10, 11, IAS 27 (2011), IAS 28 (2011)) do not change the fundamental accounting for joint ventures. There is, however, an apparent conflict between IFRS 10 and IAS 28 (2011). Under IAS 28 (2011), gains or losses on the contribution to a joint venture are recognised in income by the investor only to the extent of the equity interest of other investors at the time of the contribution to the joint venture. However, following the guidance in IFRS 10, gains or losses would be recognised in income by the investor for the full amount of the business contributed. IFRS 11 did not resolve this apparent conflict. We believe that presently both approaches are acceptable to account for the contribution of a business to a joint venture.

In December 2012, the IASB issued an exposure draft proposing amendments to IFRS 10 and IAS 28 (2011) to eliminate the apparent conflict. The final amendments, which are expected to be issued by the IASB during 2014, will require the full gain or loss to be recognized when resulting from the sale or contribution of assets that constitute a business, as defined in IFRS 3, by an investor to a joint venture.

6.9 Accounting for transaction costs associated with sale or purchase of noncontrolling interest

Transaction costs associated with the purchase or sale of a noncontrolling interest in a subsidiary when control is maintained is similar to a treasury stock or capital raising transaction, and is accounted for as an equity transaction [ASC 810-10-45-23; IFRS 10.23]. When an entity reacquires its own equity instruments, consideration paid is recognised in equity and transaction costs are accounted for as a deduction from equity [ASC 505-30-30-7; IAS 32.33,35]. Additionally, incremental and directly attributable costs to issue equity instruments are accounted for as a deduction from equity [ASC 340-10-S99-1; IAS 32.37].

The transaction costs that should be recognised as a deduction from equity are only incremental costs directly attributable to the equity transaction. The remaining transaction costs (e.g., general administrative costs) should be expensed as incurred.

Under U.S. GAAP, we understand that the SEC has allowed companies to elect an accounting policy to record all transaction costs as an expense in the statement of operations by analogy to the treatment of transaction costs in a business combination.

6.10 Earnings per share considerations

Companies are required to present basic and diluted EPS on the face of the income statement [ASC 260-10-45-2; IAS 33.66]. Because net income [profit or loss] includes both income [profit or loss] attributable to the parent and the noncontrolling interest, a determination of the numerator for the calculation of EPS (i.e., income [profit or loss] available to common shareholders) will require an adjustment to exclude from net income [profit or loss] any earnings [profit or loss] attributable to the noncontrolling interest [ASC 260-10-45-11A; IAS 33.10].

Adjustments to equity resulting from transactions with the noncontrolling interest that do not result in a change of control are generally not included in the computation of net income [profit or loss] attributable to the parent. While there may be others, one exception is if noncontrolling interest in the parent company's consolidated balance sheet is in the form of subsidiary preferred stock. In such circumstance, ASC 810-10-40-2 and IAS 33.12 require a parent company to reflect dividends relating to such preferred stock as an allocation of net income. Accordingly, net income [profit or loss] would not be reduced by dividends on the preferred stock, but net income [profit or loss] attributable to parent (which is the starting point of the numerator for EPS purposes) would be reduced by the dividend amount. In addition, purchase of noncontrolling interest in the form of subsidiary preferred stock at an amount that is different than the carrying amount of the preferred stock should be treated akin to a dividend and therefore impact net income [profit or loss] attributable to parent in calculating EPS.

A company may report a discontinued operation, extraordinary item, or the cumulative effect of a change in accounting principle. In such cases, the numerator that serves as the basis for determining whether the potential common shares are dilutive or antidilutive to EPS is income from continuing operations attributable to the parent [ASC 260-10-45-18; IAS 33.42].

For U.S. GAAP companies, the guidance in ASC 260-10-S99-2 should be applied to the calculation of EPS in an initial public offering (IPO) or when a reporting period includes the redemption or induced conversion of preferred stock.

6.11 Required disclosures and supplemental schedule

Companies must disclose a reconciliation of the carrying amount of equity at the beginning of the period and the end of the period for each of total equity, equity attributable to the parent, and equity attributable to the NCI. The reconciliation discloses separately the changes resulting from (1) net income or loss [profit or loss], (2) transactions with equity holders acting in their capacity as owners, showing separately contributions from and distributions to equity holders, and (3) each component of other comprehensive income. This disclosure must appear either on the face of the statement of changes in equity or in the notes to the consolidated financial statements [ASC 810-10-50-1A; IAS 1.106].

Additionally, companies are required to provide a supplemental schedule in the notes to the consolidated financial statements. The schedule must show the effects of any transactions with the NCI on the equity attributable to the parent for each period that any income statement is presented [ASC 810-10-50-1A; IFRS 12.18]. See FSP 5 or an example of the supplemental schedule.

6.12 Classification of financial instruments as noncontrolling interest

Figures 6-2 and 6-3 below summarise the accounting and reporting for financial instruments issued to third parties by a subsidiary. They do not reflect all possible scenarios or contain all possible financial instruments that may be issued. Additionally, the classification of the financial instruments may change if they are issued by the parent rather than the subsidiary.

Figure 6-2
Accounting and reporting for financial instruments issued to third parties by a subsidiary—U.S. GAAP

Financial instrument issued to third parties by the subsidiary or written by third parties on the subsidiary's shares	**Accounting classification at the subsidiary level**	**Parent classification in consolidation under ASC 810-10**
Common shares issued by the subsidiary	Equity	Noncontrolling interest
Perpetual preferred shares issued by the subsidiary	Equity	Noncontrolling interest
Redeemable preferred shares and redeemable common shares issued by the subsidiary which are redeemable at maturity date or are puttable for cash or other assets at a fixed or determinable date or upon an event that is outside the control of the issuer (The redemption feature is embedded).	Liability, mezzanine, or equity [ASC 480, ASC 480-10-S99].	**Public company:** **Liability:** If it is classified as a liability by the subsidiary, then it would continue to be a liability. **Mezzanine (under ASC 480-10-S99 in U.S. GAAP):** If it is classified as mezzanine by the subsidiary, it would be a noncontrolling interest, classified as mezzanine. **Non-public company:** **Liability:** If it is classified as a liability by the subsidiary, then it would continue to be a liability. **Equity**: If it is classified as permanent equity by the subsidiary, it would be a noncontrolling interest. Some non-public companies may also have accounting policies that are consistent with mezzanine classification under ASC 480-10-S99.

Financial instrument issued to third parties by the subsidiary or written by third parties on the subsidiary's shares	Accounting classification at the subsidiary level	Parent classification in consolidation under ASC 810-10
Conversion option (on a convertible bond) that is required to be separately accounted for by ASC 815 or ASC 470-20, issued by the subsidiary	Liability or equity. [ASC 815, ASC 480, ASC 470-20, ASC 815-40-15-5C]	**Liability:** If it is classified as a liability by the subsidiary, then it would continue to be a liability. **Mezzanine (under ASC 480-10-S99 in U.S. GAAP):** If it is classified as mezzanine by the subsidiary, it would be a noncontrolling interest, classified as mezzanine. **Equity:** If it is classified as permanent equity by the subsidiary, it would be a noncontrolling interest, classified as equity.
(1) Freestanding written call option on subsidiary's own common shares, (2) warrants or options issued by the subsidiary for goods and services (to non-employees) on the subsidiary's own common shares, (3) detachable warrants on the subsidiary's own common shares issued with debt and (4) employee stock options.	(1) Liability or equity [ASC 815, ASC 480, ASC 815-40-15-5C] (2) Liability or equity [ASC 815, ASC 505-50] (3) Liability or equity [ASC 815, ASC 480] (4) Liability or equity [ASC 718, ASC 505-50]	**Applicable to all four scenarios** **Liability:** If it is classified as a liability by the subsidiary, then it would continue to be a liability. **Equity:** If it is classified as permanent equity by the subsidiary, it would be a noncontrolling interest. ASC 810-10 addresses the prior mixed practice in U.S. GAAP by clarifying that all equity instruments of the subsidiary (not held by the parent) are noncontrolling interests.
Freestanding written put option on the subsidiary's own common shares	Liability. [ASC 480]	The instrument would be classified as a liability.
Freestanding purchased call option on the subsidiary's own common shares	Asset or equity. [ASC 815, ASC 480, ASC 815-40-15-5C]	**Asset:** If it is classified as an asset by the subsidiary, then it would continue to be an asset. **Equity:** If it is classified as permanent equity by the subsidiary, it would be a noncontrolling interest.

Financial instrument issued to third parties by the subsidiary or written by third parties on the subsidiary's shares	Accounting classification at the subsidiary level	Parent classification in consolidation under ASC 810-10
(1) Embedded written put and purchased call options (issued contemporaneously) on the subsidiary's own common shares with the same fixed strike price and exercise date (synthetic forward contract), and (2) forward contract at a fixed price.	(1) Liability. [ASC 480] (2) Liability. [ASC 480]	**Applicable to both scenarios** Treated as 100% acquisition with a financing. No noncontrolling interest.

Figure 6-3
Accounting and reporting for financial instruments issued to third parties by a subsidiary—IFRS

Financial instrument issued to third parties by the subsidiary or written by third parties on the subsidiary's shares	Accounting classification at the subsidiary level	Parent classification in consolidation under IAS 27 (2008)
Common shares issued by the subsidiary	Equity (IAS 32)	Noncontrolling interest
Preferred shares issued by subsidiary that meet the requirements to be classified as equity	Equity (IAS 32.16)	Noncontrolling interest
Convertible bond issued by subsidiary and the conversion option meets the requirements to be classified as equity component	Compound financial instrument with an equity and a liability component (IAS 32.28)	It would be a liability for the liability component and a noncontrolling interest for the equity component.
Preferred or common shares issued by subsidiary redeemable at the option of the holder (i.e., puttable to the subsidiary)	Equity, if specified conditions are met (IAS 32.16A-D); otherwise, a liability	Liability (IAS 32.BC68)

Financial instrument issued to third parties by the subsidiary or written by third parties on the subsidiary's shares	Accounting classification at the subsidiary level	Parent classification in consolidation under IAS 27 (2008)
Written call option on the subsidiary's own common shares that will be physically settled (not part of a share-based payment arrangement)	Equity, if it entitles the holder to acquire a fixed number of shares for a fixed amount of cash (IAS 32.22); otherwise, a derivative liability	If it is classified as equity by the subsidiary, it would be a noncontrolling interest. If it is classified as a derivative liability by the subsidiary, then it would continue to be a liability.
Purchased call option on the subsidiary's own common shares that will be physically settled	A reduction of equity, if it entitles the holder to acquire a fixed number of shares for a fixed amount of cash (IAS 32.22); otherwise, a derivative asset	If recorded in equity by the subsidiary, it would result in proportionate decreases in the net assets attributable to the parent and in the noncontrolling interest. If it is classified as an asset by the subsidiary, then it would continue to be an asset.
Written put option on the subsidiary's own common shares	Liability for the present value of the redemption amount (IAS 32.23)	It would be a liability for the present value of the redemption amount (IAS 32.23). A noncontrolling interest may or may not (continue to) be recognised in addition to the liability, based on the assessment of risks and rewards.

Financial instrument issued to third parties by the subsidiary or written by third parties on the subsidiary's shares	Accounting classification at the subsidiary level	Parent classification in consolidation under IAS 27 (2008)
Options on the subsidiary's own common shares issued by the subsidiary for goods and services to non-employees and employees (i.e., share based payments)	Liability, if cash settled at the subsidiary level (IFRS 2) Equity, if equity settled at the subsidiary level	It would be a liability if cash is settled from the consolidated perspective. A noncontrolling interest may or may not be recognised in addition to the liability, based on the assessment of risks and rewards. It would be a noncontrolling interest if equity settled using subsidiary common shares.
(1) Embedded written put and purchased call options (issued contemporaneously) on the subsidiary's own common shares with the same fixed strike price and exercise date (synthetic forward contract) and (2) forward contract at a fixed price.	(1) Liability for the present value of the redemption amount (IAS 32.23) (2) Liability for the present value of the redemption amount (IAS 32.23)	**Applicable to both scenarios** Treated as 100% acquisition with financing. No noncontrolling interest.

Chapter 7: Valuation

7.1 Chapter overview

The **acquisition method** involves recognising and measuring separately from **goodwill**, the **fair value** of **identifiable** assets acquired (e.g., the components of working capital, tangible assets, and identifiable **intangible assets**), and liabilities assumed as of the **acquisition date** [ASC 805-20-30-1; IFRS 3.18]. In addition, the **noncontrolling interest** (NCI) in the **acquiree** is required to be recognised and measured at fair value under U.S. GAAP. IFRS companies can choose on an acquisition-by-acquisition basis to measure the NCI at fair value or at the NCI's proportionate share of the acquiree's identifiable net assets [IFRS 3.19].

This chapter highlights key considerations in common challenges that may be encountered by companies, valuation specialists, and auditors with respect to measuring the fair value of the components of working capital, tangible assets, intangible assets, certain liabilities including **contingent consideration**, the **previously held equity interest** (PHEI), and the NCI in the acquiree, if any. The valuation methods typically used to measure a **reporting unit** (RU) at fair value as part of the ASC 350 goodwill impairment test or a **cash-generating unit** (CGU) at **fair value less costs of disposal** (FVLCOD) as part of the IAS 36 **impairment** test are also covered in this chapter (value-in-use under IAS 36 is covered in BCG 12).

The key takeaways from this chapter:

- **Fair value measures are integral to accounting for business combinations and for other measurements.** Most acquired assets and assumed liabilities are measured at fair value under the acquisition method. Noncontrolling interests in the acquiree also are measured at fair value under U.S. GAAP, and may be measured at fair value under IFRS. Fair value is also used for impairment testing purposes. These requirements underscore the importance of the valuation process, since fair value measurements impact accounting at both the acquisition date and subsequently.

- **A range of outcomes may result from the valuation process.** Valuation methodologies and assumptions require significant judgment. As a result, a rigorous, and well-documented process should be applied when determining fair value measurements, including identifying the inputs used and understanding the underlying assumptions and valuation techniques. The available valuation techniques are often complex and may require significant resources.

7.2 Determining fair value

ASC 820 and IFRS 13 (the Fair Value Standards) provide the same definition for fair value.

Definition from ASC 820-10-20 and IFRS 13.9

Fair value: The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market-participants at the measurement date.

Under the Fair Value Standards, fair value is based on the exit price (the price that would be received to sell an asset or paid to transfer a liability), not the transaction price or entry price (the price that was paid for the asset or that was received to assume the liability). Conceptually, entry and exit prices are different. The exit price concept is based on current expectations about the sale or transfer price from the perspective of market-participants. In accordance with the Fair Value Standards, a fair value measurement should reflect all of the assumptions that market-participants would use in pricing an asset or liability.

The significant concepts that apply to fair value measurements of most acquired assets and assumed liabilities under the acquisition method are as follows:

- Use of market-participant assumptions
- Determining the appropriate market
- Highest and best use
- Application of valuation techniques

Each of these topics is discussed below.

7.2.1 Use of market-participant assumptions

The Fair Value Standards emphasise that fair value is a market-based measurement, not an entity-specific measurement. The fair value of an asset or liability should be determined based on an exit price as if a transaction involving the asset or liability had occurred on the measurement date, considered from the perspective of a market-participant.

Identifying potential market-participants, developing market-participant assumptions, and determining the appropriate valuation premise for nonfinancial assets (as discussed in FV 4.1.5) are critical components in developing fair value measurements of nonfinancial items. Certain assets measured at fair value, such as real estate have established markets. In the absence of such markets, a hypothetical market and market-participants must be considered. While many times an identical asset does not exist, there are often similar assets whose transactions should be considered in developing market-participant assumptions. Significant judgment is required to develop the assumptions to be used in the hypothetical "exit" transaction.

Key considerations in developing market-participant assumptions include the specific location, condition, and other characteristics of the asset or liability (such as assumed growth rates and whether certain synergies are available to all market-participants. For example, there may be no apparent exit market for customer relationship intangible assets. In this case, management may consider whether there are strategic buyers in the marketplace that would benefit from the customer relationships that are being valued. Most entities seek to build up their customer base as they grow their businesses, so the entity can look to potential participants in its industry that may be seeking additional growth and from there determine a hypothetical group of market-participants.

In developing market-participant assumptions relating to synergies, only synergies that can be realised by more than one market-participant can be considered. For example, if there were a business combination in which the acquiring company had a unique technology with significant synergy with the technology of the acquired company, the valuation of the technology would be from the perspective of market-participants. If market-participants did not have technology that had synergy with the acquired technology, the synergy benefits would not be used in valuing the acquired technology.

7.2.1.1 Identifying market-participants

The first step in developing market-participant assumptions is identification of potential market-participants—who would be interested in and could benefit from ownership of a specific asset or liability?

As described in ASC 820-10-35-9 and IFRS 13.23, in developing market-participant assumptions:

Excerpt from ASC 820-10-35-9 and IFRS 13.23

… the reporting entity [entity] need not identify specific market-participants. Rather, the reporting entity [entity] shall identify characteristics that distinguish market-participants generally, considering factors specific to all of the following:

a. The asset or liability.

b. The principal (or most advantageous) market for the asset or liability.

c. Market-participants with whom the reporting entity would enter into a transaction in that market.

In identifying potential market-participants for purposes of measuring the fair value of nonfinancial assets and liabilities, the reporting entity should determine the most likely buyer(s). Market-participants could be strategic buyers, financial buyers, or both.

- Strategic buyers: Strategic buyers could include the acquirer's peers or competitors, or an entity seeking to diversify its operations. Typically, strategic buyers will have synergies specific to their existing operations, and may have the ability and willingness to transact for the same assets and liabilities.

- Financial buyers: Other buyers, including those who have no ownership interests in businesses or operations similar to that of the acquirer, may also be considered market-participants in certain situations. These market-participants, commonly referred to as financial buyers, may include individual investors, private equity and venture capital investors, and financial institutional investors.

Assumptions regarding an asset's use may be different depending on whether the market-participant is a strategic buyer or a financial buyer. For example, when measuring the fair value of internally developed software used in a financial reporting system, the value to a strategic buyer may be much less, given that a strategic buyer would likely plan to use its existing system instead. On the other hand, a financial buyer may not have a similar system in place and, therefore, would place a higher value on the software, since it would be necessary to operate the **business** on an ongoing basis.

As a result, the identification of market-participant characteristics when measuring fair value in a business combination is subjective and dependent on facts and circumstances. Helpful sources of information include press releases, prior bid attempts, board of director presentations, due diligence documents, deal models, a list of all known bidders in the transaction and those who did not participate in the bidding process (if the transaction was subject to competitive bids), and a list of comparable companies.

For recently acquired assets and liabilities, the transaction price may be a starting point in the analysis of fair value. For example, in a business combination, a starting point for determining market-participant assumptions may be the acquirer. Since the acquirer successfully purchased the target company, it could look to itself to determine if it possesses unique characteristics, or whether such characteristics are similar to its competitors (strategic buyers) or financial buyers.

Reporting entities can also look to the other bidders in a bidding process in assessing whether they themselves are representative of a market-participant. In the absence of this type of transparency, a reporting entity will need to determine the characteristics or profile of potential market-participants as discussed above.

See FV 4.1.3 for further information on determination of market-participants.

7.2.1.2 Market-participant synergies

Identification and analysis of market-participant synergies is a significant component of developing market-participant assumptions for fair value measurements in connection with a business combination.

Market-participant synergies are synergies that are available to more than one market-participant. They are considered as part of measuring the fair value of the assets that will benefit from the realisation of those synergies. Buyer specific synergies are synergies that are available only to a specific acquirer. Theoretically, such synergies should not need to be paid for because other potential acquirers do not have the ability to use these synergies. These synergies are not considered when measuring the fair value of assets acquired and liabilities assumed. Instead, to the extent that they were paid for, they would be considered a component of goodwill.

Market-participant synergies can vary depending on the characteristics of the market-participants. Strategic buyers are more likely to realise synergies because they are more likely to have overlapping functions with that of the acquired entity. Conversely, a financial buyer may be unable to combine the target with another company or business and is more likely to focus on improving efficiencies of the target as a stand-alone business.

Some synergies in a business combination may be easily identified and quantified, but there may be other synergies whose characteristics will require significant judgment in determining whether they are market-participant or entity-specific synergies. Examples of synergies that strategic buyers may be able to generate include cost savings from reducing staff, consolidating distribution, closing facilities, and eliminating duplicate departments (e.g., human resources, finance and accounting, sales, and engineering). Financial buyers often also achieve cost reductions, although they may not have duplicate key functions. Other types of synergies may consist of revenue enhancements resulting from the buyer being able to sell the target's products to its customers and vice versa.

Transaction documents may provide a useful starting point when identifying synergies. Most transaction materials discuss synergies, but do not necessarily attribute them between market-participant and entity-specific categories. A robust process should be used to determine the appropriate categories of synergies for developing market-participant assumptions for fair value measurements. These transaction documents may include analyses of:

- Current industry trends (e.g., consolidation) and whether the specific transaction aligns with those trends
- Motivations of key competitors, both those that participated and those that did not participate (including the reasons that they did not participate)
- The acquired entity's growth and profitability prospects on a stand-alone basis and in conjunction with the operations and perspectives of the potential market-participants (i.e., the actual and potential bidders); this analysis should take into account the acquired entity's expected performance within the context of key competitors' performance, industry performance, and the overall economy
- Strategic intent of the acquirer versus the intent of the potential market-participants to determine the rationale for the transaction

7.2.1.3 Market-participant versus entity-specific assumptions

The definition of fair value is market based; therefore, an entity's intended use is not considered relevant for purposes of measuring the fair value of assets acquired in a business combination. The Standards explicitly prohibit an acquirer from considering its intended use of an asset, as highlighted below:

ASC 805-20-30-6

For competitive or other reasons, the acquirer may intend not to use an acquired asset, for example, a research and development intangible asset, or it may intend to use the asset in a way that is not its highest and best use. Nevertheless, the acquirer shall measure the asset at fair value determined in accordance with Subtopic 820-10 reflecting its highest and best use in accordance with the appropriate valuation premise, both initially and for purposes of subsequent impairment testing.

IFRS 3.B43

For competitive or other reasons, the acquirer may intend not to use an acquired asset, for example, a research and development intangible asset, or it may intend to use the asset in a way that is different from the way in which other market-participants would use it. Nevertheless, the acquirer shall measure the asset at fair value determined in accordance with its use by other market-participants.

Developing market-participant assumptions for these assets and liabilities requires judgment. In such circumstances, entities often start with their own assumptions and perform procedures to assess if evidence exists that market-participants would make different assumptions.

Measuring assets based on the expected use by a market-participant can present a number of accounting challenges, including the assessment of **useful life** and **residual value**. The useful life assessment of an asset is based on entity-specific assumptions regarding the asset's use [ASC 350-30-35-3(a); IAS 38.90(a), IAS 16.6], while the fair value of the asset is based on market-participant assumptions. The residual value of an intangible asset is assumed to be zero unless certain conditions are met. See BCG 10.3.3 for further information. Entities will need to apply judgment to determine the fair value and useful life of assets that an entity does not intend to use or intends to use differently than a market-participant.

7.2.2 Determining the appropriate market

An important step in the valuation of nonfinancial assets and nonfinancial liabilities is the determination of the market in which the pricing inputs and hypothetical transaction will be determined. If there are no known markets or if the reporting entity does not have access to any markets, it should identify potential market-participants and develop a hypothetical market based on the expected assumptions of those potential market-participants.

In developing a market for a specific asset or liability, a reporting entity should evaluate how the asset could be sold or the liability transferred. In making this evaluation, a reporting entity should research existing markets to determine the types of markets that exist for the asset or liability, or similar assets or liabilities if no direct inputs are available.

In addition, reporting entities may consider information about markets for similar assets or liabilities or markets for assets with similar economic characteristics with which it has more experience. Assumptions about markets and market-participants will involve judgment and management will need to consider all reasonably available information when developing inputs for measures with few or no reference points.

7.2.3 Highest and best use

The highest and best use is the use by market-participants that maximises the value of the asset or group of assets and liabilities. The concept refers to both the different ways of utilising the individual asset (e.g., a factory or residential site) as well as whether the maximum value is on a stand-alone basis or in combination with other assets. The Fair Value Standards indicate that the highest and best use does not consider management's intended use.

Ways of utilising the individual asset

The determination of highest and best use may have a significant impact on the fair value measurement. ASC 820, Example 1, Case B (ASC 820-10-55-30 through 55-31) and IFRS 13, Illustrative Example 2 (IFRS13.IE7-IE8) illustrate the application of this concept to land acquired in a business combination. In the example, the land is currently used for a factory, but could be developed as a residential site. The highest and best use is determined by the greater of (1) the value of the land in continued use for a factory (in combination with other assets) or (2) the value of the land as a vacant site for residential development (taking into account the cost to demolish the factory and including uncertainty about whether the reporting entity can convert the asset to the alternative use).

ASC 820-10-55-26 through 55-29 and IFRS 13.15 through IFRS 13.21 (Example 1, Case A), summarised below provides an example of the unit of account concept.

EXAMPLE 7-1

Application of the highest and best use concept

A strategic buyer acquires a group of assets (Assets A, B, and C) in a business combination. Asset C is a billing software system developed by the acquired entity for use with Assets A and B. The acquirer determines that each asset would provide maximum value to market-participants principally through its use in combination with the other assets in a group; therefore, the highest and best use is in-a-group rather than stand-alone valuation premise. The unit of valuation is the asset group, which consists of Assets A, B, and C.

Analysis

In determining the highest and best use, the acquirer determines that market-participants for Assets A, B, and C would represent both strategic and financial buyers. Strategic and financial buyers each possess different characteristics related to the use of the individual assets. The strategic buyer group has related assets that would enhance the value of the asset group. Specifically, strategic buyers have substitute assets for Asset C (the billing software). Asset C would be used only for a transitional period and could not be sold on a stand-alone basis. The indicated fair values of individual Assets A, B, and C within the strategic buyer group were determined to be CU360 million, CU260 million, and CU30 million, respectively. The indicated fair value for the assets collectively within the strategic buyer group is CU650 million.

The financial buyer group does not have substitute assets that would enhance the value of the asset group (i.e., Asset C). Therefore, financial buyers would use Asset C for its full remaining economic life and the indicated fair values for individual Assets A, B, and C within the financial buyer group were determined to be CU300 million, CU200 million, and CU100 million, respectively. The indicated fair value for the assets collectively within the financial buyer group is CU600 million.

The fair values of Assets A, B, and C would be determined based on the use of the assets within the strategic buyer group, because the fair value of the asset group of CU650 million is higher (CU360 million, CU260 million, and CU30 million) than the asset group for the financial buyer. The use of the assets in-a-group does not maximise the fair value of the assets individually, it maximises the fair value of the asset group. Thus, even though Asset C would be worth CU100 million to the financial buyers, its fair value for financial reporting purposes is CU30 million.

7.2.4 *Application of valuation techniques*

The Fair Value Standards require consideration of three broad valuation techniques: market approach, cost approach, and income approach. The Fair Value Standards do not prescribe which valuation technique(s) should be used when measuring fair value and do not prioritize among the techniques. Instead, the Fair Value Standards state that reporting entities should measure fair value using the valuation technique(s) that are appropriate in the circumstances and for which sufficient data are available. See FV 4.3 for further information on the application of valuation techniques.

The application of the various techniques may indicate different estimates of fair value. These estimates may not be equally representative of fair value due to factors such as assumptions made in the valuation or the quality of inputs used. Using multiple valuation techniques can act as a check on these assumptions and inputs. The reporting entity may need to apply additional diligence in the valuation if the range of values is wide. Fair value will be based on the most representative point within the range in the specific circumstances.

7.2.4.1 *Income approach*

ASC 820-10-55-3F and IFRS 13.B10 define the income approach as follows:

ASC 820-10-55-3F and IFRS 13.B10

The income approach converts future amounts (for example, cash flows or income and expenses) to a single current (that is, discounted) amount. When the income approach is used, the fair value measurement reflects current market expectations about those future amounts.

The income approach is applied using the discounted cash flow (DCF) method, which requires (1) estimating future cash flows for a certain discrete projection period; (2) estimating the terminal value,[1] if appropriate; and (3) discounting those amounts to present value at a rate of return that considers the relative risk of the cash flows.

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[1] Represents the present value at the end of the discrete projection period of all subsequent cash flows to the end of the life of the asset or into perpetuity if the asset has an indefinite life.

7.2.4.2 *Market approach*

ASC 820-10-55-3A and B and IFRS 13.B5-6 define the market approach as follows:

ASC 820-10-55-3A and IFRS 13.B5

The market approach uses prices and other relevant information generated by market transactions involving identical or comparable (that is, similar) assets, liabilities, or a group of assets and liabilities, such as a business.

ASC 820-10-55-3B and IFRS 13.B6

For example, valuation techniques consistent with the market approach often use market multiples derived from a set of comparables. Multiples might be in ranges with a different multiple for each comparable. The selection of the appropriate multiple within a range requires judgment, considering qualitative and quantitative factors specific to the measurement.

The market approach is often used as a primary valuation technique for financial assets and liabilities when observable inputs of identical or comparable instruments are available. This approach is also used commonly for real estate where comparable transactions and prices are available. It can also be used to value a business or elements of equity (e.g., NCI). See BCG 7.5 for further information. The market approach may also be used as a secondary approach to evaluate and support the conclusions derived using an income approach. The market approach is not frequently used as a primary valuation technique for the individual assets acquired and liabilities assumed in a business combination other than for financial assets and real property. Individual assets and liabilities, particularly intangible assets, are seldom traded in active markets or only change hands in transactions where little information is publically disclosed.

7.2.4.3 *Cost approach*

ASC 820-10-55-3D and IFRS 13.B8 define the cost approach as follows:

ASC 820-10-55-3D and IFRS 13.B8

The cost approach reflects the amount that would be required currently to replace the service capacity of an asset (often referred to as current replacement cost).

The cost approach assumes that the fair value would not exceed what it would cost a market-participant to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence. That is because a market-participant buyer would not pay more for an asset than the amount for which it could replace the service capacity of that asset. Obsolescence includes “physical deterioration, functional (technological) obsolescence, and economic (external) obsolescence.” Therefore, in using a replacement cost approach, a reporting entity would need to consider the impact of product improvements.

The cost approach is rarely used as a primary valuation technique to measure the fair value of a business enterprise because it does not capture the going concern value of a business. The sum of the replacement values of a collection of assets and liabilities generally has less value than an integrated business with established operations because the cost approach would not reflect the synergistic value of the assets and liabilities operating together. The cost approach is seldom used as a valuation technique to measure the fair value of an intangible asset that is a primary intangible asset of the business because it does not capture the opportunity cost of owning the asset or the cost of unsuccessful ideas that were attempted in the process of creating the intangible asset. The cost approach is more typically used to value assets that can be easily replaced.

7.3 Applicable accounting standards requiring fair value measures related to business combinations

Figure 7-1 summarises the accounting standards requiring fair value measures related to accounting for a business combination, **asset acquisitions**, and subsequent impairment testing.

Figure 7-1
Applicable accounting standards requiring fair value measures

Purpose of valuation	U.S. GAAP Accounting Standard	IFRS Accounting Standard
Acquisition accounting — business combinations	ASC 805	IFRS 3
A group of assets acquired outside of a business combination[1]	ASC 350, ASC 805	IFRS 3
Impairment testing of indefinite-lived intangible assets, including goodwill[2]	ASC 350	IAS 36
Impairment testing of long-lived assets[2]	ASC 360-10	IAS 36

[1] Chapter 9 of this guide contains additional guidance on accounting for asset acquisitions under the Standards.

[2] Chapters 10 and 11 of this guide contain additional guidance on accounting for asset impairments.

7.4 Valuation considerations in business combinations

Understanding the interaction between corporate finance, valuation, and accounting concepts is important when estimating fair value measurements for business combinations. The valuation techniques in the Fair Value Standards are used individually or in combination to:

- Perform a **business enterprise valuation (BEV)** analysis of the acquiree as part of analysing **prospective financial information (PFI)**, including the measurements of the fair value of certain assets and liabilities for postacquisition accounting purposes (see BCG 7.5)
- Measure the fair value of the identifiable tangible and intangible assets acquired and liabilities assumed in a business combination (see BCG 7.7.1 through 7.7.5)
- Measure the fair value of any NCI in the acquiree and the acquirer's previously held equity interest (PHEI) in the acquiree for business combinations achieved in stages (see BCG 7.8.1 and 7.8.2)
- Measure the fair value of consideration transferred, including contingent consideration (see BCG 2 and 7.7.6)
- Test goodwill for impairment in each RU (see BCG 11) or CGU (see BCG 7.9 and BCG 12)

7.5 Valuation of the business enterprise

Typically, the initial step in measuring the fair value of assets acquired and liabilities assumed in a business combination is to perform a BEV analysis and related **internal rate of return (IRR)** analysis using market-participant assumptions and the consideration transferred. The BEV analysis is a key valuation tool, which supports many of the valuation assumptions (discount rate, projected cash flows, synergies, etc.) used in measuring the fair value of the identified assets and liabilities of the entity. The PFI, adjusted to reflect market-participant assumptions, serves as the source for the cash flows used to value the assets acquired and liabilities assumed. The IRR is the implied rate of return derived from the consideration transferred and the PFI. The IRR is a data point to consider when estimating the required rate of return. The calculated IRR should be compared to industry discount rates derived from market data when evaluating and selecting discount rates related to the overall transaction and identifiable tangible and intangible assets.

The BEV is often referred to as the "market value of invested capital," "total invested capital," or "enterprise value," and represents the fair value of an entity's interest-bearing debt and shareholders' equity. The BEV analysis assists in evaluating the PFI, which serves as the basis for the underlying cash flows used to measure the fair value of certain acquired assets. The cash flows used to support the consideration transferred (adjusted as necessary to reflect market-participant assumptions) should be reconcilable to the cash flows used to measure the fair value of the assets acquired. When there is no measurable consideration transferred (e.g., when **control** is gained through contractual rights and not a purchase) the fair value of the entity is measured based on market-participant assumptions.

Generally, the BEV is performed using one or both of the following methods:

- The income approach (e.g., discounted cash flow method)

- The guideline public company or the guideline transaction methods of the market approach

Market approach techniques may not require the entity's projected cash flows as inputs and are generally easier to perform. The market approach may be used as a secondary approach to evaluate and support the conclusions derived using an income approach. Although the market approach techniques are easier to apply, they rely on availability of external data.

7.5.1 *Use of the income approach in the business enterprise value (BEV) analysis*

The BEV represents the present value of the "free cash flows" available to the entity's debt and equity holders. See BCG 7.5.1.1 for a discussion of estimating free cash flow. This approach to calculating the IRR compares the consideration transferred to the underlying cash flow forecast used by the acquirer in determining the amount of consideration to pay for the acquiree.

7.5.1.1 *Evaluating prospective financial information through the business enterprise value and related internal rate of return analyses*

Free cash flows of the acquiree is typically measured as:

- Projected debt-free net income, plus

- Depreciation and amortisation expenses (to the extent they are reflected in the computation of taxable income), adjusted for

- Changes in debt-free working capital and capital expenditures

The PFI is a key input in the valuation process and it is important to understand the underlying assumptions. For example, the PFI should reflect market-participant assumptions, including only those synergies that would be available to other market-participants. That is, the PFI should be adjusted to remove entity-specific synergies.

Conforming the PFI to market-participant assumptions usually starts with analysing the financial model used to price the transaction, and adjusting it to reflect market-participant expected cash flows. If the transaction pricing was not based on a cash flow analysis, a similar concept should be applied in preparing the cash flow forecast required to value the acquired assets and liabilities. When differentiating between entity-specific synergies and market-participant synergies, entities should consider the following:

- The acquirer's rationale for the transaction, particularly as communicated in press releases, board minutes, and investment bankers' analyses

- The competitive nature of the bidding process; in a highly competitive bidding environment, an acquirer may pay for entity-specific synergies, while if no other bidders are present an acquirer may not have to pay for the value of all market-participant synergies

- The basis for the projections used to price the transaction in order to gain an understanding of the synergies considered in determining the consideration transferred

- Whether alternative PFI scenarios used to measure the purchase price might be available to assist in assessing the relative risk of the PFI

- Whether market-participants would consider and could achieve similar synergies

- Whether the highest and best use for the asset(s) may differ between the acquirer's intended use and use by market-participants

- Whether industry trends (i.e., consolidation, diversification) provide insights into market-participant synergies

The IRR is the discount rate which equates the market-participant PFI to the consideration transferred (assuming the consideration transferred represents fair value and company-specific synergies were not paid for). Entity-specific synergies, to the extent paid for, will be reflected in goodwill and not reflected in the cash flows used to measure the fair value of specific assets or liabilities. The process of reconciling the PFI to the consideration transferred should also separately consider any nonoperating assets or liabilities (see BCG 7.9.2.4) that may have been included in the business combination, as such nonoperating assets would not have been included in the PFI.

Conceptually, when the PFI reflects only market-participant synergies, and the consideration transferred is adjusted for any entity-specific synergies that were paid for, the IRR should be consistent with the industry-**weighted average cost of capital (WACC)**. That is, the industry-weighted average rate of return on debt and equity as required by market-participants (i.e., investors). Alternatively, the IRR represents the discount rate implicit in the economics of the business combination, driven by both the PFI and the consideration transferred.

If the IRR differs significantly from the industry WACC, additional analysis may be required to understand the difference. If the implied IRR and WACC differ, it may be an indication that entity-specific synergies are included in the PFI, and therefore should be adjusted accordingly. It may also indicate a bias in the projections. Figure 7-2 summarises the relationship between the IRR, WACC, the existence of synergies, and the basis of the PFI. Both the IRR and the WACC are considered when selecting discount rates used to measure the fair value of tangible and intangible assets.

Figure 7-2
Relationship between IRR, WACC, synergies, and consideration transferred

IRR = WACC	Indicates that the PFI may reflect market-participant synergies and the consideration transferred equals the fair value of the acquiree.
IRR > WACC	Indicates that the PFI may include entity-specific synergies, the PFI may include an optimistic bias, or the consideration transferred is lower than the fair value of the acquiree (potential bargain purchase).
IRR < WACC	Indicates that the PFI may exclude market-participant synergies, the PFI may include a conservative bias, the consideration transferred may be greater than the fair value of the acquiree, or the consideration transferred may include payment for entity-specific synergies.

The present value computed varies inversely with the discount rate used to present value the PFI (i.e., a higher discount rate results in lower values). Conceptually, when PFI includes optimistic assumptions, such as high revenue growth rates, expanding profit margins, etc. (i.e., higher cash flows), or the consideration transferred is lower than the fair value of the acquiree, a higher IRR is required to reconcile the PFI on a present-value basis to the consideration transferred.

7.5.1.2 Conditional versus expected cash flows

Cash flow models will use either conditional or expected cash flows, and other valuation inputs need to be consistent with the approach chosen. Conditional cash flows are based on a single outcome that is dependent upon the occurrence of specific events. For example, the cash flows may reflect a "most likely" or "promised" cash flow scenario, such as a zero coupon bond that promises to repay a principal amount at the end of a fixed time period. Alternatively, expected cash flows represent a probability-weighted average of all possible outcomes. Since expected cash flows incorporate expectations of all possible outcomes, expected cash flows are not conditional on certain events.

The discount rate applied to measure the present value of the cash flow estimate should be consistent with the nature of the cash flow estimate. An expected cash flow is discounted using an expected rate, while a conditional cash flow is discounted using a conditional rate. In principle, conditional and expected approaches consider many of the same risks but an expected cash flow reflects the risks of achieving the cash flow directly in the cash flow estimates, while a conditional cash flow requires an adjustment to the discount rate to adjust for the conditional nature of the cash flow estimate. Conceptually, both methods should result in consistent valuation conclusions. See BCG 7.7.4.3 for further information on the application of this concept to liabilities.

7.5.1.3 Discount rates

Conceptually, a discount rate represents the expected rate of return (i.e., yield) that an investor would expect from an investment. The magnitude of the discount rate is dependent upon the perceived risk of the investment. Theoretically, investors are compensated, in part, based on the degree of inherent risk and would therefore require additional compensation in the form of a higher rate of return for investments bearing additional risk.

The rate of return on the overall company will often differ from the rate of return on the individual components of the company. For example, the rates of return on an entity's individual RUs or CGUs may be higher or lower than the entity's overall discount rate, depending on the relative risk of the RUs and CGUs in comparison to the overall company. The discount rate should reflect the WACC of a particular component of the company when measuring the fair value of that business using expected cash flows based on market-participant assumptions.

7.5.1.4 Terminal value

A terminal value should be included at the end of the discrete projection period of a discounted cash flow analysis used in a BEV to reflect the remaining value that the entity is expected to generate beyond the projection period. Business enterprises are generally assumed to have perpetual lives. The most commonly used terminal value technique is the constant growth method (CGM). The terminal value is calculated by dividing annual sustainable cash flow by a capitalisation rate (cap rate). The annual sustainable cash flow is often estimated based on the cash flows of the final year of the discrete projection period, adjusted as needed to reflect sustainable margins, working capital needs and capital expenditures consistent with an assumed constant growth rate. The cap rate is calculated as the discount rate (i.e., WACC or IRR) less the long-term, sustainable growth rate. The cap rate varies inversely to the growth rate and terminal value (i.e., a lower growth rate results in a higher cap rate and a lower terminal value).

The terminal value represents the present value in the last year of the projection period of all subsequent cash flows into perpetuity. A long-term growth rate in excess of a projected inflation rate should be viewed with caution and adequately supported and explained in the valuation analysis.

If the projection period is so short relative to the age of the enterprise that significant growth is projected in the final year, then the CGM should not be applied to that year. Rather, the projection period should be extended until the growth in the final year approaches a sustainable level, or an alternative method as described below should be used.

An alternative to the CGM to calculate the terminal value is the market pricing multiple method (commonly referred to as an exit multiple). Under this method, a current observed pricing multiple of earnings—generally **earnings before interest, taxes, depreciation, and amortisation (EBITDA)** or earnings before interest and taxes (EBIT)—is applied to the entity's projected earnings for the final year of the projection period. However, this method must be used cautiously to avoid significant misstatement of the fair value resulting from growth rate differences. Inherent in observed, current pricing multiples for entities are implied income growth rates, reflecting the markets' view of its relatively short-term growth prospects. The implied growth rate inherent in the multiple must be compared to the growth rate reflected in the last year of the projection period. If a pricing multiple observed for an enterprise is applied to the final year of a projection, not only must the implied growth rate in the multiple be consistent with the projected growth, but the implied risk for the enterprise must be consistent with the risk inherent in realising the projected income.

The terminal value often represents a significant portion of total fair value. Therefore, a relatively small change in the cap rate or market pricing multiple can have a significant impact on the total fair value produced by the BEV analysis. Figure 7-3 highlights leading practices in calculating terminal value.

Figure 7-3

Leading practices when calculating terminal value

Use sustainable cash flows	The terminal value calculated using a DCF approach should be based on a sustainable set of cash flows. If one-time, nonrecurring events (e.g., a one-time large restructuring charge, cash tax impact of net operating loss (NOL), or amortisation of intangible assets) distort cash flows in the terminal period, the fair value may be distorted. Adjustments should be made to normalise the terminal year cash flows.
Apply sustainable cap rates	For developing companies experiencing rapid cash flow growth over the entire discrete cash flow forecast, the discount rate used to calculate the cap rate should reflect a "normalised" expectation of cash flow. Both the discount rate and growth rate used to calculate the cap rate should reflect a normalised level of cash flows.
Projections should reflect a mature business	Terminal values should be calculated at the point when projections reflect the maturity of the business and future significant real growth is not expected (in excess of an inflation rate) in perpetuity. Terminal values that imply significant perpetual growth may overstate fair value. If the terminal year projections do not reflect a mature business, it is necessary to incorporate the additional growth through a weighted growth or a terminal multiple that reflects companies at the same stage of development.

Multiples from current trading data should be adjusted for changes in expected growth	Multiples should reflect the growth and profitability expectations for the business at the end of the explicit projection period. Although multiples may be derived from current market trading data that reflect short-term, high-growth rates, multiples for later periods with lower growth should reflect the growth assumption as of this terminal period (e.g., ten years out).
Select appropriate multiples	The valuation multiple should best reflect how the market assesses the value of a business or an asset. If the company tends to trade on operating metrics, then multiples of earnings, such as total invested capital/sales, total invested capital/EBITDA, or total invested capital/EBIT multiples, may be appropriate multiples to apply. If the company tends to trade as a function of its capital at risk, it may be more appropriate to apply a price/book value multiple.
Use an appropriate terminal growth rate assumption	The terminal growth rate should be carefully considered. While an inflationary perpetual growth rate may be appropriate, this is a valuation input that should not be automatically assumed. In some situations, an enterprise will not be able to pass along inflationary price increases due to market and other economic circumstances. If the enterprise's earnings are not expected to keep pace with inflation, the cap rate or market pricing multiple should reflect a lower than inflationary growth rate. If growth beyond inflation is expected beyond the projection period, a terminal growth rate greater than inflation may be appropriate. In cases such as this, it may be appropriate to consider a market pricing multiple approach rather than the CGM.
Carefully consider comparability	Multiples should be derived from companies that exhibit a high degree of comparability to the business enterprise being valued. The implied values should be adjusted based on the differences between the enterprise being valued and the guideline companies.
Consider whether a perpetual model is appropriate	Certain businesses may have finite lives; for instance, a power plant can reasonably be expected to have a finite life if no investment was made to sustain its generation capacity. The terminal value may be the liquidation value of the business at the end of its projected life.
Consider capital expenditures that are consistent with expected growth	An assumption of sustained growth over a long period (approximating "in perpetuity") should reflect the necessary capital investment to support the forecasted growth.

Test the terminal value	The computed terminal value should be tested against market multiples to evaluate its reasonableness.

Example 7-2 provides an illustration of the determination of terminal value.

EXAMPLE 7-2

Calculating the terminal value

Company A was recently acquired in a business combination for CU100,000. Through the BEV and IRR analyses, the acquirer has identified the following market-participant PFI for projected years one through five:

The industry WACC for Company A is 15% and the long-term sustainable growth rate is 3%.

Year	Revenues	Net cash flow	Net cash flow growth (%)
Actual Year	CU95,000	CU9,500	—
Forecast Year 1	105,000	10,000	5.3%
Forecast Year 2	115,000	11,000	10.0%
Forecast Year 3	135,000	12,500	13.6%
Forecast Year 4	147,000	13,500	8.0%
Forecast Year 5	160,000	14,000	3.7%

Based on the consideration transferred and Company A's cash flows, the IRR was calculated to be 15%, which is consistent with the industry WACC of 15%.

Analysis

In year five, net cash flow growth trended down to 3.7%, which is fairly consistent with the expected long-term growth rate of 3%. The cash flow growth rate in the last year of the PFI should generally be consistent with the long-term sustainable growth rate. For example, it would not be appropriate to assume normalised growth using the Forecast Year 3 net cash flow growth rate of 13.6%. The constant growth model is used to measure the terminal value, as follows:

$$TV = \frac{CF_5(1 + g)}{k - g}$$

Where:

$$TV = \text{Terminal value}$$
$$CF_5 = \text{Year 5 net cash flow}$$
$$g = \text{Long-term sustainable growth rate}$$
$$k = \text{WACC or discount rate}$$

Therefore:

$$TV = \frac{CU14{,}000\ (1 + 0.03)}{0.15 - 0.03}$$

$$= \frac{CU14{,}420}{0.12}$$

$$= CU120{,}167$$

The terminal value was tested against publicly traded multiples. The computed multiple was 8.6 times prior year's cash flow (CU120,167 / CU14,000). This was within the range of multiples found for companies similar to Company A at the end of the projection period.

Conceptually, the terminal value represents the value of the business at the end of year five and is then discounted to a present value as follows:

$$\text{PV of TV}^{1} = \frac{CU120{,}167}{(1 + 0.15)_5}$$

$$= CU59{,}744^{2}$$

[1] The present value = 1/1(+k) ^ t, where k = discount rate and t = number of years.

[2] For illustrative simplicity, an end-of-year discounting convention was used.

7.5.2 *Use of the market approach in the business enterprise value analysis*

The market approach is generally used as a secondary approach to measure the fair value of the business enterprise when determining the fair values of the assets acquired and liabilities assumed in a business combination. The market approach is often used to assess the reasonableness of the implied valuation multiples derived from the income approach.

The market approach also may be used when measuring the fair value of an RU or CGU as part of the goodwill impairment analysis or when measuring the fair value of an entity as a whole (e.g., for purposes of valuing a noncontrolling interest).

Following are examples of two methods used to apply the market approach in performing a BEV analysis.

7.5.2.1 *Guideline public company method*

The most common form of the market approach applicable to a business enterprise is the guideline public company method (also referred to as the public company market multiple method). Publicly traded companies are reviewed to develop a peer group similar to the company being valued, often referred to as "comparable" companies. Market multiples are developed and based on two inputs: (1) quoted trading prices, which represent minority interest shares as exchanges of equity shares in active markets typically involving small (minority interest) blocks, and (2) financial metrics, such as net income, EBITDA, etc. Market multiples are then adjusted, as appropriate, for differences in growth rates, profitability, size, accounting policies, and other relevant factors. The adjusted multiples are then applied to the subject company's comparable financial metric. This results in the estimated fair value of the entity's BEV on a minority interest basis, because the pricing multiples were derived from minority interest prices.

If a controlling or majority interest in the subject company is being valued, then a further adjustment, often referred to as a "**control premium**," may be necessary. A control premium represents the amount paid by a new controlling shareholder for the benefits resulting from synergies and other potential benefits derived from controlling the enterprise. For example, when measuring the fair value of a publicly traded business, there could be incremental value associated with a **controlling interest** in the business. As such, a control premium could be added to the company's market capitalisation (using observed market prices) to measure the fair value of a publicly traded company as a whole. A control premium should not be automatically applied without consideration of the relevant factors (e.g., synergies, number of possible market-participant acquirers, etc.). Companies need to evaluate and assess whether such factors indicate a control premium is justified and, if so, assess the magnitude of the control premium.

7.5.2.2 *Guideline transaction method*

The guideline transaction method is another variation of the market approach that is often applied when valuing a controlling or majority ownership interest of a business enterprise. This approach is based upon prices paid in observed market transactions of guideline companies, involving exchanges of entire (or majority interests in) companies, which often include a control premium in the price paid.

Valuation multiples are developed from observed market data for a particular financial metric of the business enterprise such as earnings or total market capitalisation. The valuation multiple is then applied to the financial metric of the subject company to measure the estimated fair value of the business enterprise on a control basis. Generally, the value of control included in the transaction multiple is specific to the buyer and seller involved in the transaction and may not be broadly applicable to the subject company. Therefore, this valuation technique should consider the synergies in the transaction and whether they may be appropriate to the company being valued.

7.5.2.3 *Obtaining and reviewing guideline information*

The data used in either of the market approaches previously discussed (BCG 7.5.2.1 and 7.5.2.2) is typically obtained from several sources, including past transactions that the company has participated in, peer company securities' filings, periodicals, industry magazines and trade organisations, and M&A databases. The data for a single transaction may be derived from several sources.

The degree of similarity of the observed data to the subject company (industry, transaction date, size, demographics, and other factors) needs to be considered in evaluating the relevance and weight given to the selected financial metric.

The relevance of the market approach in measuring BEV is dependent on the comparability of the companies on which the analysis is based. The higher the degree of correlation between the operations in the peer group and the subject company, the better the analysis. Some of the more significant attributes used to determine comparability are:

- Type of product produced or service performed
- Market segment to which the product or service is sold
- Geographic area of operation
- Positioning in market
- Influence of buyers/suppliers
- Size (e.g., revenue, assets)
- Growth—historical and projected
- Profitability
- Capital intensity (fixed assets and working capital)
- Leverage
- Liquidity
- Diversification

7.5.3 *Leading practices when calculating the business enterprise value*

Figure 7-4 highlights leading practices when calculating the business enterprise value.

Figure 7-4
Best practices when calculating the business enterprise value

Confirm that cash flows provided by management are consistent with the cash flows used to measure the consideration transferred	One of the primary purposes of performing the BEV analysis is to evaluate the cash flows that will be used to measure the fair value of assets acquired and liabilities assumed. The projections should also be checked against market forecasts to check their reasonableness.
Reconcile material differences between the IRR and the WACC	Understanding the difference between these rates provides valuable information about the economics of the transaction and the motivation behind the transaction. It often will help distinguish between market-participant and entity-specific synergies and measure the amount of synergies reflected in the consideration transferred and PFI. It will also help in assessing potential bias in the PFI. If the IRR is greater than the WACC, there may be an optimistic bias in the projections. If the IRR is less than the WACC, the projections may be too conservative.
Properly consider cash, debt, nonoperating assets and liabilities, contingent consideration, and the impact of NOL or tax amortisation benefits in the PFI and in the consideration transferred when calculating the IRR	Because the IRR equates the PFI with the consideration transferred, it is important to properly reflect all elements of the cash flows and the consideration transferred. Nonoperating assets and liabilities, and financing elements usually do not contribute to the normal operations of the entity. The value of these assets or liabilities should be separately added to or deducted from the value of the business based on cash flows reflected in the PFI in the IRR calculation. If any of these assets or liabilities are part of the consideration transferred (e.g., contingent consideration), then their value should be accounted for in the consideration transferred when calculating the IRR of the transaction.
Develop the WACC by properly identifying and performing a comparable peer company or market-participant analysis	The WACC should reflect the industry-weighted average return on debt and equity from a market-participant's perspective. Market-participants may include financial investors as well as peer companies.
Use PFI which reflects market-participant assumptions instead of entity-specific assumptions	Entities should test whether PFI is representative of market-participant assumptions.

Use PFI prepared on a cash basis not an accrual basis	Since the starting point in most valuations is cash flows, the PFI needs to be on a cash basis. If the PFI is on an accrual basis, it must be converted to a cash basis such that the subsequent valuation of assets and liabilities will reflect the accurate timing of cash flows.
Use PFI that includes the appropriate amount of capital expenditures, depreciation, and working capital required to support the forecasted growth	This should be tested both in the projection period and in the terminal year. The level of investment must be consistent with the growth during the projection period and the terminal year investment must provide a normalised level of growth.
Use PFI that includes tax-deductible amortisation and/or depreciation expense	PFI should consider tax-deductible amortisation and depreciation to correctly allow for the computation of after tax cash flows. PFI that incorrectly uses book amortisation and depreciation will result in a mismatch between the post tax amortisation and depreciation expense and the pre-tax amount added back to determine free cash flow. See BCG 7.5.1.1 for further information on calculating free cash flows.
Use multiple valuation approaches when possible	Multiple valuation approaches should be used if sufficient data is available. While an income approach is most frequently used, a market approach using appropriate guideline companies or transactions helps to check the reasonableness of the income approach.

7.6 Valuation of intangible assets

The Standards require entities to recognise separately from goodwill, the identifiable intangible assets acquired in a business combination at their acquisition date fair values [ASC 805-20-30-1; IFRS 3.18]. When measuring the fair value of acquired intangible assets, reporting entities should generally consider applying the income, market, or cost approach.

Few intangible assets are traded in an active market. When they are, fair value will be measured by reference to the quoted price of an identical asset and will be a Level 1 measurement. When they are not traded, the reporting entity will need to use one of the following valuation techniques.

7.6.1 Income approach for intangible assets

The income approach is a valuation technique used to convert future cash flows to a single discounted present value amount. See FV 4.3.3 for further informatio.

The most common variations of the income approach, along with the types of intangible assets they are typically used to measure, are included in Figure 7-5.

Figure 7-5
Common variations of the income approach

Multi-period excess earnings method (MEEM) including the distributor method	Customer relationships and enabling technology
Relief-from-royalty method (RFR)	Trade names, brands, and technology assets
Greenfield method	Broadcast, gaming, and other long-lived government-issued licences
With and without method	Noncompete agreements, customer relationships

The cost savings and premium profit methods are other ways to value intangible assets but are used less frequently.

7.6.1.1 Multi-period excess earnings method

The MEEM is a commonly used method for measuring the fair value of intangible assets. The fundamental principle underlying the MEEM is to isolate the net earnings attributable to the asset being measured. Cash flows are generally used as a basis for applying this method. Specifically, an intangible asset's fair value is equal to the present value of the incremental after-tax cash flows (excess earnings) attributable solely to the intangible asset over its remaining useful life.

Intangible assets are generally used in combination with other tangible and intangible assets to generate income. The other assets in the group are often referred to as "contributory assets," as they contribute to the realisation of the intangible asset's value. To measure the fair value of an intangible asset, its projected cash flows are isolated from the projected cash flows of the combined asset group over the intangible asset's remaining economic life. Both the amount and the duration of the cash flows are considered from a market-participant perspective.

The fair value measurement of an intangible asset starts with an estimate of the expected net income of a particular asset group. "Contributory asset charges" or "economic rents" are then deducted from the total net after-tax cash flows projected for the combined group to obtain the residual or "excess earnings" attributable to the intangible asset. The contributory asset charges represent the charges for the use of an asset or group of assets (e.g., working capital, fixed assets, other intangible assets) and should be considered for all assets, excluding goodwill, that contribute to the realisation of cash flows for a particular intangible asset. Goodwill is excluded as it is not generally viewed as an asset that can be reliably measured. See BCG 7.6.1.1 for further information on contributory asset charges. The excess cash flows are then discounted to a net present value. The net present value of any tax benefits associated with amortising the intangible asset for tax purposes (where relevant) is added to arrive at the intangible asset's fair value.

The contributory asset charges are calculated using the assets' respective fair values and are conceptually based upon an "earnings hierarchy" or prioritisation of total earnings ascribed to the assets in the group. The earnings hierarchy is the foundation of the MEEM in which earnings are first attributed to a fair return on contributory assets, such as investment in working capital and property, and plant and equipment. These are considered a prerequisite to developing the ability to deliver goods and services to customers and thus their values are not included as part of the intangible asset's value.

The return or charge for each asset should be based upon comparable market rates, which reflect the amount market-participants would charge for the use of the asset (i.e., a "market-derived rent"). In addition, contributory assets may benefit a number of intangible and other assets. The total return or charge earned by a particular asset should be distributed among the assets that benefit from its use. Therefore, in determining the fair value of intangible assets, a capital-intensive manufacturing business should have a higher contributory asset charge from fixed assets (in absolute terms) than that of a service business.

Terminal values are typically not appropriate in the valuation of a finite-lived intangible asset under the income approach. However, it is typically appropriate to add a terminal value to a discrete projection period for indefinite-lived intangible assets, such as some trade names. See BCG 7.5.1.4 for further informatoin on terminal value.

The key assumptions of the MEEM, in addition to the PFI, are as follows and are discussed in the subsequent sections:

- Discount rates
- Application of contributory asset charges
- Tax amortisation benefits

Discount rates for intangible assets

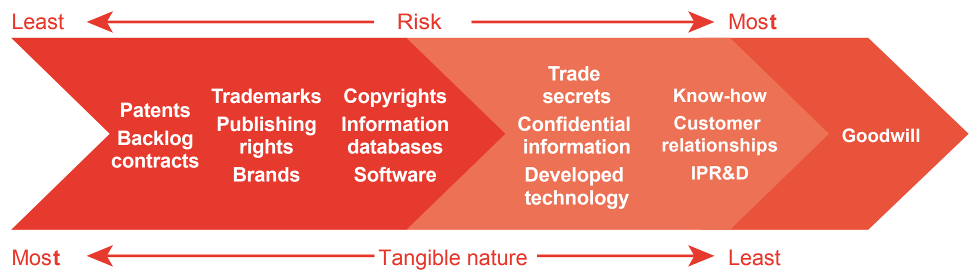
An appropriate discount rate is an important factor in a multi-period excess earnings analysis, whether using expected (i.e., probability adjusted) or conditional (i.e., management's best estimate) cash flows. The calculation of the appropriate discount rate to estimate an intangible asset's fair value requires some additional considerations as compared to those used to estimate the BEV, as discussed previously. It is generally recognised by valuation practitioners that the total cash flows attributable to a group of assets can be disaggregated according to the varying levels of risk associated with the cash flows generated by the asset groups.

The discount rate should reflect the risks commensurate with the intangible asset's individual cash flow assumptions. Some intangible assets, such as order or production backlog, may be assigned a lower discount rate relative to other intangible assets, because the cash flows are more certain. Other intangible assets, such as technology-related and customer relationship intangible assets, are generally assigned higher discount rates, because the projected level of future earnings is deemed to have greater risk and variability. While discount rates for intangible assets could be higher or lower than the entity's WACC, they are typically higher than discount rates on tangible assets.

Figure 7-6 depicts the continuum of risks that are typically associated with intangible assets, although specific facts and circumstances should be considered.

Figure 7-6

Spectrum of risk for intangible assets



The WACC represents the average expected return from the business (i.e., all the assets and liabilities used collectively in generating the cash flows of the entire business) for a market-participant investor, and includes an element to compensate for the average risk associated with potential realisation of these cash flows. The IRR, in a business combination, represents the implied return from the transaction that may include acquirer-specific elements as discussed in Figure 7-2 in BCG 7.5.1.1.

Conceptually, the WACC applicable for the acquiree should be the starting point for developing the appropriate discount rate for an intangible asset. The WACC and the IRR should be equal when the PFI is market-participant expected cash flows, and consideration transferred equals the fair value of the acquiree. However, circumstances arise in practice when the WACC and the IRR are not equal, creating the need for further analysis to determine the appropriate starting point for an intangible asset discount rate.

If a difference exists between the IRR and the WACC and it is driven by the PFI (i.e., optimistic or conservative bias rather than expected cash flows, while the consideration transferred is the fair value of the acquiree), leading practice would be to utilize PFI that represents expected cash flows. If the PFI is not adjusted, it may be necessary to consider the IRR as a starting point when considering adjustments to discount rates for intangible assets. However, in this situation it is important to assess whether the cash flows allocated to the individual intangible assets have been adjusted to eliminate any optimistic or conservative bias reflected in the overall business PFI.

For example, if the IRR is higher than the WACC because the overall PFI includes optimistic assumptions about revenue growth from selling products to future customers, it may be necessary to make adjustments to the discount rate used to value the technology in the products that would be sold to both existing and future customers. However, if the revenue growth rate for the existing customer relationships does not reflect a similar level of growth or risk, then the discount rate for existing customer relationships should generally be based on the WACC without such adjustments.

If the difference between the IRR and the WACC is driven by the consideration transferred (i.e., the transaction is a bargain purchase or the buyer has paid for entity-specific synergies), then the WACC may be more applicable to use as the basis of the intangible asset required returns. The relationship between the WACC and the IRR in certain circumstances impacts the selection of discount rates for intangible assets is illustrated in the following figure.

Figure 7-7
Relationship between WACC and IRR

The PFI represents market-participant cash flows and consideration represents fair value	WACC = IRR
Alternatively:	
The PFI are optimistic or pessimistic, therefore WACC ≠ IRR	Adjust cash flows so WACC and IRR are the same
Consideration is a bargain purchase	Use WACC
PFI include company-specific synergies not paid for	Adjust PFI to reflect market-participant synergies and use WACC
Consideration is not fair value because it includes entity-specific synergies not reflected in PFI	Use WACC

The WACC is generally the starting point for determining the discount rate applicable to an individual intangible asset. However, as discussed above, in certain circumstances the WACC may need to be adjusted due to PFI that does not represent market-participant assumptions. Premiums and discounts are applied to the company's WACC or IRR to reflect the relative risk associated with the particular tangible and intangible asset categories that comprise the group of assets expected to generate the projected cash flows.

The process of disaggregating the discount rate is typically referred to as "rate stratification." The range of discount rates assigned to the various tangible and intangible assets should reconcile, on a fair-value-weighted basis, to the entity's overall WACC. For example, working capital and fixed assets are generally assigned a lower required rate of return relative to a company's overall discount rate, whereas intangible assets and goodwill are assigned a higher discount rate. This is because achieving the lower levels of cash flows necessary to provide a "fair" return on investment (ROI) on tangible assets is more certain than achieving the higher levels of cash flows necessary to provide a fair ROI on intangible assets. Figure 7-6 illustrates the rate stratification concept for intangible assets. Application of the concept is subjective and requires significant judgment.

Reconciliation of rates of return

The assignment of stratified rates to the various classes of assets is a challenging process because there are few if any observable active markets for intangible assets. Nonetheless, reporting entities should assess the overall reasonableness of the discount rate assigned to each asset by generally reconciling the discount rates assigned to the individual assets, on a fair-value-weighted basis, to the WACC of the acquiree (or the IRR of the transaction if the PFI does not represent market-participant assumptions). This reconciliation is often referred to as a "weighted average return analysis" (WARA). The WARA is a tool to assess the reasonableness of the selected discount rates.

Although goodwill is not explicitly valued by discounting residual cash flow, its implied discount rate should be reasonable, considering the facts and circumstances surrounding the transaction and the risks normally associated with realising earnings high enough to justify investment in goodwill. Determining the implied rate of return on goodwill is necessary to assess the reasonableness of the selected rates of return on the individual assets acquired. The rate of return should be consistent with the type of cash flows associated with the underlying asset; that is, the expected cash flows or conditional cash flows, as the rate of return may be different for each. Assets valued using expected cash flows would have a lower required rate of return than the same assets valued using conditional cash flows, because the latter cash flows do not include all of the possible downside scenarios. The discount rates used in the WARA should reflect expected cash flows. Using discount rates appropriate to conditional cash flows will distort the WARA analysis as the discount rate for the overall company will generally be on an expected cash flows basis.

The value of the assets used in the WARA should be adjusted to the extent the asset's value is not amortizable for tax purposes. Some transactions (for example, share acquisitions in some jurisdictions) do not result in a change in the tax basis of acquired assets or liabilities assumed. See BCG 5.2 for further information.

Example 7-3 provides an example of a WARA reconciliation used to test the reasonableness of the discount rates applied to the individual assets.

EXAMPLE 7-3

Weighted average return analysis

Company A acquires Company B in a business combination for CU400 million. Reconciling Company B's PFI to the consideration transferred of CU400 million results in an internal rate of return of 12%. Assume a 40% tax rate. The WACC for comparable companies is 11.5%. (CU's in millions)

Assets	Fair value	% of total	After-tax discount rate	Weighted average discount rate
Working capital	CU30	7.5%	4.0%	0.3%
Fixed assets	60	15.0	8.0	1.2
Patent	50	12.5	12.0	1.5
Customer relationships	50	12.5	13.0	1.6
Developed technology	80	20.0	13.0	2.6
Residual goodwill	130	32.5	15.0	4.9
Total	CU400	100.0%		12.1%

Analysis

- The discount rates selected for intangible assets in conjunction with the rates selected for other assets, including goodwill, results in a WARA of 12.1 percent, which approximates the comparable entity WACC and IRR of 11.5 percent and 12 percent, respectively. Therefore, the selected discount rates assigned to the assets acquired appear reasonable.
- The rates used for contributory assets, which are working capital (4 percent) and fixed assets (8 percent), are generally consistent with after-tax observed market rates. In general, discount rates on working capital and fixed assets are derived assuming a combination of equity and debt financing. The cost of debt on working capital could be based on the company's short-term borrowing cost. The fixed asset discount rate typically assumes a greater portion of equity in its financing compared to working capital. The entity's overall borrowing cost for the debt component of the fixed asset discount rate would be used rather than a short-term borrowing cost as used for working capital.
- The rates used to derive the fair value of the patent, customer relationships, and developed technology of 12 percent, 13 percent, and 13 percent, respectively, each represent a premium to the WACC (11.5 percent). The premium should be based on judgment and consistent with market-participant assumptions. Certain intangible assets, such as patents and backlog contracts, are perceived to be less risky than other intangible assets, such as customer relationships, developed technology, and goodwill. Discount rates on lower-risk intangible assets may be consistent with the entity's WACC, whereas higher risk intangible assets may reflect the entity's cost of equity capital.
- The implied discount rate for goodwill (15 percent in this example) should, in most cases, be higher than the rates assigned to any other asset. Generally, goodwill has the most risk of the assets on the balance sheet; however, the implied rate of return should typically not be significantly higher than the rate of return on

most other intangible assets. If the implied rate of return on goodwill is significantly different from the rates of return on the identifiable assets, the selected rates of return on the identifiable assets should be reconsidered.

- Significant professional judgment is required to determine the stratified discount rates that should be applied in performing WARA reconciliation. A selected rate of return on intangible assets greater than 14 percent (in this example) would result in a lower fair value of the intangible assets and a higher implied fair value of goodwill (implying a lower rate of return on goodwill compared to other assets). This may suggest that the selected return on intangible assets is too high, because goodwill should conceptually have a higher rate of return than intangible assets.

Leading practices in determining contributory asset charges

Cash flows associated with measuring the fair value of an intangible asset using the MEEM should be reduced or adjusted by contributory asset charges. The practice of taking contributory asset charges on assets, such as net working capital, fixed assets, and other identifiable intangible assets, is widely accepted among valuation practitioners. However, there are varying views related to which assets should be used to calculate the contributory asset charges. Some valuation practitioners have argued that certain elements of goodwill or goodwill in its entirety should be included as a contributory asset, presumably representing going concern value, institutional know-how, repeat patronage, and reputation of a business. A majority of valuation practitioners and accountants have rejected this view because goodwill is generally not viewed as an asset that can be reliably measured.

However, assembled workforce, as an element of goodwill, may be identifiable and reasonably measured, even though it does not meet the accounting criteria for separate recognition. As a result, an assembled workforce is typically considered a contributory asset, even though it is not recognised separately from goodwill [ASC 805-20-55-6, IFRS 3.B37]. It is rare to see a valuation of an intangible asset that includes a contributory asset charge for a portion of goodwill, with the exception of an assembled workforce. Improperly including a contributory asset charge will tend to understate the fair value of the intangible asset and overstate goodwill. This is an evolving area; valuation practitioners are debating which other elements of goodwill might be treated in the same way as workforce and if such elements can be reasonably measured.

Another common practice issue in determining contributory asset charges is the inclusion of both returns "on" and "of" the contributory asset when the "of" component is already reflected in the asset's cash flow forecast. For self-constructed assets, such as customer lists, the cost to replace them (i.e., the return of value) typically is included in normal operating costs and, therefore, already is factored into the PFI as part of the operating cost structure. Because this component of return is already deducted from the entity's revenues, the returns charged for these assets would include only the required return on the investment (i.e., the profit element on those assets has not been considered) and not the return of the investment in those assets. The return of component encompasses the cost to replace an asset, which differs from the return on component, which represents the expected return from an alternate investment with similar risk (i.e., opportunity cost of funds). Where returns of the asset are not included in the operating cost structure, a "return on" and a "return of" value would be charged.

The applied contributory asset charge may include both a "return on" and a "return of" component in certain circumstances. This may require an adjustment to the PFI used to value a particular intangible asset. For example, when a royalty rate is used as a technology contributory asset charge, the assumption is that the entity licenses its existing and future technology instead of developing it in-house. If the PFI was developed on the assumption that future technology will be developed in-house, it would reflect cash expenditures for research and development. In this case, the PFI used to value the individual intangible asset (e.g., customer relationships) should be adjusted by eliminating the cash spent on research and development for future technology. This is because the royalty is the cost for licensing completed technology (whether current or future) from a third party. As a result, inclusion of cash spent on research and development in the PFI results in double counting as there is no need to develop a technology in-house when it is assumed to be licensed from a third party.

Tax amortisation benefits

The effect of income taxes should be considered when an intangible asset's fair value is estimated as part of a business combination, an asset acquisition, or an impairment analysis. The fair values of the acquired assets and liabilities assumed for financial reporting purposes and tax purposes are generally the same in a taxable business combination. See BCG 5.2 for further information. Accordingly, the present value of the intangible asset's projected cash flows should reflect the tax benefit that may result from amortising the new tax basis in the intangible asset. Generally, the tax amortisation benefit is applied when using the income approach and is not applied when using the market approach. Market-based data used in the market approach is assumed to include the potential tax benefits resulting from obtaining a new tax basis.

A nontaxable business combination usually results in the acquiring entity carrying over the acquiree's tax basis. As a result, the amounts recorded for financial reporting purposes will most likely differ from the amounts recorded for tax purposes. A **deferred tax asset** or **deferred tax liability** should generally be recognised for the effects of such differences. Although no "step up" of the intangible asset's tax basis actually occurs, the estimation of fair value should still reflect hypothetical potential tax benefits as if it did. The Fair Value Standards require each asset to be measured at fair value as if hypothetically acquired separately, in which case the tax benefit would be realised. U.S. GAAP requires that the tax amortisation benefit be factored into an asset's fair value, regardless of the tax attributes of the transaction (e.g., taxable or nontaxable) [FAS 109.129]. The tax benefits should reflect the tax legislation in the domicile where the asset is situated. However, if there are no tax benefits possible (i.e., the tax legislation in the subject jurisdiction does not permit market-participants to recognise a new tax basis under any circumstance), then the fair value of the assets should not include any tax benefits.

IFRS does not contain specific guidance with respect to applying the tax amortisation benefit. However, the asset's fair value is independent of the way an asset is acquired, whether acquired alone or together with other assets in a business combination. An asset's fair value in a business combination should reflect the price that would be paid for the individual asset if it was acquired separately. The tax amortisation benefit that would be available if the asset was acquired separately is reflected in the asset's fair value, if such a benefit would be available to potential purchasers of the asset.

Distributor method

The distributor method is a variation of the MEEM that has recently emerged in practice as a method used to value customer relationship intangible assets when they are not a primary value driver of an acquired business. The distributor method may be an appropriate valuation model for valuing customer relationships where the nature of the relationship between the company and its customers, and the value added by the activities the company provides for its customers, are similar to the relationship and activities found between a distributor and its customers. For example, valuing the customer relationship asset using the distributor method may be appropriate when the company sells a commodity-like product where customer purchasing decisions are driven largely by price. The Distributor method would likely be an inappropriate method in cases where the company provides significant value added products or services that may be highly specialized and difficult for customers to switch vendors.

The fundamental concept underlying the distributor method is that an earnings approach can be performed similar to how one might value a distribution company. Profit margins are estimated consistent with those earned by distributors for their distribution effort, and contributory asset charges are taken on assets typically used by distributors in their business (e.g., use of warehouse facilities, working capital, etc.). This is contrasted with the traditional MEEM approach that considers the overall cash flows of a product or business (that will frequently earn higher margins) and have more contributory assets (e.g., use of intellectual property, trade names, etc.). Discount rates used to value the customer relationship using the distributor method should reflect the risks of a distribution business.

Although considered a MEEM approach the distributor method can be seen as being similar to a relief-from-royalty method in that both methods attempt to isolate the cash flows related to a specific function of a business. One advantage of using the distributor method is that the customer relationship asset can be valued using a defined subset of cash flows of the total business. As a result, the remaining cash flows of the business can be used in a separate MEEM for the primary value driving asset, such as intellectual property or other assets, without the need for contributory assets charges that result in double counting or omitting cash flows from the valuation of those assets (see Figure 7-9).

Potential concerns of the use of the distributor method include the following:

- The relationship between a reporting entity and its customers is often greater than that found between a distributor and its customers. As a result, in these cases the use of the distributor method may understate the value of the customer relationship asset.

- Finding appropriate comparable distributor inputs (profit margins and contributory asset returns) consistent with the industry of the company being analyzed may be difficult for several reasons including:
    - Distributors are not found in all industries
    - Distributors are often small companies and may not have the economies of scale of a larger company
    - Disaggregating the functions of a business in order to estimate distributor inputs may be viewed as arbitrary
- The distributor method should not be used to value a primary asset as it likely does not capture all of the cash flows that the business derives from the asset. The primary asset of a business should be valued using the cash flows of the business of which it is the primary asset. It is unlikely that cash flows of a proxy would be a better indication of the value of a primary asset.

7.6.1.2 Relief-from-royalty method

The RFR is a commonly used method for measuring the fair value of intangible assets that are often the subject of licensing, such as trade names, patents, and proprietary technologies.

The fundamental concept underlying this method is that in lieu of ownership, the acquirer can obtain comparable rights to use the subject asset via a licence from a hypothetical third-party owner. The asset's fair value is the present value of licence fees avoided by owning it (i.e., the royalty savings). To appropriately apply this method, it is critical to develop a hypothetical royalty rate that reflects comparable comprehensive rights of use for comparable intangible assets. The use of observed market data, such as observed royalty rates in actual arm's length negotiated licences, is preferable to more subjective unobservable inputs.

Royalty rate selection requires judgment because most brands, trade names, trademarks, and intellectual property have unique characteristics. If available, the actual royalty rate charged by the company for the use of the technology or brand to other parties is generally the best starting point for an estimate of the appropriate royalty rate. The use of observed market data, such as observed royalty rates in actual arm's length negotiated licences for similar products, brands, trade names, or technologies, may also be used to estimate royalty rates. Market rates are adjusted so that they are comparable to the subject asset being measured, and to reflect the fact that market royalty rates typically reflect rights that are more limited than those of full ownership. Market royalty rates can be obtained from various third-party data vendors and publications.

In the absence of market derived rates, other methods have been developed in order to estimate royalty rates. These include the profit split method (where the profits of the business are allocated to the various business functions), the return on assets method (returns on other assets are subtracted from the profits of the business), and the comparable profits method (where the profitability measures of companies or business units that carry out activities similar to that provided by the intangible asset are considered).

Example 7-4 provides an example of a relief-from-royalty method.

EXAMPLE 7-4

The relief-from-royalty method

Company A acquires technology from Company B in a business combination. Prior to the business combination, Entity X was licensing the technology from Company B for a royalty of 5% of sales. The technology acquired from Company B is expected to generate cash flows for the next five years.

Analysis

Company A has determined the relief-from-royalty method is appropriate to measure the fair value of the acquired technology.

The following is a summary of the assumptions used in the relief-from-royalty method:

- Revenue: Represents the projected revenue expected from the technology over the period of expected cash flows, which is estimated to be five years.

- Royalty rate: The royalty rate of 5% was based on the rate paid by Entity X before the business combination, and is assumed to represent a market-participant royalty rate. Actual royalty rates charged by the acquiree (Company B) should be corroborated by other market evidence where available.

- Discount rate: Based on an assessment of the relative risk of the cash flows and the overall entity's cost of capital, 15% is considered reasonable.

- Tax amortisation benefits: Represents the present value of tax benefits generated from amortising the intangible asset.

Based on the discount rate, tax rate, and a statutory 15-year tax life, the tax benefit was calculated to be 18.5% of the summation of present values.

	Year 1	Year 2	Year 3	Year 4	Year 5
Revenue	CU10,000	CU8,500	CU6,500	CU3,250	CU1,000
Royalty rate	5.0%	5.0%	5.0%	5.0%	5.0%
Royalty savings	500	425	325	163	50
Income tax rate	40%	40%	40%	40%	40%
Less: Income tax expense	(200)	(170)	(130)	(65)	(20)

	Year 1	Year 2	Year 3	Year 4	Year 5
After-tax royalty savings	CU300	CU255	CU195	CU98	CU30
Discount period[1]	0.5	1.5	2.5	3.5	4.5
Discount rate	15%	15%	15%	15%	15%
Present value factor[2]	0.9325	0.8109	0.7051	0.6131	0.5332
Present value of royalty savings[3]	CU280	CU207	CU137	CU60	CU16
Sum of Present Values	CU700				
Tax amortisation benefit[4]	129				
Fair value	CU829				

[1] Represents a midperiod discounting convention, because cash flows are recognised throughout the year.

[2] Calculated as 1/(1 + k) ^ t, where k = discount rate and t = discount period.

[3] Calculated as the after-tax royalty savings multiplied by the present value factor.

[4] The tax amortisation benefit was calculated to be 18.5 percent of the summation of the present value of cash flows.

7.6.1.3 *Greenfield method*

The subject intangible asset is valued under the greenfield method using a hypothetical cash flow scenario of developing an operating business from an entity that at inception only holds the subject intangible asset. Consequently, this valuation method is most relevant for assets that are considered to be scarce or fundamental to the business, even if they do not necessarily drive the excess returns that may be generated by the overall business. For example, the greenfield method is frequently used to value broadcasting licences. These assets are fundamental for a broadcasting business but do not necessarily generate excess returns for the business. Excess returns may be driven by the broadcasted content or technology.

This method considers the fact that the value of a business can be divided into three value categories: (1) the “going concern value,” (2) the value of the subject intangible asset, and (3) the value of the excess returns driven by other assets. The going concern value is the value of having all necessary assets and liabilities assembled such that normal business operations can be performed. Under the greenfield method, the investments required to recreate the going concern value of the business (both capital investments and operating losses) are deducted from the overall business cash flows. This results in the going concern value being deducted from the overall business value. Similarly, the value of the excess returns driven by intangible assets other than the subject intangible asset is also excluded from the overall business cash flows by using cash flows providing only market-participant or normalized level of returns. The result of deducting the investment needed to recreate the going concern value and excluding the excess returns driven by other intangible assets from the overall business cash flows provides a value of the subject intangible asset, the third element of the overall business.

The greenfield method requires an understanding of how much time and investment it would take to grow the business considering the current market conditions. The expenses and capital expenditures required to recreate the business would be higher than the expense and capital expenditure level of an established business. In addition, the time to recreate or the ramp-up period also determines the required level of investments (e.g., to shorten the ramp-up period more investment would be required). In summary, the key inputs of this method are the time and required expenses of the ramp-up period, the market-participant or normalized level of operation of the business at the end of the ramp-up period, and the market-participant required rate of return for investing in such a business (discount rate).

The tax amortisation benefit of the intangible asset should also be included in determining the value of the subject intangible asset.

7.6.1.4 With and without method

The value of an intangible asset under the with and without method is calculated as the difference between the business value estimated under two sets of cash flow projections:

- The value of the business with all assets in place at the valuation date
- The value of the business with all assets in place except the intangible asset at the valuation date

The fundamental concept underlying this method is that the value of the intangible asset is the difference between an established, on-going business and one in which the intangible asset does not exist. If the intangible asset can be rebuilt or replaced in a certain period of time then the period of lost profit, which would be considered in valuing the intangible asset, is limited to the time to rebuild. However, the incremental expenses required to rebuild the intangible asset also increase the difference between the scenarios and, therefore, the value of the intangible asset.

This valuation method is most applicable for assets that provide incremental benefits, either through higher revenues or lower cost margins, but where there are other assets that drive revenue generation. This method is sometimes used to value customer related intangible assets when the MEEM method is used to value another asset. Key inputs of this method are the assumptions of how much time and additional expenses are required to recreate the intangible asset, and the amount of lost cash flows that should be assumed during this period. The expenses required to recreate the intangible asset should generally be higher than the expenses required to maintain its existing service potential. In addition, to shorten the time to recreate it would generally require a higher level of investment.

The tax amortisation benefit of the intangible asset should also be included in determining the value of the intangible asset.

7.6.2 Market approach for intangible assets

The market approach may be applied to measure the fair value of an intangible asset that is, or can be, traded, and for which market data is reasonably available. Intangible assets tend to be unique and typically do not trade in active markets. For those transactions that do occur, there tends to be insufficient information available. However, there are some types of intangible assets that may trade as separate portfolios (such as brands, cable television, or wireless telephone service subscriptions), as well as some licences to which this approach may apply.

When applying the market approach to intangible assets, relevance and weight should be given to financial and key nonfinancial performance indicators. See BCG 7.5.2 for further information. As a practical matter, information about key nonfinancial performance indicators (e.g., value per bed for hospitals, value per advisor for an advisory business, value per subscriber for a telecommunications company) may be more relevant and available than pure financial metrics. When used, these performance metrics should be reviewed carefully. For example, a cell phone subscription in an area with low monthly usage would not be of equivalent value to a subscription in an area with a high monthly usage.

Another factor to consider when valuing assets is that price and value are often affected by the motivations of the buyer and seller. For example, the selling price of an asset that is sold in liquidation is not a useful indication of fair value.

The market approach typically does not require an adjustment for incremental tax benefits from a “stepped-up” or new tax basis. The market-based data from which the asset’s value is derived is assumed to implicitly include the potential tax benefits resulting from obtaining a new tax basis. An adjustment may be required, however, if the tax rules in the domicile where comparable transactions occurred are different from the tax rules where the subject asset is domiciled.

7.6.3 Cost approach for intangible assets

The cost approach, while more commonly used to value machinery and equipment, can be an effective means of estimating the fair value of certain intangible assets that are readily replicated or replaced, such as routine software and assembled workforce. However, it is seldom appropriate to use a cost approach for an intangible asset which is one of the primary assets of the business.

The cost approach, applied to intangible assets, may fail to capture the economic benefits expected from future cash flows. For example, the costs required to replace a customer relationship intangible asset will generally be less than the future value generated from those customer relationships. This is because the cost approach may fail to capture all of the necessary costs to rebuild that customer relationship to the mature level/stage that exists as of the valuation date, as such costs are difficult to distinguish from the costs of developing the business.

A market-participant may pay a premium for the benefit of having the intangible asset available at the valuation date, rather than waiting until the asset is obtained or created. If the premium would be significant, then an "opportunity cost" should be considered when using the cost approach to estimate the fair value of the intangible asset. That opportunity cost represents the foregone cash flows during the period it takes to obtain or create the asset, as compared to the cash flows that would be earned if the intangible asset was on-hand today. Some factors to consider when determining if opportunity cost should be applied include:

- Difficulty of obtaining or creating the asset
- Period of time required to obtain or create the asset
- Scarcity of the asset
- Relative importance of the asset to the business operations

If this additional opportunity cost included in the cost approach is based on the total enterprise cash flows, then the calculation would be similar to the approach in the with and without method. However, intangible assets valued using the cost approach are typically more independent from other assets and liabilities of the business than intangible assets valued using the with and without method. Further analysis is required to determine whether the opportunity cost can be estimated by alternative approaches, like renting a substitute asset for the period required to create the subject intangible asset.

Estimating the opportunity cost can be difficult and requires judgment. Also, it may not be appropriate to include the total lost profit of a business in the value of one intangible asset if there are other intangible assets generating excess returns for the business.

The cost approach typically requires no adjustment for incremental tax benefits from a "stepped-up" or new tax basis. The market-based data from which the asset's value is derived under the cost approach is assumed to implicitly include the potential tax benefits resulting from obtaining a new tax basis. Under the cost approach the assumed replacement cost is not tax effected while the opportunity cost is calculated on a post-tax basis.

7.6.4 Assets not intended to be used or used in a way other than their highest and best use

The Standards clarify that assets that an acquirer does not intend to use or intends to use in a way other than their highest and best use must still be recorded at fair value based on market-participant assumptions. In general, assets that are not intended to be used by the acquirer include overlapping assets (e.g., systems, facilities) that the acquirer already owns, thus they do not view such assets as having value. The following figure shows the relationship between the relative values at initial recognition of assets the acquirer does not intend to actively use.

Figure 7-8
Considerations for assets the acquirer does not intend to actively use

Categories	Observations
▫ Acquirer entity will not actively use the asset, but a market-participant would (e.g., brands, licences)	▫ Typically smaller value relative to other assets not intended to be used ▫ Common example: Manufacturing process technology or know-how that is generally common and relatively unvaried within the industry, but still withheld from the market to prevent new entrants into the market
▫ Acquirer entity will not actively use the asset, nor would another market-participant in the same industry (e.g., process technology, know-how)	▫ Typically smaller value relative to other assets not intended to be used ▫ Common example: Manufacturing process technology or know-how that is generally common and relatively unvaried within the industry, but still withheld from the market to prevent new entrants into the market

Defensive intangible assets are a subset of assets not intended to be used and represent intangible assets that an acquirer does not intend to actively use, but intends to prevent others from using. Defensive intangible assets may include assets that the acquirer will never actively use, as well as assets that will be actively used by the acquirer only during a transition period. In either case, the acquirer will lock up the defensive intangible assets to prevent others from obtaining access to them for a period longer than the period of active use. Examples of defensive intangible assets include brand names and trademarks. However, not all assets that are not intended to be used are defensive intangible assets. If an asset is not being used and market-participants would not use the asset, it would not necessarily be considered a defensive intangible asset. For example, the billing software acquired by the strategic buyer in example 7-1 is not considered a defensive asset even if it is used only for a transition period. See BCG 2.5.1.1 and BCG 4.5 for further information on the recognition of defensive assets.

A business may acquire in-process research and development (IPR&D) that it does not intend to actively use. However, if a market-participant would use it, the IPR&D must be measured at fair value. See BCG 4.3.5.1 for further information on IPR&D not intended to be used by the acquirer.

A reporting entity's determination of how a market-participant would use an asset will have a direct impact on the initial value ascribed to each defensive asset. Therefore, identifying market-participants, developing market-participant assumptions, and determining the appropriate valuation basis are critical components in developing the initial fair value measurement for defensive assets. Additional considerations would include the following:

- Unit of account—All defensive assets should be recognised and valued separately. They should not be combined with other assets even if the purpose of acquiring the defensive asset is to enhance the value of those other assets. By locking up a trade name, for example, and preventing others from using it, the acquirer's own trade name may be enhanced. The enhancement in value is measured as a separate unit of account rather than as additional value to the acquirer's pre-existing trade name even if assumptions about the enhanced value of the existing asset are the basis for valuation of the defensive asset.

- Defining market-participants—Market-participants for a given defensive asset may be different from those for the transaction as a whole.

- Valuation techniques and approaches—Common valuation techniques will likely still apply for defensive assets (e.g., relief from royalty, with-and-without), taking into account the cash flows reflecting market-participant assumptions. However, while the valuation techniques may be consistent with other intangible assets, the need to use market-participant assumptions and hypothetical cash flow forecasts will require more effort. For example, determining the hypothetical cash flows that a market-participant would generate if it were to use the defensive asset in the marketplace will require a significant amount of judgment. Accordingly, assumptions may need to be refined to appropriately capture the value associated with locking up the acquired asset. Such assumptions may consider enhancements to other complementary assets, such as an existing brand, increased projected profit margins from reduced competition, or avoidance of margin erosion from a competitor using the brand that the entity has locked up. If no market-participants in the industry would actively use the asset, it may also be appropriate to estimate the direct and indirect benefits associated with the defensive use of the asset although the value is likely to be low.

Regardless of the methodology used in valuing the defensive asset, it is important not to include value in a defensive asset that is already included in the value of another asset.

Example 7-5 provides an example of the valuation of a defensive asset.

EXAMPLE 7-5

Defensive asset

Company A (a large beverage company) acquires Company B (a smaller beverage company) in a business combination. Company A acquired Company B in order to gain distribution systems in an area that Company A had an inefficient distribution system. While Company A does not plan on using Company B's trademark, other market-participants would continue to use Company B's trademark.

Analysis

Although Company A has determined that it will not use Company B's trademark, other market-participants would use Company B's trademark. As a result, the trademark is a defensive asset and should be valued using market-participant assumptions.

7.6.5 Reacquired rights

An acquirer may reacquire a right that it had previously granted to the acquiree to use one or more of the acquirer's recognised or unrecognised assets. Examples of such rights include a right to use the acquirer's trade name under a franchise agreement or a right to use the acquirer's technology under a technology licensing agreement. Such **reacquired rights** generally are identifiable intangible assets that the acquirer separately recognises from goodwill [ASC 805-20-25-14; IFRS 3.B35]. The reacquisition should be evaluated separately to determine if a gain or loss on the settlement should be recognised. See BCG 2.7.3.1 for further informtaion. Additionally, see BCG 2.5.6 for further information on the recognition of reacquired rights.

Reacquired rights are identified as an exception to the fair value measurement principle, because the value recognised for reacquired rights is not based on market-participant assumptions for the life of the reacquired right. The value of a reacquired right is determined based on the estimated cash flows over the remaining contractual life, even if market-participants would reflect expected renewals in their measurement of that right [ASC 805-20-30-20; IFRS 3.29]. See BCG 2.5.6 for further information.

The value of a reacquired right should generally be measured using an income approach valuation technique. That technique considers the acquiree's cash flows after payment of the royalty rate to the acquirer for the right that is being reacquired.

The market and the cost approaches are rarely used to value reacquired rights. The usefulness of these approaches is diminished by the requirement to limit the term of the reacquired right to the remaining contractual term. For example, a market approach could not be readily applied to a reacquired right as a market price for a comparable intangible asset would likely include expectations about contract renewals; however, these expectations are excluded from the measurement of a reacquired right.

7.6.6 Leading practices when measuring the fair value of intangible assets

Figure 7-9 highlights some leading practices when measuring the fair value of intangible assets.

Figure 7-9
Leading practices when measuring the fair value of intangible assets

Use an appropriate valuation methodology for the primary intangible assets	The income approach is most commonly used to measure the fair value of primary intangible assets. The market approach is not typically used due to the lack of comparable transactions. The cost approach is generally not appropriate for intangible assets that are deemed to be primary cash-generating assets, such as technology or customer relationships. As discussed in BCG 7.2.4.3, the cost approach is sometimes used to measure the fair value of certain software assets used for internal purposes, an assembled workforce, or assets that are readily replicated or replaced.
Use an appropriate valuation methodology for the primary intangible assets	The income approach is most commonly used to measure the fair value of primary intangible assets. The market approach is not typically used due to the lack of comparable transactions. The cost approach is generally not appropriate for intangible assets that are deemed to be primary cash-generating assets, such as technology or customer relationships. As discussed in BCG 7.2.4.3, the cost approach is sometimes used to measure the fair value of certain software assets used for internal purposes, an assembled workforce, or assets that are readily replicated or replaced.
Value intangible assets separately	In most cases, intangible assets should be valued on a stand-alone basis (i.e., trademark, customer relationships, technology, etc.). In some instances the economic life, profitability, and financial risks will be the same for several intangible assets such that they can be combined. See BCG 4.2.2 for further information.
Carefully consider and assess the economic life of an asset	For example, the remaining economic life of patented technology should not be based solely on the remaining legal life of the patent because the patented technology may have a much shorter economic life than the legal life of the patent. The life of customer relationships should be determined by reviewing customer relationship turnover.
Select discount rates on intangible assets that are within a reasonable range of the WACC and/or IRR	In general, low-risk assets should be assigned a lower discount rate than high-risk assets. The required return on goodwill should be highest in comparison to the other assets acquired.

Use the MEEM only for the primary intangible asset	The MEEM, which is an income approach, is generally used only to measure the fair value of the primary intangible asset. Secondary or less-significant intangible assets are generally measured using an alternate valuation technique (e.g., relief-from royalty, distributor, greenfield, or cost approach). Using the MEEM to measure the fair value of two intangible assets using a common revenue stream and contributory asset charges results in double counting or omitting cash flows from the valuations of the assets.
Include the tax amortisation benefit when using an income approach	As discussed in BCG 7.6.1.1, the tax benefits associated with amortising intangible assets for tax purposes should generally be applied regardless of the tax attributes of the transaction. The tax jurisdiction of the country the asset is domiciled in should drive the tax amortisation benefit calculation.

7.7 Valuation approaches for other assets and liabilities

Generally, variations of the cost, market, and income approaches are used to measure the fair value of the major components of working capital (e.g., accounts receivable, inventory, and accounts payable) and tangible assets, such as property, plant, and equipment.

7.7.1 Measuring the fair value of working capital

Working capital is current assets less current liabilities. ASC 820 and IFRS 3 require that the components of working capital be recorded at fair value. Valuation considerations for selected components of working capital are as follows.

7.7.1.1 Inventories

The fair value of finished goods inventory is generally measured by determining net realisable value (i.e., estimated selling prices of the inventory, less the sum of (1) costs of disposal and (2) a reasonable profit allowance for the selling effort) as this represents an exit price. ASC 820-10-55-21 and IFRS 13 paragraph B35 describe the valuation of finished goods inventory as follows:

ASC 820-10-55-21 and IFRS 13.B35

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

Work in process inventory is measured similarly to finished goods inventory except that, in addition, the estimated selling price is adjusted for the costs to complete the manufacturing, and a reasonable profit allowance for the remaining manufacturing effort. Raw material inventories are recorded at fair value and are generally measured based on the price that a market-participant would pay currently for the inventory.

7.7.1.2 Accounts receivable

It is acceptable to value accounts receivable either on a stand-alone basis or in combination with other assets. When valued on a stand-alone basis, fair value is the price that would be received to sell the accounts receivable (i.e., an exit price). The price that would be received will generally be based on the sale of accounts receivable to a market-participant that is in the business of acquiring accounts receivable. In that circumstance, the fair value of accounts receivable would result in a reduction to the face amount, which reflects the collection risk, the timing of payment, and a profit element to the market-participant.

When valued in combination with other assets, the fair value measurement assumes the collection of the accounts receivable within a reporting entity's ongoing business operations. However, any risks associated with nonperformance of the counterparty should be incorporated into the fair value estimate of the accounts receivable. Accordingly, a separate allowance for doubtful accounts should not be recorded.

7.7.1.3 Accounts payable

The fair value of accounts payable and accrued liabilities assumed in a business combination would be based on the price paid to transfer the accounts payable and accrued liabilities to a market-participant. The fair value will incorporate timing of the payments to be made, nonperformance risk, the current interest rate environment, and a profit element required by market-participants to service the liability.

In practice, the carrying value of accounts payable is often a good approximation of fair value as the future liability amount is certain and due in a short period of time. The implied time value of money likely provides the required return to the party assuming the liability. For accrued liabilities, if a performance obligation exists and amounts are uncertain, additional elements such as a profit factor may be required to provide the required return to the party assuming the liability.

7.7.2 *Measuring the fair value of tangible assets*

The fair value of certain tangible assets (e.g., buildings, machinery, and equipment) is established using the market approach or the income approach because there is usually available market data for sales and rentals of buildings, machinery, and equipment. In the rare instances in which an reporting entity is valuing buildings, machinery, and equipment for which there is no market data for sales or rentals, the depreciated replacement cost approach may be used to measure fair value, although not for impairment testing under IAS 36.

The fair value of other tangible assets, such as specialised properties or plant and equipment, is often measured using the replacement-cost method or the cost approach. This represents the highest value that a market-participant would pay for an asset with similar utility. The cost approach is based on the principle of substitution. It uses the cost to replace an asset as an indicator of the fair value of that asset. To determine the appropriate substitute asset or asset group as a measure of fair value, the utility of the replacement asset is compared to the utility of the asset being measured. Comparable utility implies similar economic satisfaction, but does not necessarily require that the substitute asset be an exact duplicate of the asset being measured. The cost of an exact duplicate is referred to as reproduction cost. The substitute asset is perceived as equivalent if it possesses similar utility and, therefore, serves as a measure of fair value of the asset being valued.

Typically, the first step in the cost approach is to identify the asset's original cost. The next step is to adjust the original cost for changes in price levels between the asset's original in-service date and the date of the valuation to measure its **replacement cost new**. Replacement cost new represents the indicated value of current labour and materials necessary to construct or acquire an asset of similar utility to the asset being measured.

Next, adjustments are made to replacement cost new to reflect any losses in value due to physical deterioration or functional obsolescence of the asset, which results in the value of **replacement cost new less depreciation**. Physical deterioration represents the loss in value due to the decreased usefulness of a fixed asset as the asset's useful life expires. This can be caused by factors such as wear and tear, deterioration, physical stresses, and exposure to various elements.

Excessive physical deterioration may result in an inability to meet production standards or in higher product rejections as the tolerance on manufacturing equipment decreases. Higher than average maintenance expenditure requirements may also suggest higher levels of physical deterioration. However, below average maintenance expenditures may also indicate higher levels of physical deterioration due to inadequate or deferred maintenance.

Functional obsolescence represents the loss in value due to the decreased usefulness of a fixed asset that is inefficient or inadequate relative to other more efficient or less costly replacement assets resulting from technological developments. Functional obsolescence is observed in several different forms. If the subject asset has higher operating costs relative to a new asset, this may indicate a form of functional obsolescence. If in developing an asset's replacement cost new, that replacement cost is less than its reproduction cost, this may also be indicative of a form of functional obsolescence. The objective of the measurement is to identify the replacement cost of a modern equivalent asset.

Physical and functional obsolescence are direct attributes of the asset being valued. However, to provide an indication of the fair value of the asset being measured, further adjustment may be necessary to "replacement cost new less depreciation" for loss in value due to economic obsolescence. Economic obsolescence represents the loss in value due to the decreased usefulness of a fixed asset caused by external factors, independent from the characteristics of the asset or how it is operated. Increased cost of raw materials, labour, or utilities, that cannot be offset by an increase in price due to competition or limited demand, as well as a change in environmental or other regulations, inflation, or high interest rates may suggest the presence of economic obsolescence.

It is permissible to value certain tangible assets using the replacement-cost method. However, there may be instances or industry practice in which certain tangible assets are measured using an income or market approach. An example is the measurement of a power plant in the energy sector, which often has few, if any, intangible assets other than the embedded licence. The cash flows from the plant reflect only the economic benefits generated by the plant and its embedded licence. Management should consider other U.S. GAAP or IFRS to determine whether the assets measured together need to be accounted for separately. This could result in a fair value measurement above the replacement cost. In this situation, management should consider whether any of the difference relates to other assets included in the cash flows, such as customer or contractual assets that could be separately recognised.

See FV 4.3 and FV 4.4 for further information about available valuation techniques and evaluation of related inputs.

7.7.3 Measuring the fair value of financial assets and financial liabilities

Financial assets and financial liabilities of the acquiree acquired in a business combination should be recognised separately from goodwill and measured at fair value. See FV 4 and 6 for further information on determining the fair value of financial assets and financial liabilities under U.S. GAAP and IFRS.

7.7.3.1 Restricted securities

If an acquired entity holds a security that has restrictions on its sale or transferability (i.e., a restricted security), the fair value measurement should be adjusted to reflect the discount a market-participant would require as a result of the holding period if the restriction is an attribute of the security and not just on the acquired entity. That general principle applies regardless of when the restriction ends.

Example 6, Case A, Restriction on the Sale of an Equity Instrument, of ASC 820 (ASC 820-10-55-52) and Example 8, Restriction on the sale of an equity instrument, of IFRS 13 (IFRS13.IE28) illustrate the impact of a legal restriction on the sale of an equity instrument. They note that the "restriction is a characteristic of the instrument and, therefore, would be transferred to market-participants." Accordingly, the restriction should be considered in the valuation of the security as, presumably, it would be considered by market-participants when determining the fair value of the security. However, if the restriction arises outside of the security, it would not be included in the valuation. This may occur as a result of side agreements or compliance with statutory requirements imposed on the holder of the security that are not a direct attribute of the security.

Question 7-1

When should an acquirer incorporate restrictions on sale when determining fair value?

PwC response

The impact of a restriction on the sale or use of an asset depends on whether the restriction would be considered by market-participants in pricing the asset. In determining whether a restriction should be considered in the valuation of an asset, the source of the restriction and its connection to the underlying security should be carefully analysed.

For a restriction to be considered an attribute of the security, the restriction should be specific to the security, not to the reporting entity holding the security. For example, a company holding a block of stock in another company may also hold a board seat on the investee. Through the board seat, the company obtains material, nonpublic information and as a result cannot sell the security until such information becomes public. Since the board seat is not a specific attribute of the security held, the material nonpublic information and accompanying restriction should not be considered in the valuation of the security. Similarly, holders of securities may at times be subject to blackout periods as a result of possessing material nonpublic information. In those cases, the restriction is not attributable to the security, but rather the holder, and therefore should not be considered in determining the fair value. The key factor is whether the security itself carries the legal restriction or if the restriction exists due to the nature of the business of the reporting entity holding the security or by any means other than restriction on transfer of the security itself.

The date that the restriction is established is not critical to the analysis. Whether the restriction existed on the date the security was acquired or the restriction was created subsequent to acquisition, the holder should consider its impact on the security's fair value at each reporting date if the restriction is specific to the security and would be considered by market-participants in determining the exit price.

7.7.3.2 Blockage factors

When measuring the fair value of a financial instrument that trades in an active market, the Fair Value Standards prohibit the use of a blockage factor, a discount applied to reflect the inability to trade a block of the security because the market for the security, although an active one, cannot absorb the entire block at one time without adversely affecting the quoted market price.

7.7.3.3 *Debt*

When an entity with listed debt is acquired, market evidence shows that the listed price of the debt changes to reflect the credit enhancement to be provided by the acquirer (i.e., it reflects the market's perception of the value of the liability if it is expected to become a liability of the new group). If the acquirer does not legally add any credit enhancement to the debt or in some other way guarantee the debt, the fair value of the debt may not change.

The Standards require the fair value of debt to be determined as of the acquisition date. If the acquiree has public debt, the quoted price should be used. If the acquiree has both public and nonpublic debt, the price of the public debt should also be considered as one of the inputs in valuing the nonpublic debt.

Question 7-2

How should a company measure the fair value of debt assumed in a business combination?

PwC response

The credit standing of the combined entity in a business combination will often be used when determining the fair value of the acquired debt. For example, if acquired debt is credit-enhanced because the debt holders become general creditors of the combined entity, the value of the acquired debt will reflect the characteristics of the acquirer's postcombination credit rating.

However, if the credit characteristics of the acquired debt remain unchanged after the acquisition because, for example, the debt remains secured by only the net assets of the acquired entity, the value of the acquired debt will reflect the characteristics of the acquiree's pre-combination credit rating.

7.7.4 *General principles for measuring the fair value of liabilities*

The Fair Value Standards provide high-level guidance and a framework for measuring the fair value of nonfinancial liabilities, but do not provide practical valuation guidance. The fair value definition of a liability under the Fair Value Standards is based on a transfer concept. The transfer concept under the Fair Value Standards assumes that the liability is transferred to a market-participant and, therefore, continues in existence and is not settled with the counterparty. The following discussion focuses on these general, conceptual principles and potential issues that may emerge if these principles are applied.

7.7.4.1 *A liability is not necessarily a negative asset*

A liability is not considered merely a "negative asset" when measuring fair value. Some concepts applied in appraising assets, such as "highest and best use" or "valuation premise," may not have a readily apparent parallel in measuring the fair value of a liability. In measuring liabilities at fair value, the reporting entity must assume that the liability is transferred to a credit equivalent entity and that it continues after the transfer (i.e., it is not settled). As such, it follows that the hypothetical transaction used for valuation is based on a transfer to a credit equivalent entity that is in need of funding and willing to take on the terms of the obligation. Under the Fair Value Standards, the fair value of a liability is based on the price to transfer the obligation to a market-participant at the measurement date, assuming the liability will live on in its current form. However, in the absence of an observable market for the transfer of a liability, the Fair Value Standards require that preparers consider the value of the corresponding asset held by a market-participant when measuring the liability's fair value. The Basis for Conclusions of ASU 2011-4 and IFRS 13 states, "in the boards' view, the fair value of a liability equals the fair value of a … corresponding asset …, assuming an exit from both positions in the same market." However, assets and liabilities typically trade in different markets (if they trade at all) and therefore may have different values. For example, the holder of an automobile warranty asset (the right to have an automobile repaired) likely views the warranty asset in a much different way than the automaker who has a pool of warranty liabilities. The holders of the asset and liability don't transact in the same market and wouldn't likely value the asset and liability in the same way. The valuation of liabilities is an evolving area.

7.7.4.2 Not all liabilities are the same

Various accounting guidance differentiate an obligation to deliver cash (i.e., a financial liability) from an obligation to deliver goods and services (i.e., a nonfinancial liability). Financial liabilities are typically interest bearing and nonfinancial liabilities typically are not. An entity's financial liabilities often are referred to as debt and its nonfinancial liabilities are referred to as operating or performance obligations. Unlike debt, which requires only a cash transfer for settlement, satisfying a performance obligation may require the use of other operating assets.

In addition to being classified as debt or performance obligations, liabilities can have other fundamentally different characteristics. For example, the payment date may be specified or may vary depending on some outcome. A debt or a performance obligation may mature simply by the passage of time (i.e., noncontingent) or may depend on other events (i.e., contingent) resulting in performance and other related risks.

A performance obligation may be contractual or noncontractual, which affects the risk that the obligation is satisfied. These differences affect the variability and magnitude of risks and uncertainties that can influence the settlement or satisfaction of the obligation and its fair value. Therefore, it is important to be aware of these differences when measuring the fair value of performance obligations. This is particularly critical when considering future cash flow estimates and applicable discount rates when using the income method to measure fair value.

7.7.4.3 Not all cash flows and rates of return are the same

Projected future cash flows can be "conditional" (sometimes referred to as "promised" or "traditional") or "expected" (see BCG 7.5.1.2). While these principles apply in using future cash flow estimates to measure the fair value of assets and liabilities, they are more widely used in the context of measuring assets. They are discussed below in the context of liabilities. A conditional cash flow estimate reflects a specific (single) condition, such as the "most likely," "maximum," or "promised" amount or set of conditions. For example, for a zero coupon bond in which a debtor promises to repay CU500 million at the end of a five-year period, the CU500 million is referred to as a contractual amount, and the condition is that the debtor does not default.

In contrast, an "expected" amount represents a statistical aggregation of the possible outcomes reflecting the relative probability or likelihood of each outcome. In the following zero coupon bond example, for illustration purposes there are three possible outcomes, with the expected cash flow amount summarised below (CUs in millions):

	Cash flow payment	**Probability**	**Weighted payment**
Outcome 1	CU500	85%	CU425
Outcome 2	250	10%	25
Outcome 3	0	5%	0
Expected cash flow			CU450

In this example, the conditional amount (i.e., CU500 million) and the expected amount (i.e., CU450 million) differ.[2] This distinction is important because the discount rate used to measure the present value of the cash flows should be determined on the same basis as the cash flow assumptions. A conditional cash flow is discounted using a conditional discount rate, and an expected cash flow is discounted using a risk-adjusted discount rate. The fair value calculation using both approaches should give a similar result.

Consideration of taxes

Market-participants will generally consider the potential effects of income taxes when determining the fair value of a liability; however, those considerations are different than those for an asset. Taxes represent a reduction of the cash flows available to the owner of the asset. The broad definition of a liability should also be considered to avoid inappropriate treatment of tax impacts on fair value measurements. A liability is a probable future sacrifice of assets by the reporting entity to a third party. The payment of a liability may result in a tax deduction for the reporting entity. However, the tax consequences do not change the amount owed by the reporting entity to the third party. Taxes are generally not deducted from the amount owed to the third party.

Comparable debt securities that have observable prices and yields are a common starting point when estimating a discount rate to use to fair value a liability using the income approach. Different instruments may have different tax attributes and the data used should be comparable. For example, the interest payments on a debt

[2] For simplicity of presentation, the effect of income taxes is not considered.

instrument may be taxable, but the principal payments may be nontaxable. Accordingly, the market interest rate selected should be consistent with the characteristics of the subject liability.

Impact of changes in uncertainty

Assume, the example in 7.7.4.3, an increase in the uncertainty of the expected repayment amounts. Market-participants would require compensation for additional risk, even though the expected principal amount itself does not change. For example, consider the impact if repayment possibilities are expanded to the following scenarios (CUs in millions):

	Cash flow payment	Probability	Weighted payment
Outcome 1	CU800	45%	CU360
Outcome 2	200	45%	25
Outcome 3	0	10%	0
Expected cash flow			CU450

These outcomes should be viewed by market-participants as more uncertain than the first example (85 percent chance of CU500 million, 10 percent chance of CU250 million, and 5 percent chance of zero), even though the expected amount is still CU450 million.[3] Market-participants may require additional compensation for accepting increased uncertainty as indicated by a wider dispersion of possible outcomes.

7.7.5 Contingent assets and liabilities

The valuation of contingent assets and liabilities is an area for which there is limited practical experience and guidance. ASC 805-20-25-19 through 25-20B clarifies the initial recognition, subsequent measurement, and related disclosures arising from contingencies in a business combination. Under ASC 805, assets acquired and liabilities assumed in a business combination that arise from contingencies will be recognised at fair value at the acquisition date if fair value can be determined during the measurement period. If the acquisition date fair value of such assets acquired or liabilities assumed cannot be determined during the measurement period, the asset or liability should generally be recognised in accordance with ASC 450. See BCG 2.5.13 for more information.

IFRS requires that an acquirer recognise, at fair value on the acquisition date, all contingent liabilities assumed that are reliably measurable present obligations [IFRS 3.23]. IAS 37 defines contingent liabilities as either present or possible obligations. Present obligations are legal or constructive obligations that result from a past event

[3] For simplicity of presentation, the effect of income taxes is not considered.

[IAS 37.10]. Possible obligations are obligations that arise from past events whose existence will be confirmed only by the occurrence or nonoccurrence of one or more uncertain future events not wholly within the control of an entity [IAS 37.10]. Contingent assets and possible obligations assumed are not recognised by the acquirer on the acquisition date.

Some variation of the income approach will most likely be used to estimate the fair value if fair value is determinable. A straightforward discounted cash flow technique may be sufficient in some circumstances, while in other circumstances more sophisticated valuation techniques and models such as real options, option pricing, Probability Weighted Expected Return Method ("PWERM"), or Monte Carlo simulation may be warranted.

Example 7-6 provides an overview of the application of a basic discounted cash flow technique to measure a contingent liability.

EXAMPLE 7-6

Measuring the fair value of a contingent liability

Company A is acquired in a business combination. Company A is a manufacturer of computers and related products and provides a three-year limited warranty to its customers related to the performance of its products. Expenses related to expected warranty claims are accrued based on detailed analyses of past claims history for different products. Company A's experience indicates that warranty claims increase each year of a contract based on the age of the computer components.

Company A has three distinct computer products. One of its product lines (Line 1) has significant new components for which there is little historical claims data, as well as other components for which historical claims data is available.

Taking into account the short-term nature of the liability and the expected cash flows over the warranty period, the acquirer determines that a 7% discount rate is applicable.

Analysis

Cash flow models can be based on expected cash flows or conditional cash flows, as noted in BCG 7.5.1.2. Given the availability of historical claims data, the acquirer believes that the expected cash flow technique will provide a better measure of the warranty obligation. To develop the probabilities needed to estimate expected cash flows, the acquirer evaluates Company A's historical warranty claims. This includes evaluating how the performance of the new components used in Line 1 compares to the performance trends of the other components for which historical claims data is available.

The acquirer develops expected cash flows and a probability assessment for each of the various outcomes as shown below. The cash flows are based on different assumptions about the amount of expected service cost plus parts and labour related to a repair or replacement. The acquirer estimates the following outcomes for Line 1, each of which is expected to be payable over the three-year warranty period.

The expected cash flows of the warranty claims are as follows.

Warranty claims expected cash flows

Product line 1	Probability	Year 1	Year 2	Year 3
Outcome 1	50%	CU3,000	CU6,000	CU12,000
Outcome 2	30%	8,000	14,000	20,000
Outcome 3	20%	12,000	20,000	30,000

In calculating the amount of the warranty obligation, the acquirer needs to estimate the level of profit a market-participant would require to perform under the warranty obligations. The acquirer considers the margins for public companies engaged in the warranty fulfillment business as well as its own experience in arriving at a pre-tax profit margin equal to 5% of revenue.[1]

The acquirer would also need to select a discount rate to apply to the probability weighted expected warranty claims for each year and discount them to calculate a present value. Because the expected claim amounts reflect the probability weighted average of the possible outcomes identified, the expected cash flows do not depend on the occurrence of a specific event. In this case, the acquirer determined that the discount rate is 7%.[3]

The table below reflects the expected cash flows developed from the data in the previous table with the value of each outcome adjusted for the acquirer's estimate of the probability of occurrence.

The probability adjusted expected cash flows of warranty claims are as follows.

Warranty claims expected cash flows probability adjusted

Product line 1	Year 1	Year 2	Year 3
Outcome 1	CU1,500	CU3,000	CU6,000
Outcome 2	2,400	4,200	6,000
Outcome 3	2,400	4,000	6,000
Probability weighted	6,300	11,200	18,000
Pre-tax profit (5%)[1]	315	560	900
Warranty claim amount	CU6,615	CU11,760	CU18,900

Warranty claims expected cash flows probability adjusted

Product line 1	Year 1	Year 2	Year 3
Discount period[2]	0.5	1.5	2.5
Discount rate[3]	7%	7%	7%
Present value factor[4]	0.9667	0.9035	0.8444
Present value of warranty claims[5]	CU6,395	CU10,625	CU15,959
Estimated fair value[6] (rounded)	CU33,000		

[1] Under U.S. GAAP, the expected payment should include a profit element required by market-participants, which is consistent with ASC 820's fair value transfer concept for liabilities. The profit element included here represents an assumed profit for this example and should only be viewed from the perspective of how to apply the profit element.

[2] A mid-year discounting convention was used based on the assumption that warranty claims occur evenly throughout the year.

[3] In practice, determining the discount rate can be a challenging process requiring a significant amount of judgment. The discount rate should consider a risk premium that market-participants would consider when determining the fair value of a contingent liability. For performance obligations (e.g., warranties, deferred revenues) determination of discount rates may be more challenging than for financial liabilities as assessment of nonperformance risk component is not so readily obtainable as it may be for financial assets.

[4] Calculated as 1 / (1 + k) ^ t, where k = discount rate and t = discount period.

[5] Calculated as the warranty claim amount multiplied by the present value factor.

[6] Calculated as the sum of the present value of warranty claims for years 1 through 3.

7.7.6 Contingent consideration

Contingent consideration is generally classified either as a liability or as equity at the time of the acquisition. See BCG 2.6.4 for further information on the determination of the classification of contingent consideration. Recognizing contingent consideration at fair value presents a number of valuation challenges. Entities will need to consider the key inputs of the arrangement and market-participant assumptions when developing the assumptions used to determine the fair value of the arrangement. This will include the need to estimate the likelihood and timing of achieving the relevant milestones of the arrangement. Entities will also need to exercise judgment when applying a probability assessment for each of the potential outcomes. On the acquisition date, the amount to be paid under the arrangement is uncertain and should be carefully considered.

The fair value of liability classified contingent consideration will need to be updated each reporting period after the acquisition date. Changes in fair value measurements should consider the most current probability estimates and assumptions, including changes due to the time value of money.

Valuation methods for contingent consideration often range from discounted cash flow analyses and binomial models linked to discounted cash flow models to the more intricate Monte Carlo simulations. The terms of the arrangement and the payout structure will influence the type of valuation model used by the entity.

Example 7-7 provides an overview of the application of a basic technique to measure contingent consideration.

EXAMPLE 7-7

Measuring the fair value of cash settled contingent consideration—liability classified

Company A purchases Company B for CU400 million. Company A and Company B agree that if revenues of Company B exceed CU2,500 million in the year following the acquisition date, Company A will pay CU50 million to the former shareholders of Company B.

Analysis

The arrangement requires Company A to pay cash. Therefore, Company A should measure the fair value of the arrangement on the acquisition date and classify it as a liability. Any changes in the fair value of the liability will be recognised in Company A's earnings until the arrangement is settled.

Entities would most likely consider a best estimate discounted cash flow methodology to measure the fair value of the arrangement. A key determination for this approach is selecting a discount rate that best represents the risks inherent in the arrangement. In reality, there is more than one source of risk involved. For example, both projection risk (the risk of achieving the projected revenue level) and credit risk (the risk that the entity may not have the financial ability to make the arrangement payment) need to be considered.

Each of these risks may be quantifiable in isolation. When the two risks exist in tandem, consideration should be given to factors such as the potential correlation between the two risks and the relative impact of each risk upon the realization of the arrangement.

One alternative approach to determine the fair value of the cash settled contingent consideration would be to develop a set of discrete potential outcomes for future revenues. Some outcomes would show revenue levels above the CU2,500 million performance target and some would be below. For those outcomes showing revenues above the CU2500 million threshold, a payout would result. For those below this threshold, there would be no payout.

Each of these discrete payout outcomes could then be assigned a probability and the probability-weighted average payout could be discounted based on market-participant assumptions. For example, the following probability-weighted alternative might be utilized in determining the fair value of the arrangement.

(in millions)

Outcome	Revenue level	Payout	Probability	Probability-weighted payout
1	CU2,000	CU0	10%	CU0
2	2,250	0	15	0
3	2,500	0	15	0
4	2,750	50	40	20
5	3,000	50	20	10
		Total:	**100%**	**CU30**
		Discount rate[1]		20
		Fair value:		**CU25**

[1] A discount rate of 20% is used for illustrative purposes.

EXAMPLE 7-8

Measuring the fair value of share-settled contingent consideration—liability classified

Company A purchases Company B by issuing 1 million common shares of Company A stock to Company B's shareholders. At the acquisition date, Company A's share price is CU40 per share. Company A and Company B agree that if the common shares of Company A are trading below CU40 per share one year after the acquisition date, Company A will issue to Company B's former shareholders additional common shares sufficient to protect against price declines below CU40 million (i.e., the acquisition date fair value of the 1 million common shares issued).

Analysis

The guarantee arrangement creates an obligation that Company A would be required to settle with a variable number of Company A's equity shares, the amount of which varies inversely to changes in the fair value of Company A's equity shares. For example, if Company A's share price decreases from CU40 per share to CU35 per share one year after the acquisition date, the amount of the obligation would be CU5 million. Therefore, the guarantee arrangement would require liability classification on the acquisition date. Further, changes in the liability will be recognised in Company A's earnings until the arrangement is settled.

The contingent consideration arrangements illustrated above would likely be valued using an option pricing technique that estimates the value of a put option. In this example, Company A is guaranteeing its share price, effectively giving a put option on the transferred shares. A one-year put option with a stock price of CU40 million, a strike price of CU40 million, time to expiration of one-year, risk free rate of 2%, no dividends, and 55% volatility yields a put value of CU8.2 million.

The best estimate or the probability-weighted approach will likely not be sufficient to value the share-settled arrangement. In addition to the quantification of projection and credit risks, the modeling of Company A's share price is required. The following factors, which are relevant in performing a valuation for such arrangements, are what make it unlikely that the probability-weighted approach would be appropriate:

- Potential outcomes for Company A's share price returns over the coming year.
- Correlation of the distributions of the financial results and share price returns.
- Potential outcomes for other market events that could impact the overall stock market.
- Selection of an appropriate discount rate that adequately reflects all of the risks (e.g., projection risk, share price return estimation risk, Company A's credit risk) not reflected in other assumptions of the valuation.
- Potential outcomes for Company A's financial results next year.

EXAMPLE 7-9

Measuring the fair value of share-settled contingent consideration—equity classified

Company A acquires Company B in a business combination. The consideration transferred is 10 million Company A shares at the acquisition date and 2 million shares 2 years after the acquisition date if a performance target is met. The performance target is for Company B's revenues (as a wholly-owned subsidiary of Company A) to be greater than CU500 million in the second year after the acquisition. The market price of Company A's shares is CU15 at the acquisition date. Company A management assesses a 25% probability that the performance target will be met. A dividend of CU0.25 per share is expected at the end of years 1 and 2, which the seller will not be entitled to receive.

Analysis

Because Company A has already received Company B's business upon transfer of the 10 million Company A shares, the contingent agreement for Company A to deliver another 2 million shares to the former owners of Company B is a prepaid contingent forward contract. Using one method to measure the fair value of the forward contract results in an estimated value of CU7,296,786 (see below). This fair value of the contingent consideration at the acquisition date in this example is based on the acquisition date fair value of the shares and incorporates the probability that Company B will have revenues in 2 years greater than CU500m. The value excludes the dividend cash flows in years 1 and 2 and incorporates the time value of money. The discount rate for the present value of dividends should be the acquirer's cost of equity[1] because returns are available to equity holders from capital appreciation and dividends paid. Those earnings are all sourced from net income of the acquirer. There may be other acceptable methods for determining the fair value of this forward contract.

The following entry is recorded on the acquisition date for the fair value of the contingent consideration:

Consideration	CU7,296,786	
Equity		CU7,296,786

There are no remeasurements of the fair value in subsequent periods. See BCG 2.6.4.1 and 2.6.4.2 for further information.

	A	B	C
Revenue forecast (CU Millions)	**Probability**	**Payment in shares**	**Probability weighted number**
350	30%	0	
450	45%	0	
550	20%	2,000,000	400,000
650	5%	2,000,000	100,000
Total			500,000

C	Probability weighted shares	500,000
D	Share price[1]	15
E	Probability weighted value	7,500,000
F	Acquirer's cost of equity[2]	15%
G	Dividend year 1	125,000
G	Dividend year 2	125,000
H	Present value of dividend cash flow	203,214
I	Present value of contingent	7,296,786

C = sum of (A x B)
E = C x D

G = 0.25 x C
H = G / (1 + F) + G / (1 + F) ^ 2

I = E – H

[1] In most cases, there will be a correlation between the revenues of Company B and the share price of Company A. This requires a more complex analysis in which the movement of Company A's share price fluctuates with Company B's revenues. A simplifying assumption has been made in this example that Company B's revenues and Company A's share price are not correlated.

[2] The required rate of return on dividends would likely be less than the cost of equity in many cases.

As the examples illustrate, each arrangement has its own specific features requiring different modeling techniques and assumptions. Additionally, for liability classified contingent consideration, the valuation model will need to be flexible enough to handle changing inputs and assumptions that need to be updated each reporting period. The PFI used in valuing the contingent consideration arrangement should be consistent with the PFI used in valuing the intangible assets. The valuation model used to value the contingent consideration needs to capture the optionality in a contingent consideration arrangement and may therefore be complex.

7.7.7 Deferred revenue

Deferred revenue represents an obligation to provide products or services to a customer when payment has been made in advance and delivery or performance has not yet occurred. Examples of deferred revenue obligations that may be recognised in a business combination include upfront subscriptions collected for magazines or upfront payment for post-contract customer support for licenced software. Deferred revenue is a liability and represents a performance obligation. The acquirer will first assess whether the liability represents a performance obligation. If so, the liability is measured at fair value. The deferred revenue amount recorded on the acquiree's balance sheet generally represents the cash received in advance, less the amount amortised for services performed to date, rather than a fair value amount.

The fair value of a deferred revenue liability typically reflects how much an acquirer has to pay a third party to assume the liability (i.e., a transfer of the liability). The acquiree's recognised deferred revenue liability at the acquisition date is rarely the fair value amount that would be required to transfer the underlying contractual obligation.

7.7.7.1 Unit of account considerations for deferred revenue

The unit of account for certain multiple-element transactions should be considered when measuring the fair value of deferred revenue. This issue is frequently encountered when measuring the fair value of deferred revenue in the software industry, because certain software arrangements may offer multiple software-oriented deliverables in the form of PCS obligation (e.g., unspecified software products and/or upgrades or enhancements on a when-and-if available basis, "bug fixes," and telephone support). Questions arise as to whether a customer's right to receive unspecified deliverables represents a legal performance obligation for purposes of measuring the fair value of deferred revenue.

There are currently two views in practice that may help to address this issue. The first view is based on the guidance found in ASC 985-605 (Statement of Position 97-2, *Software Revenue Recognition* (SOP 97-2)), which defines the entire PCS arrangement as its own "unit of account." Accordingly, the PCS contract may be measured as a "single" unit of account, which would consider all components of the PCS contract, including when-and-if-available upgrades when measuring the fair value of deferred revenue.

Alternatively, the deferred revenue can be measured at fair value based on an "unbundled" unit of account basis under the approaches discussed in BCG 7.7.7.2. In that regard, a valuation method would be attributed only to the direct legal obligations associated with unfulfilled obligations (e.g., the stated obligation to provide telephone support and bug fixes). Under this method, the when-and-if-available upgrades are not considered a legal obligation, because there is not a contractual obligation on the part of the software vendor. Either method is acceptable, but should be applied on a consistent basis.

7.7.7.2 Fair value considerations when deferred revenue exists

Generally, there are two methods of measuring the fair value of a deferred revenue liability. The first method, commonly referred to as a bottom-up approach, measures the liability as the direct, incremental costs to fulfill the legal performance obligation, plus a reasonable profit margin if associated with goods or services being provided, and a premium for risks associated with price variability. Direct and incremental costs may or may not include certain overhead items, but should include costs incurred by market-participants to service the remaining performance obligation related to the deferred revenue obligation. These costs do not include elements of service or costs incurred or completed prior to the consummation of the business combination, such as upfront selling and marketing costs, training costs, and recruiting costs.

The reasonable profit margin should be based on the nature of the remaining activities and reflect a market-participant's profit. If the profit margin on the specific component of deferred revenue is known, it should be used if it is representative of a market-participant's normal profit margin on the specific obligation. If the current market rate is higher than the market rate that existed at the time the original transactions took place, the higher current rate should be used. The measurement of the fair value of a deferred revenue liability is generally performed on a pretax basis (consistent with the explanation for valuing a liability in BCG 7.7.4.3 "Consideration of taxes") and, therefore, the normal profit margin should be on a pre-tax basis.

An alternative method of measuring the fair value of a deferred revenue liability (commonly referred to as a top-down approach) relies on market indicators of expected revenue for any obligation yet to be delivered with appropriate adjustments. This approach starts with the amount that a market-participant entity would receive in a transaction, less the cost of the selling effort (which has already been performed) including a profit margin on that selling effort. This method is used less frequently, but is sometimes used for measuring the fair value of remaining post-contract customer support (PCS) for licenced software.

When valuing intangible assets using the income approach (e.g., RFR or MEEM) in instances where deferred revenues exist at the time of the business combination, adjustments may be required to the PFI to eliminate any revenues reflected in those projections that have already been received by the acquiree (i.e., the cash collected by the acquiree includes the deferred revenue amount). If the excess earnings method is used, the expenses and required profit on the expenses that are captured in valuing the deferred revenue are also eliminated from the PFI. However, if cash based PFI is used in the valuation, and therefore acquired deferred revenues are not reflected in the PFI, then no adjustment is required in the valuation of intangible assets using the income approach.

7.8 *Measuring the fair value of the noncontrolling interest and previously held equity interest*

Any NCI in the acquiree must be measured at its acquisition date fair value under U.S. GAAP. At the date of acquisition, IFRS preparers have the option to measure the NCI in an acquiree either at fair value or at the NCI's proportionate share of the acquiree's identifiable net assets [IFRS 3.19]. A business combination in which an acquirer holds a noncontrolling equity investment in the acquiree immediately before obtaining control of that acquiree is referred to as a **business combination achieved in stages**, or a **step acquisition**. The acquirer remeasures its PHEI in the acquiree at its acquisition date fair value in a step acquisition and recognises the resulting gain or loss in earnings (profit or loss) [ASC 805-10-25-10; IFRS 3.42].

The fair value of the controlling ownership interest acquired may generally be valued based on the consideration transferred. However, the determination of the fair value of the NCI in transactions when less than all the outstanding ownership interests are acquired and the fair value of the PHEI when control is obtained may present certain challenges. The consideration transferred for the controlling interest on a per-share basis may be an indication of the fair value of the NCI and PHEI on a per-share basis in some, but not all circumstances. In certain circumstances, an acquirer will be able to measure the acquisition date fair value of the NCI and PHEI based on active market prices for the remaining equity shares not held by the acquirer, which are publicly traded. However, in other situations, an active market for the equity shares will not be available. In those circumstances, the fair value of the NCI and PHEI will likely need to be established through other valuation techniques and methods, as discussed in the sections that follow [ASC 805-20-30-7; IFRS 3.B44].

In response to implementation questions arising since the issuance of IFRS 13, the IASB is currently deliberating the use of Level 1 inputs when measuring the fair value of NCI and PHEI.

7.8.1 *Determining the impact of control on the noncontrolling interest*

The existence of control premiums or minority interest discounts should be considered when measuring the fair value of the NCI. The acquirer may have paid a control premium on a per-share basis or conversely there may be a discount for lack of control in the per-share fair value of the NCI [ASC 805-20-30-8; IFRS 3.B45].

A control premium generally represents the amount paid by a new controlling shareholder for the benefit of controlling the acquiree's assets and cash flows. The elements of control derived by an acquirer can be categorised as (1) benefits derived from potential synergies that result from combining the acquirer's assets with the acquiree's assets and (2) the acquirer's ability to influence the acquiree's operating, financial, or corporate governance characteristics (e.g., improve operating efficiency, appoint board members, declare dividends, and compel the sale of the company).

Synergies will often benefit the acquiree as a whole, including the NCI. Entities should understand whether, and to what extent, the NCI will benefit from those synergies.

Consideration of a noncontrolling (minority interest) discount may be necessary to account for synergies that would not transfer to the NCI. Companies should not mechanically apply a noncontrolling discount to a controlling interest without considering whether the facts and circumstances related to the transaction indicate a difference exists between the controlling and noncontrolling values. It is helpful to understand how the negotiations between the acquiree and acquirer evolved when assessing the existence of a control premium. For example, if multiple bidders were involved in the negotiations, it is important to understand what factors were included in determining the amount of consideration transferred and what synergies were expected to be realised. Additionally, understanding the significant issues that were subject to the negotiations and how they were eventually resolved may provide valuable insight into determining the existence of a control premium.

7.8.2 Measuring the fair value of the noncontrolling interest

Generally, the fair value of the NCI will be determined using the market and income approaches, as discussed in BCG 7.2.4.1 and 7.2.4.2. However, the determination of fair value for the NCI that remains publicly traded postacquisition should be made using the NCI's quoted market price if an active market price for the shares not held by the acquirer is available. This is consistent with the Fair Value Standards which state that price quotations at the acquisition date in an active market provide the most reliable and best evidence of fair value, and should be used when they exist [ASC 820-10-35-41; IFRS 13.38].

A reasonable method of estimating the fair value of the NCI, in the absence of quoted prices, may be to gross up the fair value of the controlling interest to a 100 percent value to determine a per-share price to be applied to the NCI shares (see Example 7-10). This method reflects the goodwill for the acquiree as a whole, in both the controlling interest and the NCI, which may be more reflective of the economics of the transaction. This method assumes that the NCI shareholder will participate equally with the controlling shareholder in the economic benefits of the post combination entity which may not always be appropriate. However, although there is no control inherent in the NCI, in some circumstances the NCI may receive a portion of the overall benefits from the synergies that are inherent in the control premium. Therefore, when discussing NCI in this guide we refer to the synergistic benefit as a "control premium" even though control clearly does not reside with the NCI. Use of both the market and income approaches should also be considered, as they may provide further support for the fair value of the NCI.

7.8.2.1 Measuring the fair value of the noncontrolling interest—market approach

Entities may need to consider using the guideline public company method to value an NCI that is not publicly traded and for which the controlling interest value is not an appropriate basis for estimating fair value. See BCG 7.5.2.1 for further infomation. The first step in applying this method is to identify publicly traded companies that are comparable to the acquiree. Pricing multiples of revenue or earnings are calculated from the guideline companies; these are analysed, adjusted, and applied to the revenue and earnings of the acquiree. Applying the pricing multiples to the acquiree's earnings produces the fair value of the acquiree on an aggregate basis. This is then adjusted to reflect the pro rata NCI and control premium, if required, for any synergies from the acquisition that would be realised by the NCI. Similarly, the pricing multiples could be applied directly to the pro rata portion of the acquiree's earnings to estimate the fair value of the NCI.

Example 7-10 provides an example of measuring the fair value of the NCI using the guideline public company method. It also presents issues that may arise when this approach is used.

EXAMPLE 7-10

Measuring the fair value of the NCI using the guideline public company method

Company A acquires 350 shares, or 70%, of Company B, which is privately held, for CU2,100 or CU6.00 per share. There are 500 shares outstanding. The outstanding 30% interest in Company B represents the NCI that is required to be measured at fair value by Company A. At the acquisition date, Company B's most recent annual net income was CU200. Company A used the guideline public company method to measure the fair value of the NCI. Company A identified three publicly traded companies comparable to Company B, which were trading at an average price-to-earnings multiple of 15. Based on differences in growth, profitability, and product differences, Company A adjusted the observed price-to-earnings ratio to 13 for the purpose of valuing Company B.

Analysis

To measure the fair value of the NCI in Company B, Company A may initially apply the price-to-earnings multiple in the aggregate as follows:

Company B net income	CU200
Price-to-earnings multiple	x13
Fair value of Company B	2,600
Company B NCI interest	30%
Fair value of Company B NCI	CU780

Entities will have to understand whether the consideration transferred for the 70 percent interest includes a control premium paid by the acquirer and whether that control premium would extend to the NCI when determining its fair value. In this example, the fair value of Company B using the market approach is CU2,600, which represents a minority interest value because the price-to-earnings multiple was derived from per-share prices (i.e., excludes control). If it had been determined to be appropriate to include the control premium in the fair value estimate, grossing up the 70 percent interest yields a fair value for the acquiree as a whole of CU3,000 (CU2,100/0.70), compared to the CU2,600 derived above, and a value for the NCI of CU900 (CU3,000 x .30).

7.8.2.2 *Measuring the fair value of the noncontrolling interest—income approach*

The income approach may be used to measure the NCI's fair value using a discounted cash flow anlaysis to measure the value of the acquired entity. The BEV and IRR analysis performed as part of assigning the fair value to the assets acquired and liabilities assumed may serve as the basis for the fair value of the acquiree as a whole. Again, understanding whether a control premium exists and whether the NCI shareholders benefit from the synergies from the acquisition is critical in measuring the fair value of the NCI. This can be achieved by understanding the motivation behind the business combination (e.g., expectations to improve operations or influence corporate governance activities) and whether the expected synergies would result in direct and indirect cash flow benefits to the NCI shareholders.

If it is determined that a control premium exists and the premium would not extend to the NCI, there are two methods widely used to remove the control premium from the fair value of the business enterprise. One method is to calculate the NCI's proportionate share of the BEV and apply a minority interest discount. Another method adjusts the PFI used for the BEV analysis to remove the economic benefits of control embedded in the PFI.

7.8.2.3 *Measuring the fair value of the previously held equity interest*

The acquirer should remeasure any PHEI in the acquiree and recognise the resulting gain or loss in earnings [profit or loss] [ASC 805-10-25-10; IFRS 3.42]. The fair value of any PHEI should be determined consistent with paragraph B387 of FAS 141(R) and paragraph BC387 of IFRS 3. A PHEI that has been measured at fair value as of each reporting date prior to the acquisition should be measured similarly as of the acquisition date. The resulting gain or loss is recognised in the income statement and may include previously unrecognised gains or losses deferred in equity.

The fair value of the PHEI in a company that remains publicly traded should generally be based on the observable quoted market price without adjustment. If there are multiple classes of stock and the PHEI is not the same class of share as the shares on the active market (ASC 820-10-35-2B; IFRS 13.11(b)), it may be appropriate to use another valuation method. A PHEI of a company that is not publicly traded is measured using the market and income approaches or the fair value derived from the consideration transferred.

7.9 Valuation implications for impairment testing

Fair value measurements are not only a critical part of applying the acquisition method but are also important in postacquisition accounting, including the various impairment tests required by both U.S. GAAP and IFRS. The general guidance in this chapter is, therefore, equally applicable for fair value measurements for the postacquisition accounting. BCG 10 describes the impairment test of long-lived assets under U.S. GAAP. BCG 11 describes goodwill impairment testing under U.S. GAAP. BCG 12 discusses impairment testing of nonfinancial assets and goodwill under IFRS.

This section addresses certain valuation considerations related to impairment testing for indefinite- and long-lived assets and goodwill.

7.9.1 Impairment tests—key considerations

Key considerations in determining fair value to measure impairment include the following:

- Market-participants—Management may start with internal cash flow estimates, but it then considers the need to adjust its assumptions to incorporate the perspective of market-participants. Reporting entities should not presume that entity-specific projected financial information is representative of market-participant assumptions. One of the inputs to the discounted cash flow model is the discount rate. The weighted average cost of capital should reflect the starting point for determining the rate that a market-participant would demand based upon industry-weighted average returns on debt and equity adjusted for the relative advantages or disadvantages of the entity, rather than an entity-specific rate.

- Markets—There may not be a principal market for the sale of the reporting unit (under U.S. GAAP)/cash-generating unit (under IFRS) or indefinite-lived intangible asset being considered in the impairment analysis. If the reporting entity determines that there is no principal or most advantageous market, it should assess potential market-participants and develop a hypothetical market based on its assessment of market-participant assumptions.

- Valuation premise—The reporting entity should assess potential markets, considering the highest and best use of the asset. The highest and best use of the reporting unit/cash-generating unit from the perspective of market-participants may differ from that of the reporting entity. The reporting entity should use market-participant assumptions in this analysis.

- Multiple valuation techniques—Although a discounted cash flow model may be the most suitable valuation technique in many cases, management should also consider the use of alternative methodologies each time an impairment test is performed. For example, valuation professionals often use the market approach as a secondary method to the income approach when valuing a business. Reporting entities need to consider whether both approaches are appropriate when valuing reporting units/cash generating units. In determining the fair value of the reporting unit/cash generating unit, reporting entities may need to consider a weighting of reasonable results from all methods appropriate in the circumstances.

7.9.2 Fair value considerations for a reporting unit or cash generating unit

Measuring the fair value of an RU or CGU, which is a business unit (that is, the BEV of the RU or CGU), is no different than measuring the fair value of a business enterprise. Measuring the fair value of an RU or CGU employs the same income and market approaches, as discussed earlier in this chapter. In general, the cost approach is not used to measure the fair value of an RU, as the cost approach will not reflect all of the future economic benefits expected from the RU. IAS 36 does not permit the cost approach.

Typically, the fair value of an RU or CGU is estimated using the DCF method or earnings capitalisation method of the income approach. The DCF is a more commonly used method of measuring the fair value of an RU or CGU, given its flexibility to capture varying assumptions over a discrete cash flow period. The earnings capitalisation method is similar to a terminal value calculation using a single-period cash flow and is used for mature companies with stable cash flows. See BCG 7.5.1.4 for further information.

The market approach may also be used to value an RU or CGU. When reporting entities have multiple RUs or CGUs, however, the market approach becomes less reliable because the RUs or CGUs may represent a small segment of the entire entity, and market comparable multiples reflect the entire business entity.

The sections that follow discuss issues in measuring the fair value of an RU or CGU:

- Adjustments to observed market capitalisation
- Multiple reporting units
- Thinly traded securities
- Nonoperating assets and liabilities

7.9.2.1 Adjustments to observed market capitalisation

Quoted market prices for identical assets and liabilities in active markets are considered the best evidence of fair value. Therefore, for a public company with a single RU or CGU, or for an RU or CGU that is a **subsidiary** of a company but has its own publicly traded equity securities, its market capitalisation may be the best evidence of its fair value. However, in a number of situations, the observed market prices of individual equity securities and the associated market capitalisation may not be representative of the fair value of an RU or CGU. Application of a control premium is permitted by ASC 350 and may result in the fair value of the reporting entity exceeding its market capitalization. See BCG 7.5.2.1 for further information.

In response to implementation questions arising since the issuance of IFRS 13, the IASB is currently deliberating the use of Level 1 inputs when measuring the fair value of a CGU.

7.9.2.2 Multiple reporting units or cash generating units

An observed market capitalisation is not possible for a single RU or CGU where a public company has more than one RU or CGU, because each individual RU or CGU should be separately valued. However, while not a requirement, the reporting entity's overall market capitalisation should reconcile, within a reasonable range, to the sum of the fair values of the individual RUs or CGUs. While frequently the sum of the individual RU or CGU values may not equal the market capitalisation, the test may still indicate the reasonableness of the individual valuations of the RUs or CGUs if the difference can be adequately explained. Some potential explanations for these differences are:

- The fair value of an RU or CGU should be measured on a control basis as if the RU or CGU was a stand-alone company. When aggregated into a single entity, there may be operational synergies that resulted from combining multiple RUs or CGUs into a single company. Reporting entities should review the synergies to determine whether they should be included in the fair value of the individual RU or CGU from a market-participant perspective.

- Market capitalisation represents the value of the individual equity shares, whereas the individual RU or CGU fair value measures represent the expected cash flow from the RU or CGU. Capital market volatility related to liquidity, trading volume, control issues, dividend policy, and investor sentiment/emotion can have a greater impact on the market capitalisation compared to the fair value of the RUs or CGUs.

- Individual RU or CGU fair values are based on PFI, which have been adjusted to reflect market-participant-based assumptions. Such PFI may incorporate more specific and detailed information about the company than is generally available to the market to determine the share price if the entity as a whole is publicly traded.

7.9.2.3 Fair value measurements in inactive markets

In some circumstances market capitalisation may not be representative of fair value, and other valuation methods may be required to measure the fair value of an entity comprised of a single RU or CGU. Use of a value other than market capitalisation will require other evidence and documentation that clearly supports that the quoted market prices are not the best indication of fair value. The guidance set out in ASC 820-10-35 and 820-10-65, which is further discussed at FG 4.4.1.2, is helpful to address these situations.

7.9.2.4 Nonoperating assets and liabilities

The market capitalisation of a reporting entity may reflect any nonoperating assets it owns (e.g., excess working capital, fine arts, nonoperating real estate, corporate jets, and tax loss carryforwards) or nonoperating liabilities owed (e.g., contingent liabilities).The DCF approach provides an estimate of the value of a business enterprise's net operating assets, and so the impact on the fair value of the enterprise of nonoperating items is not typically reflected in a DCF analysis. Accordingly, adjustments may be necessary to account for these items if they are relevant in determining the fair value of the RU or CGU.

Chapter 8: Common control transactions

8.1 Chapter overview

Common control transactions occur frequently, particularly in the context of reorganisations, spin-offs, and initial public offerings. Combinations between entities that are under common control are excluded from the scope of the **business combinations** guidance in ASC 805 or IFRS 3. Common control transactions are defined differently under U.S. GAAP and IFRS. ASC 805 states they are transfers and exchanges between entities that are under the control of the same parent [ASC 805-50-15-6]. IFRS 3 states they are transactions in which all of the combining entities are controlled by the same party or parties before and after the transaction and that control is not transitory [IFRS 3.B1].

The accounting and reporting for common control transactions can differ between U.S. GAAP and IFRS. Under U.S. GAAP, common control transactions are generally accounted for by the receiving entity based on the nature of the transactions. For example, transactions involving the transfer of an asset (such as an unoccupied building) are accounted for by the receiving entity at historical carrying values. Transactions involving the transfer of a **business** ordinarily will result in a **change in reporting entity** for the receiving entity and require the application of the relevant guidance in the Transactions Between Entities Under Common Control Subsections of ASC 805-50. Whether a transfer of net assets results in a change in reporting entity will depend on whether the nature of the net assets is more similar to assets or a business.

There is no specific U.S. GAAP guidance on how the contributing entity should account for the transfer of a business or an asset in a common control transaction. The contributing entity in a transaction involving entities under common control may be required to prepare its own separate financial statements. In these circumstances, additional complexities may arise in relation to the nature and the basis of the transfer. See BCG 8.2.4.1 for further information.

IFRS provides no guidance on the accounting for common control transactions, but requires that entities develop an accounting policy for them [IAS 8.10]. The two methods most commonly chosen for accounting for business combinations between entities under common control are (1) the **acquisition method** and (2) the **predecessor values method**. Once a method has been adopted it should be applied consistently as a matter of accounting policy. Neither IFRS 3 nor any other IFRS require or prohibit the application of either method to business combinations involving entities under common control.

IFRS companies can therefore elect (but are not required) to apply acquisition accounting to a business combination involving entities under common control. The acquisition method may be used because the transaction is a business combination and IFRS 3 provides guidance for business combinations [IAS 8.11(a)]. IFRS companies could also elect to apply the predecessor values method. This method may be used by reference to other GAAP that permit or require it for similar transactions [IAS 8.12].

Under both U.S. GAAP and IFRS, companies will need to use judgment to determine the nature of the transaction and the appropriate method of accounting.

The key takeaways from this chapter are:

- **Under U.S. GAAP, accounting and reporting for common control transactions by the receiving entity can differ depending on the nature of the transactions.** Transactions involving the transfer of an asset are accounted for at historical carrying values. Transactions involving the transfer of a business ordinarily will result in a change in reporting entity and require retrospective combination of the entities for all periods presented, as if the combination had been in effect since inception of common control.

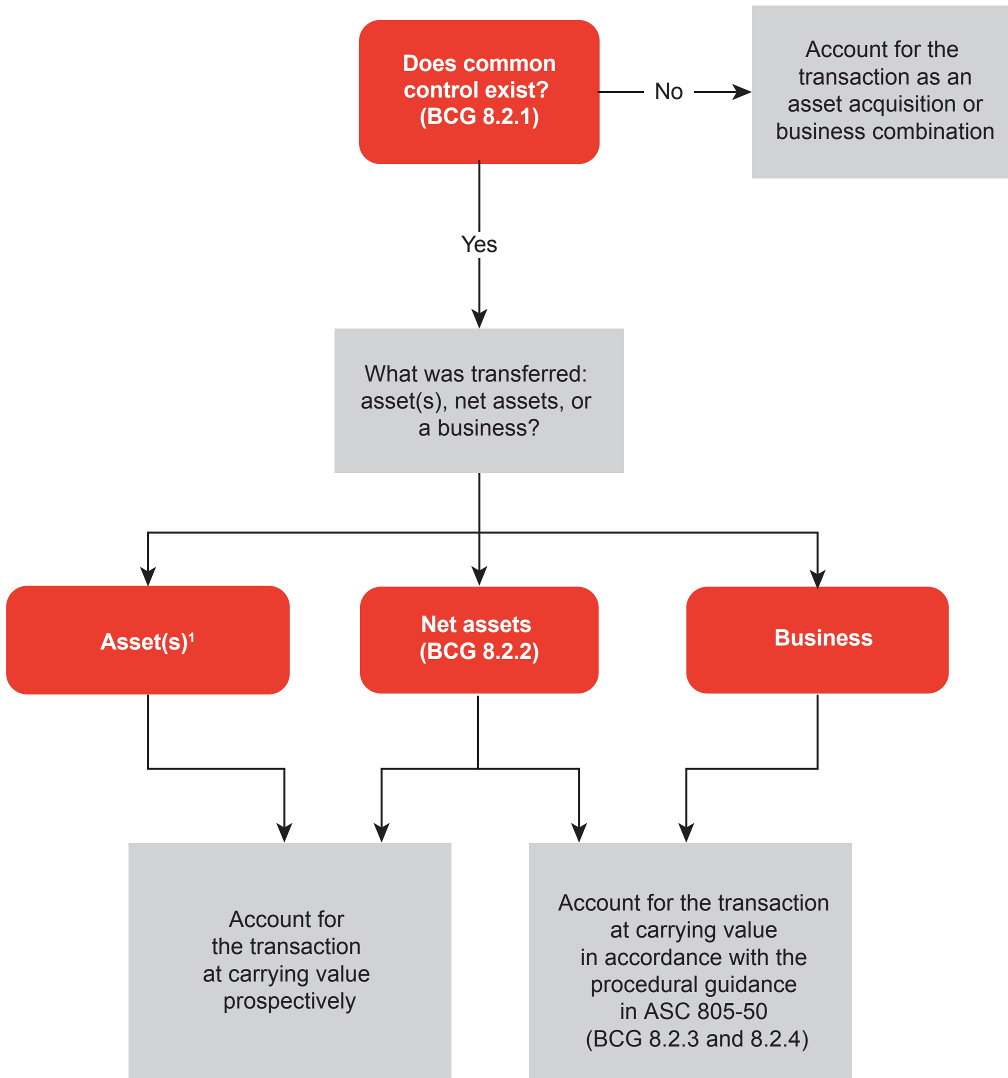
- **IFRS gives no guidance on the accounting for common control transactions.** An acquiring entity needs to develop an accounting policy for them. The two methods most commonly chosen for accounting for business combinations between entities under common control are (1) the acquisition method and (2) the predecessor values method. Once a method has been adopted it should be applied consistently as a matter of accounting policy.

- **Additional complexities may arise in relation to the contributing (selling) entity's accounting.** There is no specific guidance under U.S. GAAP or IFRS on how the contributing (selling) entity should account for the transfer of a business or an asset in a common control transaction. Two alternative methods of accounting have developed in practice (1) the "de-pooling" method and (2) the disposal accounting method. A number of criteria must all be met to apply the "de-pooling" method under U.S. GAAP and, as a result, this method is not common. "De-pooling" is not appropriate under IFRS and the disposal accounting method should be applied.

8.2 Common control transactions under U.S. GAAP

Figure 8-1 provides a decision tree which may help determine how the transaction should be measured and presented for financial reporting purposes under U.S. GAAP.

Figure 8-1
Accounting for common control transactions under U.S. GAAP



[1] When nonrecurring transactions (e.g., transfers of long-lived assets) involving entities under common control occur, any nonfinancial assets are recorded at the parent's basis in such assets by the receiving entity. However, for recurring transactions for which valuation is not in question, such as routine inventory transfers, the exchange price is normally used regardless of whether a common control relationship exists. Depending on the nature of the transaction, nonrecurring transfers of financial assets may be at fair value (i.e., qualify for sale accounting) or at historical cost at the subsidiary level, by the receiving entity. See BCG 8.2.2.1 for more information on transfers of financial assets involving entities under common control.

Transfers among entities with a high degree of common ownership are not common control transactions, and are separately discussed in BCG 8.2.1.3. The following sections provide guidance on identifying common control transactions and accounting for such transactions.

8.2.1 Assessing whether common control exists

In ASC 805, "**control**" has the same meaning as "controlling financial interest" in ASC 810-10-15-8. A "controlling financial interest" is generally defined as ownership of a majority voting interest by one entity, directly or indirectly, of more than 50 percent of the outstanding voting shares of another entity, with certain exceptions (e.g., bankruptcy) [ASC 810-10-15-8]. U.S. GAAP does not define the term "common control." However, ASC 805-50-15-6 provides the following examples of the types of transactions that qualify as common control transactions:

- An entity charters a newly formed entity and then transfers some or all of its net assets to that newly chartered entity.
- A **parent** transfers the net assets of a wholly owned **subsidiary** into the parent and liquidates the subsidiary. That transaction is a change in legal organisation but not a change in the reporting entity.
- A parent transfers its **controlling interest** in several partially owned subsidiaries to a new wholly owned subsidiary. This transaction is a change in legal organisation, but not in the reporting entity.
- A parent exchanges its ownership interests or the net assets of a wholly owned subsidiary for additional shares issued by the parent's less-than-wholly owned subsidiary, thereby increasing the parent's percentage of ownership in the less-than-wholly owned subsidiary, but leaving all of the existing **noncontrolling interest** outstanding.
- A parent's less-than-wholly owned subsidiary issues its shares in exchange for shares of another subsidiary previously owned by the same parent, and the noncontrolling shareholders are not party to the exchange. That is not a business combination from the perspective of the parent.
- A limited liability company is formed by combining entities under common control.

Several factors must be considered to determine if common control exists. While majority voting ownership interests are the most common form of control, control may also be established through other means, such as variable interests under the Variable Interest Entities Subsections of ASC 810-10, contractual or other legal arrangements, or the rights of a sole general partner in a partnership (see ASC 810-20-25). An assessment of whether common control exists is based on all of the facts and circumstances surrounding the relationship(s) between the parties (both direct and indirect). Generally, entities that are consolidated by the same parent, or that would be consolidated if **consolidated financial statements** were required to be prepared by the parent or controlling party, are considered to be under common control. If common control exists, the guidance discussed in this chapter should be applied in the same manner, regardless of the means through which common control was attained.

In addition, sometimes a new parent company may be added to an existing company (or consolidated group of companies) by setting up a new holding company. The shareholders of the existing company exchange their shares for shares in the new company in proportion to their existing ownership interests (i.e., share for share exchange). In such cases, there is no change in the substance of the reporting entity. Therefore, the consolidated financial statements of the new company should reflect the accounting of the previous company (or existing consolidated group), except that the legal capital (i.e., issued and outstanding capital stock or membership interests) should reflect the capital of the new parent company.

8.2.1.1 Common control and control groups

The Emerging Issues Task Force attempted to define common control in EITF Issue No. 02-5, *Definition of "Common Control" in Relation to FASB Statement No. 141* (EITF 02-5), but did not reach a consensus. Nevertheless, as set forth in EITF 02-5, the SEC staff concluded that common control exists between (or among) separate entities in the following situations:

- An individual or enterprise holds more than 50 percent of the voting ownership interest of each entity.

- A group of shareholders holds more than 50 percent of the voting ownership interest of each entity, and contemporaneous written evidence of an agreement to vote a majority of the entities' shares in concert exists.

- Immediate family members (married couples and their children, but not their grandchildren) hold more than 50 percent of the voting ownership interest of each entity (with no evidence that those family members will vote their shares in any way other than in concert).

Entities may be owned in varying combinations among living siblings and their children. Those situations require careful consideration regarding the substance of the ownership and voting relationships [EITF 02-5].

Due to the lack of other authoritative guidance, the SEC's guidance is widely applied by public and private companies. Judgment is required to determine whether common control exists in situations other than those described above.

In an SEC staff speech, the staff expressed its views with respect to the existence of common control through a control group in two examples:

- Two brothers own a 60 percent controlling interest in a public company. Their father owns 100 percent of two other companies that provide services to the company that is controlled by the two brothers. If these three companies merged into a single entity, would the brothers and the father constitute a control group, thus permitting historical cost accounting for the interests owned by the father and two brothers? The SEC staff indicated that, absent evidence to the contrary, it would not object to the assertion that the immediate family is a control group.

- One person has ownership in three entities: 60 percent in two, and 45 percent in the third. In the third entity, the 45 percent shareholder has an agreement with the entity's employee **owners** that stipulates that the 45 percent shareholder must repurchase the employees' shares if they are terminated or leave the company voluntarily. In addition, the 45 percent shareholder has the ability to cause a termination of the employee owners. The question is whether these three entities are under common control. The SEC staff believes that for the third entity to be under common control, the employee owners would have to give the 45 percent shareholder sufficient voting proxies to ensure the shareholders act and vote in concert.

8.2.1.2 Entities consolidated under the variable interest approach (the variable interest entities subsections of ASC 810-10)

In addition to voting ownership interests, control may be established through various other means, including the ownership of variable interests that result in consolidation by a primary beneficiary under the Variable Interest Entities subsections of ASC 810-10. Generally, entities that are consolidated by the same parent company are considered to be under common control. However, to determine if common control exists, consideration should be given to all of the facts and circumstances surrounding the relationship(s) between the parties (both direct and indirect).

The Variable Interest Entities subsections of ASC 810-10 incorporates the general principles governing common control transactions in ASC 805 and other guidance contained in U.S. GAAP. ASC 810-10-30-1 states:

ASC 810-10-30-1

If the primary beneficiary of a variable interest entity (VIE) and the VIE are under common control, the primary beneficiary shall initially measure the assets, liabilities, and the noncontrolling interest of the VIE at amounts at which they are carried in the accounts of the reporting entity that controls the VIE (or would be carried if the reporting entity issued financial statements prepared in conformity with generally accepted accounting principles).

This paragraph requires that there be no remeasurement of a VIE's assets and liabilities if the primary beneficiary and VIE are under common control. For example, assume Company A and Company B are under the common control of Company XYZ. An agreement is entered into between Company A and Company B. The agreement results in Company B obtaining a variable interest in Company A. After performing an analysis under the Variable Interest Entities Subsections of ASC 810-10, Company A is determined to be a VIE and Company B is identified as the primary beneficiary. Following the guidance in ASC 810-10-30-1, the net assets of Company A would be recorded by Company B at the amounts at which they are carried in Company XYZ's financial statements. In this case, Company B's financial statements and financial information presented for prior years should be retrospectively adjusted in accordance with the guidance in BCG 8.2.3.2.

8.2.1.3 *Entities with a high degree of common ownership*

A high degree of common ownership exists when multiple shareholders hold similar ownership interests in multiple entities. Transfers among entities that have a high degree of common ownership, but in which no one shareholder controls the entities, are not common control transactions. However, such transfers may be accounted for in a manner similar to a common control transaction if it is determined that the transfers lack economic substance. For example, a transaction in which shareholders have identical ownership interests before and after the transaction generally has been determined to lack economic substance and has been accounted for in a manner similar to a common control transaction.

The SEC staff has historically looked to the guidance provided in FASB Technical Bulletin No. 85-5, *Issues Relating to Accounting for Business Combinations, Including Costs of Closing Duplicate Facilities of an Acquirer*, *Stock Transactions between Companies under Common Control*, *Downstream Mergers*, *Identical Common Shares for a Pooling of Interests*, *Pooling of Interests by Mutual and Cooperative Enterprise* (FTB 85-5), paragraph 6, to evaluate whether a transaction lacked economic substance. In response to the question of how a parent company should account for minority interest in an exchange of stock between two of its subsidiaries if one or both of the subsidiaries are partially owned, that guidance stated:

Excerpt from FTB 85-5

…if the exchange lacks substance, it is not a purchase event and should be accounted for based on existing **carrying amounts**. That is, if the minority interest does not change and if in substance the only assets of the combined entity after the exchange are those of the partially owned subsidiary prior to the exchange, a change in ownership has not taken place, and the exchange should be accounted for based on the carrying amounts of the partially owned subsidiary's assets and liabilities.

The SEC staff has stated that if the ownership percentages and interests are not, in substance, the same before and after the transaction, a substantive transaction occurred, and the staff would object to historical cost accounting. Transfers of businesses that have been determined to have economic substance should be accounted for using the **acquisition method**.

FTB 85-5 was nullified by the issuance of ASC 805. However, we believe the underlying guidance contained in paragraph 6 continues to be relevant until the SEC staff indicates otherwise. That is, we believe one should evaluate whether a transfer among entities with a high degree of common ownership lacks economic substance when determining the appropriate accounting.

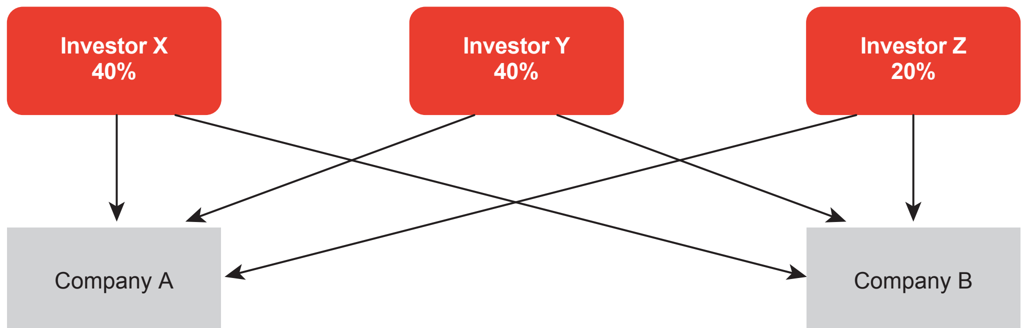
Example 8-1 illustrates an exchange (transaction) that lacks economic substance between entities with a high degree of common ownership.

EXAMPLE 8-1

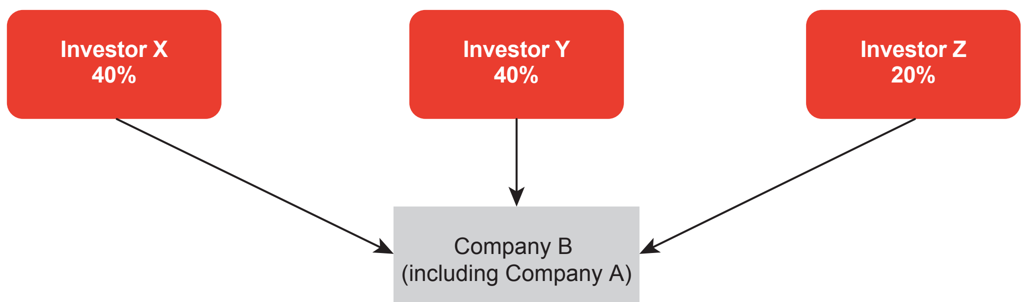
Transfer between entities with a high degree of common ownership that lacks economic substance

Company A and Company B are each owned 40 percent by Investor X, 40% by Investor Y, and 20 percent by Investor Z. Company A and Company B each constitute a business under ASC 805. On 31 December 20X7, Company A is merged with and into Company B. Each of the investor's ownership interests in the merged entity is the same before and after the transaction.

Before



After



Analysis

Although no single investor controls Company A and Company B, each investor's ownership interest in the underlying net assets comprising the combined entity is the same before and after the transaction. As a result, the transaction is deemed to lack economic substance, and Company B would generally record the assets and liabilities of Company A at the carrying amounts recorded in Company A's financial statements. The transaction would be presented in Company B's financial statements in accordance with the guidance contained in the Transactions Between Entities Under Common Control Subsections of ASC 805-50. See BCG 8.2.3.2 for further information. For the investors' financial reporting purposes, consideration should be given to any difference between the investors' bases in Company A and their proportionate interests in the equity of Company A in Company B's financial statements.

In assessing transactions among entities with a high degree of common ownership, questions arise as to whether a small change in ownership percentages can preclude historical cost accounting. Although there is no bright line in making such a determination, the SEC staff has evaluated situations where the minority-ownership percentage changed by a relatively small amount and concluded that there was a substantive economic change in ownership interests, precluding historical cost accounting. In assessing changes in ownership, consideration should be given to all interests outstanding on a fully diluted basis. Consideration should also be given to other economic factors (beyond ownership percentages) which may indicate a transaction has economic substance.

8.2.2 *Nature of the transfer*

ASC 805-50-05-5 states that some transfers of net assets or exchanges of shares between entities under common control result in a change in reporting entity. The ASC Glossary defines a change in reporting entity as a change that results in financial statements that, in effect, are those of a different reporting entity. A change in reporting entity is limited mainly to (1) presenting consolidated or **combined financial statements** in place of financial statements of individual entities, (2) changing specific subsidiaries that make up the group of entities for which consolidated financial statements are presented, and (3) changing the entities included in the combined financial statements. Neither a business combination accounted for by the acquisition method nor the consolidation of a VIE under the Variable Interest Entities Subsections of ASC 810-10 is a change in reporting entity [ASC Glossary].

Judgment must be applied in determining whether a transaction constitutes an asset transfer (that would not result in a change in reporting entity), or a transfer of net assets (that would result in a change in reporting entity). There is no specific guidance on differentiating asset transfers from net asset transfers. Some factors that may be helpful in making the determination include:

- Determining whether the assets transferred constitute a business under ASC 805
- Determining whether the assets transferred constitute an **asset group** as defined in ASC 360-10
- Making a qualitative assessment of the characteristics of the assets transferred in conjunction with the characteristics of a business described in Article 11 of Regulation S-X; see BCG 13.2.1 for further information

This list is not intended to be all inclusive, and all facts and circumstances of each transfer should be considered in determining whether the transfer constitutes the transfer of an asset or the transfer of net assets.

Transfers of a business or net assets between entities under common control that result in a change in reporting entity require retrospective combination of the entities for all periods presented as if the combination had been in effect since the inception of common control. See BCG 8.2.3.2 for further information. Transfers of assets are accounted for prospectively.

8.2.2.1 *Specialised accounting considerations*

Other sections of the ASC prescribe the accounting treatment for related party transactions in certain specific situations where common control may exist, as described below.

ASC 360-20-40-47 specifies that if the seller of real estate controls the buyer, no profit on the sale should be recognised until it is realised from transactions with outside parties through sale or operation of the property.

ASC 860-10-55-78 indicates that a transfer of a financial asset between subsidiaries of a common parent would be accounted for as a sale in the transferring subsidiary's separate-entity financial statements if all the conditions of ASC 860-10-40-5 are met and the transferee subsidiary is not consolidated into the separate-entity financial statements of the transferring subsidiary. This guidance may not apply to transfers of financial assets between a parent company and its subsidiaries as ASC 860-10-55-78 only applies to transfers of financial assets between subsidiaries of a common parent that are accounted for in the subsidiaries' stand-alone financial statements. This guidance also does not apply to the transfer of nonfinancial assets, or the shares or net assets of a subsidiary that are not principally financial assets, between entities under common control. Rather, those transactions should generally be recorded at historical cost by the receiving subsidiary under the Transactions Between Entities Under Common Control Subsections of ASC 805-50.

Examples 8-2 through 8-5 provide additional guidance related to real estate transactions where common control or common management may exist (Examples 8-2 to 8-4) and transactions involving the transfer of financial assets between subsidiaries of a common parent (Example 8-5).

EXAMPLE 8-2

Real estate contributed by 100% owner

An individual contributes real estate to a 100% owned real estate development company. The real estate has appreciated in value since the individual acquired it.

Analysis

The real estate development company should record the contributed property at its carryover basis since the transaction is with its controlling shareholder.

EXAMPLE 8-3

Sale between two real estate investment trusts (REIT) with a common manager

Company A, a public REIT, sells its 25% interest in a real estate property to Company B, which is also a REIT. Company A and Company B are not entities under common control, but they are managed by the same third party. The management agreements do not result in **control** by the common manager of Company A or Company B.

Analysis

Company A and Company B are not entities under common control, but rather are entities with common management. The existence of a common manager in and of itself would not preclude recognition of a real estate sales transaction or gain on the sale by Company A. However, the transaction is subject to the general requirements of ASC 360-20, which may limit or preclude recognition of a real estate sales transaction or gain on the sale for other reasons.

EXAMPLE 8-4

Property sold to subsidiary, and then sold to a third party

Company A agrees to sell a building with a book value of CU20 million and a fair value of CU35 million to a third party. Prior to consummation of the sale, Company A sells the building to its subsidiary, Subsidiary B, for CU20 million and the subsidiary sells the building to the third party for CU35 million.

Analysis

Subsidiary B should record the additional CU15 million sales proceeds as a contribution to capital. In substance, since the subsidiary did not previously hold the building as an operating asset, the transaction may be viewed as a dividend distribution of CU20 million from Subsidiary B to Company A with a concurrent capital contribution of CU35 million from Company A to Subsidiary B. However, the gain on sale of CU15 million would be credited to income in Company A's consolidated financial statements.

EXAMPLE 8-5

Transfer of a financial asset between subsidiaries of a common parent

Company A and Company B are entities under common control, with Parent owning 100 percent of both companies. Company A holds marketable securities accounted for as available-for-sale under ASC 320-10. The fair value of the marketable securities is CU1,000,000 with a cost basis of CU800,000 at 31 December 20X9. Company A recorded the CU200,000 unrealised gain in these marketable securities in other comprehensive income (this example ignores tax effects). On 31 December 20X9, Company A transfers the marketable securities to Company B. Company A does not consolidate Company B into its separate-entity financial statements.

Analysis

ASC 860-10-55-78 indicates that a transfer of a financial asset between subsidiaries of a common parent would be accounted for as a sale in the transferring subsidiary's separate-company financial statements if all the conditions of ASC 860-10-40-5, addressing the accounting for transfers of financial assets, are met and the transferee subsidiary is not consolidated into the separate-company financial statements of the transferring subsidiary. Since marketable securities are financial assets and Company A does not consolidate Company B into its separate-entity financial statements, Company A would apply ASC 860-10-55-78 to this transaction. If Company A determines that this transaction qualifies as a sale in accordance with ASC 860-10-40-5, then Company A would account for the transfer of the marketable securities at their fair value and record a gain of CU200,000 in its separate-entity financial statements upon the transfer of the marketable securities to Company B.

8.2.3 Accounting and reporting by the receiving entity

This section provides guidance on the accounting and reporting of the entity that receives net assets or equity interests from an entity that is under common control.

8.2.3.1 Basis of transfer

When accounting for a transfer of assets or exchange of shares between entities under common control, the entity that receives the net assets or the **equity interests** should initially recognise the assets and liabilities transferred at their carrying amounts in the accounts of the transferring entity at the date of the transfer. If the carrying amounts of the assets and liabilities transferred differ from the historical cost of the parent of the entities under common control, for example, because pushdown accounting had not been applied, then the financial statements of the receiving entity should reflect the transferred assets and liabilities at the historical cost of the parent of the entities under common control [ASC 805-50-30-5].

Examples 8-6 through 8-9 provide additional guidance for use in determining the proper basis at which to record transfers.

EXAMPLE 8-6

Accounting by the receiving subsidiary

The parent of both Company A and Company B will contribute its ownership interest in Company B to Company A. Company B meets the definition of a business. The assets and liabilities transferred to Company A will be accounted for at historical cost in accordance with the Transactions Between Entities Under Common Control Subsections of ASC 805-50. The parent's basis in Company B exceeded the underlying equity recorded in Company B's stand-alone financial statements at the transfer date. This is because the parent did not pushdown its basis to Company B's separate financial statements at the acquisition date.

Analysis

The transaction represents a transfer of net assets between entities under common control. Pursuant to ASC 805-50-30-5, the historical cost of the parent's basis in Company B should be reflected in Company A's consolidated financial statements upon the transfer. For the accounting and reporting by the contributing entity (Company B). See BCG 8.2.4 for further information.

EXAMPLE 8-7

Parent sells division to partially owned subsidiary

Company A owns 80% of Company B. Company A plans to sell one of its divisions to Company B with a book value of CU150 million and an estimated fair value of CU250 million for CU250 million in cash.

Analysis

The transaction represents a transfer of net assets between entities under common control because Company A controls Company B. Company B should record its investment in the division at the parent's basis of CU150 million, and the excess paid over the parent's basis of the transferred division of CU100 million should be charged to equity as a deemed dividend.

EXAMPLE 8-8

Subsidiary sells its wholly owned subsidiary to another subsidiary

Company A and Company B are controlled by the same corporate parent, Company P. Company A sells one of its wholly owned subsidiaries, Company C, to Company B for CU115 million in cash. Company C meets the definition of a business. The fair value of Company C, as determined by an independent third party, is CU115 million and its book value is CU100 million. There is no basis difference between Company A's carrying value of its investment in Company C and the underlying equity of Company C. Further, there is no basis difference between Company P's carrying value of its investment in Company A and the underlying equity of Company A.

Analysis

The transaction represents a transfer of business between entities under common control. Even though the fair value of Company C has been determined by an independent third party, ASC 805-50-30-5 indicates that assets and liabilities transferred between entities under common control should be accounted for at the parent's historical cost. Company B should record its investment in Company C at the parent's basis of CU100 million, and the excess paid over the parent's basis in Company C of CU15 million should be charged to equity as a deemed dividend. In addition, the excess of the cash proceeds of CU115 million over Company C's book value of CU100 million should be recorded as additional paid-in capital in Company A's separate financial statements. If the fair value of Company C had been determined to be lower than the carrying value of its assets and liabilities, Company A should consider following the guidance for long-lived assets to be disposed of other than by sale in ASC 360-10-40-4 in preparing its separate financial statements. See BCG 8.2.4.1 for further information.

EXAMPLE 8-9

Parent transfers acquired entity to newly formed subsidiary

ABC Corporation acquired Company A for CU7 million. Company A was then transferred to a newly formed subsidiary of ABC Corporation, Company B, for consideration of CU1 million in cash and a CU8 million note. The initial capitalisation of Company B was CU1 million.

Analysis

Company B should record the net assets of Company A at the parent's basis of CU7 million. Accordingly, the financial statements of Company B should reflect no cash, a note payable to the parent of CU8 million and a deemed dividend of CU2 million resulting in a net shareholder's deficit of CU1 million.

8.2.3.2 Guidance for presenting a change in reporting entity

If a transaction combines two or more commonly controlled entities that historically have not been presented together, the resulting financial statements are, in effect, considered to be those of a different reporting entity. The resulting change in reporting entity requires retrospective combination of the entities for all periods presented as if the combination had been in effect since inception of common control [ASC 250-10-45-21]. The following guidance should be applied when preparing financial statements and related disclosures for the entity that receives the net assets:

ASC 805-50-30-6

In some instances, the entity that receives the net assets or equity interests (the receiving entity) and the entity that transferred the net assets or equity interests (the transferring entity) may account for similar assets and liabilities using different accounting methods. In such circumstances, the carrying amounts of the assets and liabilities transferred may be adjusted to the basis of accounting used by the receiving entity if the change would be preferable. Any such change in accounting method should be applied retrospectively, and financial statements presented for prior periods should be adjusted unless it is impracticable to do so. Section 250-10-45 provides guidance if retrospective application is impracticable.

ASC 805-50-45-2

The financial statements of the receiving entity should report results of operations for the period in which the transfer occurs as though the transfer of net assets or exchange of equity interests had occurred at the beginning of the period. Results of operations for that period will thus comprise those of the previously separate entities combined from the beginning of the period to the date the transfer is completed and those of the combined operations from that date to the end of the period. By eliminating the effects of intra-entity transactions in determining the results of operations for the period before the combination, those results will be on substantially the same basis as the results of operations for the period after the date of combination. The effects of intra-entity transactions on current assets, current liabilities, revenue, and cost of sales for periods presented and on retained earnings at the beginning of the periods presented should be eliminated to the extent possible.

ASC 805-50-45-3

The nature of and effects on earnings per share (EPS) of nonrecurring intra-entity transactions involving long-term assets and liabilities need not be eliminated. However, paragraph 805-50-50-2 requires disclosure.

ASC 805-50-45-4

Similarly, the receiving entity shall present the statement of financial position and other financial information as of the beginning of the period as though the assets and liabilities had been transferred at that date.

ASC 805-50-45-5

Financial statements and financial information presented for prior years also shall be retrospectively adjusted to furnish comparative information. All adjusted financial statements and financial summaries shall indicate clearly that financial data of previously separate entities are combined. However, the comparative information in prior years shall only be adjusted for periods during which the entities were under common control.

ASC 805-50-50-3

The notes to the financial statements of the receiving entity shall disclose the following for the period in which the transfer of assets and liabilities or exchange of equity interests occurred:

a. The name and brief description of the entity included in the reporting entity as a result of the net asset transfer or exchange of equity interests

b. The method of accounting for the transfer of net assets or exchange of equity interests.

ASC 805-50-50-4

The receiving entity also shall consider whether additional disclosures are required in accordance with Section 850-10-50, which provides guidance on related party transactions and certain common control relationships.

When there is a change in reporting entity, companies may need to determine a predecessor entity in certain common control transactions as discussed in the next section.

8.2.3.3 *Determining the reporting entity (predecessor) in certain common control transactions*

For accounting purposes, the ongoing reporting entity (predecessor) is the entity deemed to be the receiving entity in a common control transaction. However, the reporting entity for accounting purposes is not always the entity that legally received the net assets or equity interests transferred. If both entities were under common control during the entire reporting period, it is not necessary to determine which entity is the reporting entity, because doing so has no impact on the retrospectively adjusted historical financial statements. However, caution should be utilised when determining the appropriate predecessor entity in a common control transaction in which one of the combined entities was not under common control during the entire retrospectively adjusted reporting period.

At the 2006 AICPA National Conference on Current SEC and PCAOB Developments, an SEC staff member expressed a view that the predecessor entity is "normally going to be the entity first controlled by the parent of the entities that are going to be combined." This is because in these situations the predecessor entity should be determined from the perspective of the parent company, as the parent controls the form of the transaction, and different accounting should not result solely based on the legal form of the transaction. Thus, from the parent's perspective, the entity that first came under control of the parent is usually presented as the predecessor entity. One exception might be when the entity that first came under control of the parent is *de minimis*.

For example, Parent Company P acquired 100 percent of Subsidiary X in March 20X4. Parent Company P acquired Subsidiary Y in December 20X5. In December 20X5 Parent Company P legally merges Subsidiary X into Subsidiary Y, and Subsidiary Y is the surviving entity. Assume that Subsidiary X and Subsidiary Y both contain significant substantive operations. For accounting purposes, the merger should be viewed as a change in reporting entity and, as a result, requires retrospective adjustment of the historical financial statements pursuant to the Transactions Between Entities Under Common Control Subsections of ASC 805-50. See BCG 8.2.3.2 for further information. Despite the legal form of the merger, Subsidiary X would be deemed to be the accounting predecessor of the combined entity, because Parent Company P controlled Subsidiary X prior to acquiring Subsidiary Y. Thus, for the period prior to December 20X5, the retrospectively adjusted historical combined financial statements would include only the activity of Subsidiary X. The common control transfer of Subsidiary Y should be reflected in the combined entity's financial statements as if Subsidiary X had acquired Subsidiary Y in December 20X5 using Parent Company P's purchase consideration as its basis. Although the transfer results in a change in reporting entity, it would not be appropriate to bifurcate (often referred to as a "black-line" presentation) the financial statements into two separate periods in December 20X5, because there was no change in the accounting basis in the underlying assets and liabilities presented during the period of presentation.

8.2.3.4 *Noncontrolling interest in a common control transaction*

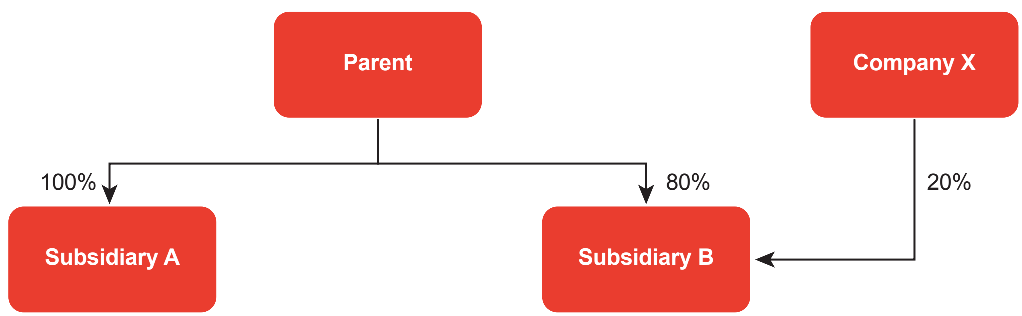
The accounting for any noncontrolling interest should follow the guidance in ASC 810-10 if one or more entities in a common control transaction are partially owned by the parent. Under ASC 810-10, changes in the parent's ownership interest while it retains a controlling financial interest in its subsidiary will be accounted for as equity transactions. The carrying amount of the noncontrolling interest should be adjusted to reflect the change in the ownership interest the noncontrolling shareholders have in the subsidiary. The noncontrolling interest is recorded at **fair value** only on the **acquisition date** in a business combination under ASC 805. The noncontrolling interest should not be recorded at fair value in a common control transaction, because common control transactions, by definition, do not result in a change in control.

Example 8-10 illustrates the accounting for the noncontrolling interest in a common control transaction.

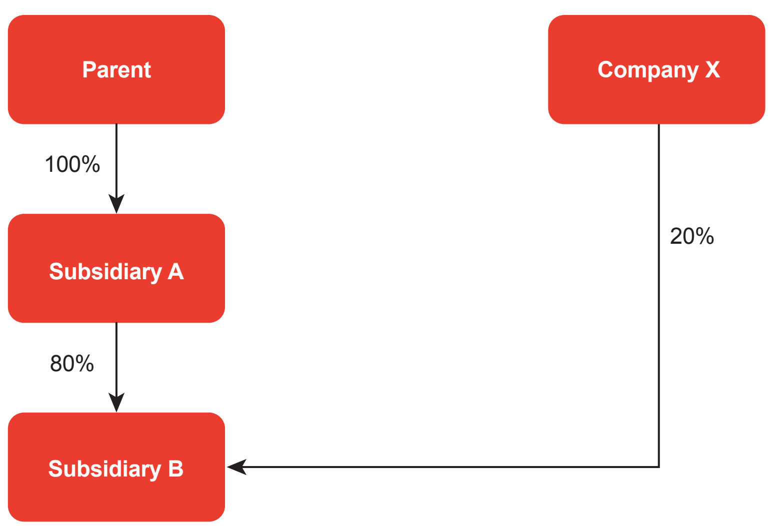
EXAMPLE 8-10

Acquisition of a noncontrolling interest in a common control transaction

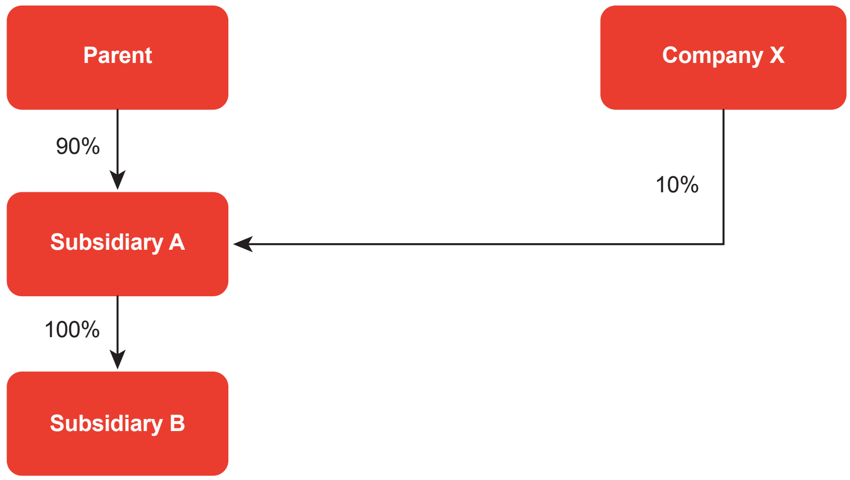
Parent owns 100% of Subsidiary A and 80% of Subsidiary B. Company X owns 20% of Subsidiary B.



Parent transfers its investment in Subsidiary B to Subsidiary A in a common control transaction.



In conjunction with the transaction, Company X exchanges its 20% interest in Subsidiary B for a 10% interest in Subsidiary A.



Also assume the following additional facts:

	Fair value	Net book value
Subsidiary A	CU500	CU200
Subsidiary B	CU500	CU300

- Parent's basis in 100% of Subsidiary A is CU200.
- Parent's basis in 80% of Subsidiary B is CU240.
- In Parent's financial statements, Company X's noncontrolling interest in Subsidiary B is CU60.
- Fair value of 10% of Subsidiary A and Subsidiary B combined is CU100.

Analysis

Parent's contribution of subsidiary B to subsidiary A

The transfer by Parent of its investment in Subsidiary B to Subsidiary A is a common control transaction and would be recorded at Parent's carrying amount of CU240. The transaction would have no impact on Parent's consolidated financial statements.

Subsidiary A's acquisition of company X's noncontrolling interest in subsidiary B in exchange for a 10% noncontrolling interest in subsidiary A

Subsidiary A acquires Company X's noncontrolling interest in Subsidiary B in exchange for a 10% noncontrolling interest in Subsidiary A. Under ASC 810-10, the transaction is accounted for as an equity transaction with the noncontrolling interest in the consolidated financial statements of Parent and would be recorded as follows:

NCI—subsidiary B	CU60[1]	
Equity/APIC—parent		CU10[2]
NCI—subsidiary A		CU50[3]

[1] Elimination of Company X's noncontrolling interest in Subsidiary B.

[2] The net increase in Parent's equity in the consolidated financial statements as a result of the transaction with the noncontrolling interest is calculated as follows:

	Net book value	**20% NCI in Subsidiary B**	**10% NCI in Subsidiary A**	**Total adjustment**
Subsidiary A	CU200	--	CU20	CU20
Subsidiary B	CU300	CU(60)	30	(30)
Adjustment to parent's APIC		CU(60)	CU50	CU(10)

The effect of the CU60 reduction in the noncontrolling interest in Subsidiary B and CU50 increase in the noncontrolling interest in Subsidiary A results in a net CU10 increase in Parent's equity in the consolidated financial statements. The changes in the carrying value of the noncontrolling interests are accounted for through equity/APIC (additional paid in capital). The noncontrolling interest is only recorded at fair value at the date of a business combination.

[3] Recording of the new noncontrolling interest in Subsidiary A (consolidated net book value of CU500 x 10%).

Other Considerations

In the example above, if Company X did not participate in the exchange (i.e., Company X maintained its 20% interest in Subsidiary B), the transaction would simply be accounted for as a transfer of Parent's investment in Subsidiary B to Subsidiary A at Parent's historical cost.

See BCG 6 for information and additional illustrative examples on how to account for transactions between a parent company and the noncontrolling interest.

Another type of transaction between entities under common control is one in which a partially owned subsidiary exchanges its common shares for the outstanding voting common shares of its parent (usually referred to as a "downstream merger"). Whether a parent acquires the noncontrolling interest of a subsidiary, or a subsidiary acquires its parent, the end result is that the consolidated net assets are owned by a single stockholder group that includes both the former shareholders of the parent and the former shareholders of the noncontrolling interest in the subsidiary. Accordingly, these transactions are also accounted for in accordance with ASC 810-10 as an acquisition of noncontrolling interest as if the parent had exchanged its common shares for the noncontrolling interest in its subsidiary.

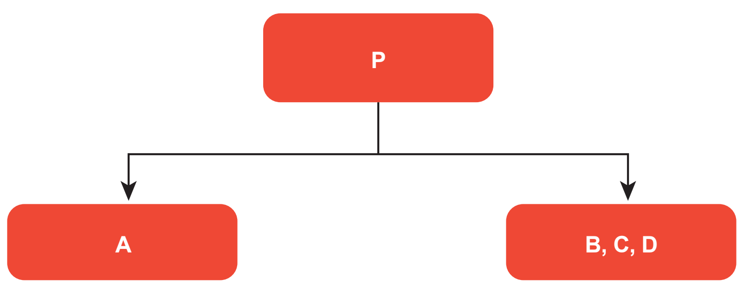
8.2.3.5 *Goodwill impairment and reporting unit assessment*

When an entity prepares combined financial statements following the guidance in the Transactions Between Entities Under Common Control Subsections of ASC 805-50, it must consider how it should test **goodwill** for **impairment** in the combined financial statements. The question that often arises is whether the historical annual goodwill impairment tests should be performed assuming the transferred entity was its own separate **reporting unit** or whether the transferred entity should be assumed to have been integrated into the combined entity's reporting units as if it actually had been acquired at the earlier date. There is no specific guidance on this issue; and two alternative approaches have developed in practice.

The first alternative is based on an interpretation of the guidance in the Transactions Between Entities Under Common Control Subsections of ASC 805-50. That guidance indicates that the new reporting entity's financial statements should result in financial reporting similar to the pooling-of-interest method. Under that premise, the combined entity should reassess its historical reporting units for goodwill impairment testing as if the contributed entity actually had been transferred at the inception of common control. This method requires management of the new reporting entity to make assumptions about how the financial reporting of the entity would have been structured and managed in historical periods, which may not necessarily reflect how the entities were actually managed during those periods.

An alternative view is that the entities being combined should utilise the historical reporting unit structures of each of the combined entities. In the event the contributed entity, the receiving entity, or both did not have stand-alone reporting requirements, the entity (the contributing entity, the receiving entity, or both) would be treated as its own reporting unit for historical goodwill impairment testing purposes.

To illustrate both alternatives, assume Parent Company P has four wholly owned subsidiaries: A, B, C, and D. Subsidiary A comprises a single reporting unit and subsidiaries B, C, and D comprise a second single reporting unit.



Subsidiary A previously prepared stand-alone financial statements and it constituted a single reporting unit for goodwill impairment testing purposes. On 31 December 20X7, Parent Company P transfers its interest in Subsidiary B to Subsidiary A in a common control transaction, resulting in a change in reporting entity.

Under the first alternative discussed above, management of Subsidiary A would be required to determine how the combined operations of Subsidiary A and Subsidiary B would have been managed had the operations of Subsidiary B been transferred at the beginning of the earliest reporting period.

Under the second alternative, the historical single reporting unit of Subsidiary A would remain unchanged and the operations of Subsidiary B would have been treated as a second stand-alone reporting unit prior to the actual transfer date.

Regardless of the method used, the consolidated financial statement of Parent Company P will account for this change in reporting structure prospectively. Goodwill should be reassigned to the affected reporting units by using a relative fair value approach. See BCG 11.4.4 for further information.

8.2.3.6 Deferred taxes

The guidance in the Transactions Between Entities Under Common Control Subsections of ASC 805-50 does not specifically address the accounting for the deferred tax consequences that may result from a transfer of net assets or the exchange of equity interests between enterprises under common control. Although such a transaction is not a pooling-of-interests, we believe the historical guidance in FAS 109, paragraphs 270-272, which addresses the income tax accounting effects of a pooling-of-interests transaction, should be applied by analogy.

When preparing the retrospectively adjusted financial statements for the periods prior to the transaction date, a combining entity's deferred tax assets (e.g., operating loss carryforwards) cannot offset the other entity's taxable income unless allowed under certain jurisdictional tax laws. However, taxable income of the combined operations subsequent to the combination date should be considered in assessing the need for a valuation allowance in the retrospectively adjusted historical financial statements if the combined enterprise expects to file consolidated tax returns. Similarly, any tax law limitations on the use of entity-specific attributes subsequent to the transfer or exchange date should also be considered in evaluating the valuation of a deferred tax asset. Accordingly, in the retrospectively adjusted historical financial statements, a valuation allowance against **deferred tax assets** that is necessary for the combined entity may be different than the sum of the valuation allowances reflected in each of the combining entity's separate financial statements before the transfer or exchange. If the transfer or exchange causes any change in the combined entities' valuation allowance, the reduction or increase should be recognised as part of the adjustment to restate the entities' prior-period financial statements on a combined basis.

For purposes of restating periods prior to the transfer or exchange, a retrospective analysis is required to take into account (1) that the transfer or exchange has occurred and (2) any tax law limitations on the use of carry-over tax benefits after the transfer or exchange. However, a retrospective analysis or hindsight is precluded for purposes of assessing pre-transfer or exchange estimates of future taxable income. In other words, any increase or reduction in the valuation allowance for either entity's deferred tax assets would be reflected in the years the deductible differences or **carryforwards** arose, provided that one of the following conditions exists:

- Estimates that would have been made at the time of future combined taxable income (i.e., after the transfer or exchange, other than reversing differences and carryforwards of the other enterprise) would have been sufficient for realisation of the deferred tax assets.

- The other entity's taxable differences existing at that time will generate sufficient future post-transfer or exchange taxable income to ensure realisation of the deferred tax assets.

- A valid tax-planning strategy ensures realisation of the deferred tax assets.

If none of these conditions were met in the year the deductible differences and carryforwards arose, the increase or reduction in the valuation allowance will be reflected in the first subsequent year in which one or more of these conditions are met.

In addition to adjustments that may be required to restate prior periods, in a taxable transfer or exchange, new tax bases may be established for assets and liabilities transferred. Because a new basis is not established for accounting purposes, taxable **temporary differences** may be reduced or eliminated, and deductible temporary differences may be increased or created. As of the transfer or exchange date, the tax effects attributable to any change in tax basis (net of valuation allowance, if necessary) should be charged or credited to contributed capital. If a valuation allowance is provided against the deferred tax assets at the combination date, any subsequent release of the valuation allowance should be reported as a reduction of income tax expense and reflected in continuing operations, unless the release is based on income recognised during the same year and classified in a category other than continuing operations. See TX 10.9 for further information.

8.2.3.7 Last-In, First-Out (LIFO) inventories

In a nontaxable transfer of net assets or exchange of equity interests between entities under common control, any LIFO inventories of the entities are carried over at the historical LIFO basis and with the same LIFO layers for financial reporting and for tax purposes. In a taxable transfer or exchange, LIFO inventories of the entities are carried over at the same historical LIFO basis and with the same LIFO layers for financial reporting purposes. However, for income tax purposes, the LIFO inventories of one of the entities are stepped up and considered purchases of the current year. Deferred taxes arising from differences in the financial reporting and income tax bases of LIFO inventories resulting from a taxable transfer or exchange should be credited to contributed capital.

8.2.4 Accounting and reporting by the contributing entity

This section provides guidance on the accounting and reporting of the entity that contributes net assets or equity interests to an entity that is under common control.

8.2.4.1 Accounting for the transfer

ASC 805-50-05-5 indicates that certain common control transactions are changes in the reporting entity and provides accounting guidance for the entity that receives the net assets in a common control transaction. However, ASC 805 is silent regarding the accounting by the entity that contributes the net assets or equity interests.

In situations where the contribution or sale transaction is to one of the contributing entity's wholly owned subsidiaries, the consolidated financial statements of the contributing entity will not be affected, except in certain cases for tax effects associated with an intra-entity sale or transfer of subsidiary stock. See TX 2.3.4.2.1 for further information. Otherwise, any differences between the proceeds received or transferred by the parent and the book value of the disposal or acquired group would be eliminated in consolidation, and no gain or loss would be recogniposted. In contrast, the financial statements of the contributing entity will be impacted by a contribution or sale to another party under common control that is not a subsidiary of the contributing entity (e.g., a fellow subsidiary under a common parent). A transfer of long-lived assets between entities under common control would generally be accounted for at carrying value prospectively. Any difference between the proceeds received by the contributing entity and the book value of the assets would be recognised as an equity transaction. For those transactions that constitute a transfer of a business, two alternative methods of accounting by the contributing entity have developed in practice. Regardless of the method used, the consolidated financial statements of the common parent will not be affected.

First, some infer from the receiving entity guidance that the same financial reporting should be applied to the contributing entity. This method is often referred to as a "de-pooling." In a de-pooling, the assets, liabilities, and related operations of the transferred business are retrospectively removed from the financial statements of the contributing entity at their historical carrying values.

Alternatively, some believe the contributing entity should report the transfer as a disposal pursuant to ASC 360-10. The guidance in ASC 360-10 indicates that the **disposal group** of long-lived assets that are to be disposed of other than by sale should continue to be classified as **held-and-used** until the disposal date [ASC 360-10-45-15]. Specifically, ASC 360-10-40-4 states that if a long-lived asset is to be disposed of in an exchange or a distribution to owners in a spin-off, and if that exchange or distribution is to be accounted for based on the recorded amount of the nonmonetary asset relinquished, the asset should continue to be accounted for as held-and-used until it is exchanged or distributed. Any difference between the proceeds received by the contributing entity and the book value of the disposal group (after impairment included in earnings, if any) would be recognised as a capital transaction and no gain or loss would be recorded. If the disposal group qualifies as a **component** of the contributing entity, it should be assessed for discontinued operations reporting on the disposal date.

For public companies in the United States, the SEC staff has issued Staff Accounting Bulletin (SAB) Topic 5-Z.7, *Miscellaneous Accounting,Accounting and Disclosure Regarding Discontinued Operations,Accounting for the Spin-off of a Subsidiary*, which addresses accounting for the spin-off of a subsidiary. While this topic is not written in the context of a change in reporting entity that results from a common control transaction, preparers should carefully consider this guidance in determining the appropriate accounting by the contributing entity in a common control transaction. The topic provides a number of stringent criteria, all of which must be met to "de-pool" a transferred business retroactively from its historical financial reporting periods. The SEC staff often challenges a company's assertion that all the requirements of the SAB have been met. Therefore, the more frequently applied accounting by the contributing entity has been to reflect the contribution as a disposal under ASC 360-10. Although this guidance is specific to public companies, we believe the underlying concepts are applicable to private companies as well.

Example 8-11 provides additional guidance for use in determining the basis of transfer in the contributing entity's separate financial statements.

EXAMPLE 8-11

Subsidiary sells its wholly owned subsidiary to a sister subsidiary that is owned by the same parent

Company A and Company B are controlled by the same corporate parent, Parent Company P. Company A is required to prepare separate financial statements for statutory reporting purposes. Company A sells one of its wholly owned subsidiaries, Company C, to Company B for CU115 million in cash, which is determined to be its fair value. Company C meets the definition of a business. The book value of Company C is CU130 million. There is no basis difference between Company A's carrying value of its investment in Company C and the underlying equity of Company C. Further, there is no basis difference between Parent Company P's carrying value of its investment in Company A and the underlying equity of Company A.

Analysis

The transaction represents a transfer of net assets between entities under common control. Company A would continue to account for the assets of Company C as held-and-used until Company C is distributed to Company B. On the date of the distribution to Company B, Company A should consider recognising an impairment loss of CU15 million based on the difference between the fair value and the book value of Company C. Any difference between the proceeds received by Company A and the book value of Company C (after impairment, if any) would be recognised as an equity transaction and no gain or loss would be recorded. Additionally, since Company C qualifies as a **component** of Company A, it should be assessed for discontinued operations reporting on the date of the distribution.

8.2.4.2 Allocation of contributed entity goodwill

In certain circumstances, the contributed entity may constitute a business and comprise a portion of a larger reporting unit at the parent-company level. In addition, the parent company may not have previously pushed down goodwill related to the contributed entity for stand-alone reporting purposes. In connection with the preparation of the contributing entity's separate financial statements, the contributing entity needs to determine the appropriate method to allocate goodwill to the disposed business. There are two alternative methods to allocate goodwill to the contributed entity that are acceptable.

The contributing entity may apply the guidance prescribed in ASC 350-20-40-1 through 40-7. That guidance requires that goodwill of the reporting unit be allocated to the contributed entity based on the relative fair values of the retained portion of the reporting unit and the contributed entity on the date of the transfer.

Alternatively, by applying the historical cost approach, the contributing entity, in its separate financial statements, could utilise the guidance prescribed in ASC 805-50-30-5, and record the specifically identified original goodwill value of the contributed business from the original acquisition that generated such goodwill.

Subsequent to the allocation under either method, the contributing entity is required to test the remaining goodwill for impairment in accordance with ASC 350. Regardless of the method utilised to allocate goodwill to the transferred entity by the contributing entity, the receiving entity will record goodwill based on the parent's historical cost in the contributed entity in accordance with paragraph ASC 805-50-30-5. As a result, there may not be symmetry between the goodwill allocated to the transferred entity by the contributing entity and the goodwill recorded by the receiving entity.

8.2.4.3 *Nonreciprocal transfers to owners*

A nonreciprocal transfer is a transfer of assets or services in one direction, either from an entity to its owners (whether or not in exchange for their ownership interests) or to another entity, or from owners or another entity to the entity [ASC 845-10-20]. A nonreciprocal transfer of assets to owners of an entity could be in the form of a pro rata spinoff or a non-pro rata split-off.

A spinoff is defined in ASC 505-60 as:

Definition from ASC 505-60-20

Spinoff: The transfer of assets that constitute a business by an entity (the spinnor) into a new legal spun-off entity (the spinnee), followed by a distribution of the shares of the spinnee to its shareholders, without the surrender by the shareholders of any stock of the spinnor.

A transfer of assets that constitute a business to owners in a spinoff should be accounted for based on the recorded amount of those assets transferred (after reduction, if appropriate, for any impairment). In contrast, if the assets transferred do not constitute a business, the transaction is not a spinoff even though the distribution is pro rata. Rather, it would be considered a dividend-in-kind, which is generally accounted for based on the fair value of the assets transferred.

ASC 505-60 addresses whether or not to account for a spinoff as a reverse spinoff based on the substance instead of the legal form of the transaction. There is a presumption that the spinoff should be accounted for based on its legal form (i.e., the legal spinnor is also the accounting spinnor). When determining whether to account for a spinoff as a reverse spinoff, ASC 505-60-25-8 provides several indicators to consider when deciding if the presumption to account for the transaction based on legal form should be overcome. However, no one indicator should be considered presumptive or determinative.

A split-off is defined in ASC 845-10 as:

Definition from ASC 845-10-20

Split-off: A transaction in which a parent entity exchanges its stock in a subsidiary for parent entity stock held by its shareholders.

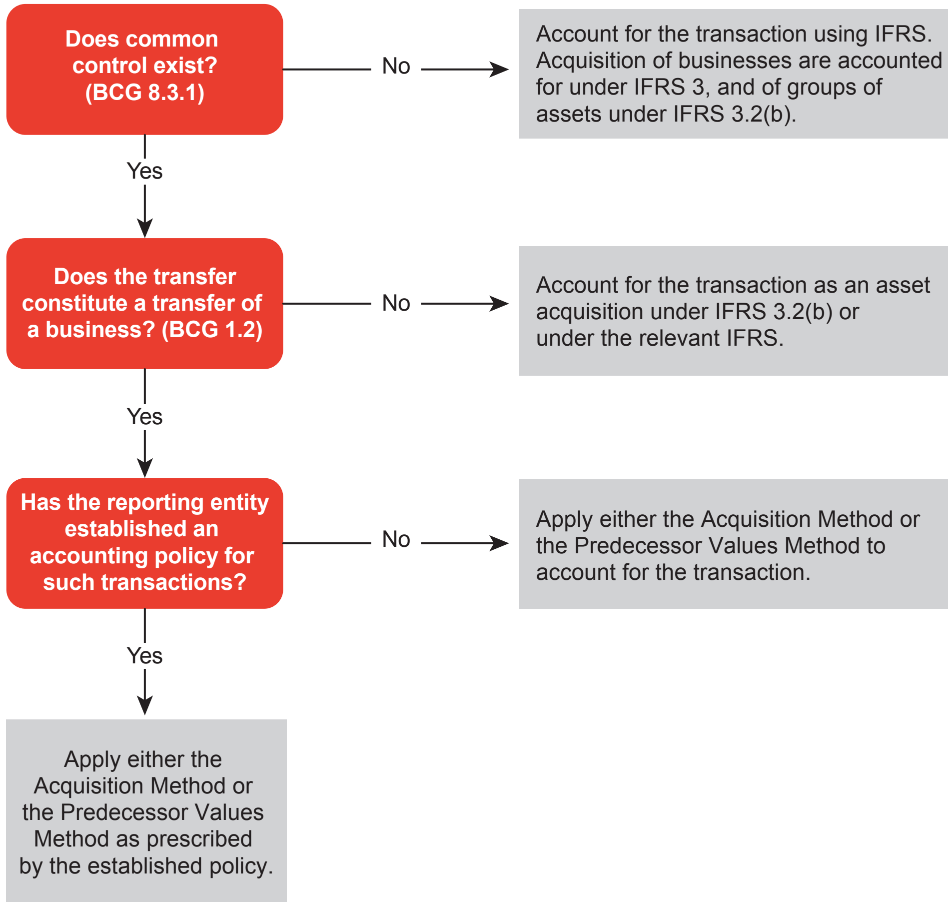
A split-off transaction is a non-pro rata distribution that may or may not involve all shareholders. If the shareholder receiving the split-off entity is not a controlling shareholder of the parent, a non-pro rata split-off is akin to a sale. The transaction is accounted for based on the fair value of the assets transferred, regardless of whether the subsidiary being split-off constitutes a business or an asset. See BCG 10.4.3 for further information regarding how spinoff and split-off transactions may impact long-lived asset impairment tests. A split-off to a controlling shareholder is a common control transaction and would be accounted for based on the recorded amount of those assets transferred.

8.3 Common control transactions under IFRS

Business combinations between entities under **common control** are not covered by IFRS 3. IFRS gives no guidance on the accounting for these types of transactions, but requires that entities develop an accounting policy for them [IAS 8.10]. The two methods most commonly chosen for accounting for business combinations between entities under common control are (1) the **acquisition method** and (2) the **predecessor values method**.

Figure 8-2 provides a decision tree that may assist in assessing these transactions under IFRS.

Figure 8-2
Accounting for common control transactions under IFRS



Common control issues not covered by the basic guidance contained in IFRS 3 often arise. Such issues include determining if common control exists, differentiating between business combinations and reorganisations, and applying the predecessor values method. This chapter addresses these and other common control issues and provides guidance for companies reporting under IFRS.

All other transactions under common control are accounted for under relevant IFRS.

8.3.1 Assessing whether common control exists

Control is defined in IFRS 10 as possessing power over the investee, having exposure, or rights, to variable returns from its involvement with the investee, and having the ability to use its power over the investee to affect the amount of the investor's returns [IFRS 10.7]. IFRS 10 is effective for reporting periods beginning on or after January 1, 2013. BCG 1 discusses the concept of control under IFRS 10 in more detail. A business combination involving entities or **businesses** under common control is a business combination in which all of the combining entities or businesses are ultimately controlled by the same party or parties. Common control must exist both before and after the business combination so that control is not transitory [IFRS

3.B1]. There cannot be a change in the ultimate control of the combining entities in a business combination involving entities under common control.

An entity may be controlled by an individual or by a group of individuals acting together under a contractual arrangement. The individual or group of individuals may not be subject to the financial reporting requirements of IFRS. Therefore, it is not necessary that combining entities be included as part of the same **consolidated financial statements** for a business combination to be regarded as one involving entities under common control [IFRS 3.B3]. Control can be exercised by an entity, such as a **parent** company or partnership, by an individual, or by a government. For example, entities would be under common control if they were wholly owned by an individual shareholder who was not required to prepare financial statements.

Example 8-12 illustrates how to assess common control in transactions involving government-controlled entities.

EXAMPLE 8-12

Assessing common control in transactions involving government-controlled entities

Company R operates city bus services. Company R was partially privatised four years ago when 49% of its equity was sold to the public. The government retained 51% of the voting rights and retained control. Company R has now acquired from the government for cash all of the voting shares of Company B, the regional bus operator. This is Company R's first acquisition since privatisation. The government is not a "parent" as defined by IFRS 10 and so does not prepare consolidated financial statements.

Analysis

This is a business combination involving entities under common control. The combining entities are Company R and Company B. The government controls the combining entities before and after the transaction, so it is a transaction among entities under common control.

No accounting policy has previously been established and management has a choice of accounting treatment. Company R can account for its acquisition of Company B using the acquisition method or the predecessor values method.

If the predecessor values method is used, and the government did not prepare consolidated financial statements, the assets and liabilities of Company B are recognised in Company R's financial statements using the carrying values in Company B's financial statements. See BCG 8.3.5.1 for further guidance in these instances.

The extent of the **noncontrolling interest** in each of the combining entities before and after the business combination is not relevant to determining whether the combination involves entities under common control. The fact that one of the combining entities is a **subsidiary** that has been excluded from the consolidated financial statements is also not relevant [IFRS 3.B4]. What is relevant is that the combining entities remain under common control and control is not transitory. See BCG 8.3.2 for further information.

8.3.1.1 *Common control and control groups*

Control can be exercised by a group of individuals or a group of entities, rather than a single entity or a single individual. A group of individuals shall be regarded as controlling an entity when, as a result of contractual arrangements, they collectively have the power to govern its financial and operating policies so as to obtain benefits from its activities [IFRS 3.B2]. The existence of a contractual arrangement is critical to the existence of common control. In the absence of a contractual arrangement, a control group is deemed not to exist other than in close family relationships.

A family-owned business may consist of a number of separate entities that are not controlled by any one individual or collectively under the terms of a contractual arrangement. Control groups involving close family relationships should be assessed to see if common control exists based on the specific facts and circumstances. A control group exists in other circumstances only if there is a contractual arrangement.

Example 8-13 illustrates how to assess common control in transactions between family-owned or managed businesses.

EXAMPLE 8-13

Assessing common control in transactions between family-owned or managed businesses

The Yarra family runs a retail business. The retail outlets are operated by seven companies that are owned in different proportions by Mr. Yarra, his wife, and their three children. No one member of the family has more than 50% of the equity of any of the operating companies; and there is no contractual arrangement among the members of the family. None of the companies has previously acquired a business from a member of the family.

The family has been advised to consolidate their holdings for tax purposes. A new holding company, Company X, has been formed and will acquire all of the operating companies by issuing shares to Mr. and Mrs. Yarra and their three children. Each family member will own 20% of Company X after the transaction.

Analysis

The Yarra family together controls all of the combining entities before and after the transaction. The reorganisation is a business combination involving entities under common control. The combining entities are Company X and the existing operating companies. Even though there is no contractual arrangement that gives the family common control, such an arrangement is deemed to exist due to the close family relationships.

Management has a choice of accounting treatment if this is the acquiring company's first common control business combination. All of the requirements of IFRS 3 are applied if the acquisition method is used. Company X cannot be the acquirer. If a new entity is formed to issue equity interests to effect a business combination, one of the combining entities that existed before the business combination shall be identified as the acquirer by applying the guidance in IFRS 3. All of the existing companies together should be identified as the acquirer if they are managed together as a single business. The accounting result would be similar to predecessor accounting in the case where all of the companies together are the acquirer under IFRS 3.

The Yarra family is not a "parent" within the meaning of IFRS 10.2(a) if the predecessor values method is used. The Yarra family has not previously prepared consolidated financial statements because these were not required. The assets and liabilities of the operating companies are recognised in Company X's consolidated financial statements using the carrying values in the financial statements of each company under the predecessor values method. This is because there are no consolidated financial statements from the highest level of common control. See BCG 8.3.5.1 for further information.

8.3.1.2 Entities with a high degree of common ownership

Transactions between entities with a high degree of common ownership or other joint arrangements must be assessed to determine if they are common control transactions. The assessment should determine whether the group collectively has control under IFRS 10 (e.g., as a result of a contractual arrangement).

Business combinations between entities that have a high degree of common ownership, but not common control, are not business combinations involving entities under common control. These business combinations are within the scope of IFRS 3 and should be accounted for using the acquisition method.

Examples 8-14 and 8-15 illustrate how to assess common control in transactions between entities with a high degree of common ownership.

EXAMPLE 8-14

Assessing common control in transactions between entities with a high degree of common ownership

Company A is owned 40%, 40%, and 20% by three unrelated shareholders. There is no contractual agreement in place that creates control for any single shareholder or group of shareholders. Company B is owned by the same shareholders in the same proportions.

Company A incorporates a new company, Company X, which issues shares and acquires 100 percent of the shares of Company A and Company B. The shareholders own 40%, 40%, and 20%, respectively, of Company X subsequent to the transaction.

Analysis

This is not a business combination between entities under common control. There is no contractual agreement in place that gives an individual shareholder or group of shareholders control of Company A or Company B. The acquisition method should be applied in this fact pattern. Company A or Company B should be identified as the acquirer.

Situations arise where two or more entities or individuals sometimes act collectively to manage and operate the activities of another entity. These arrangements may be joint arrangements in the context of the definition in IFRS 11.

EXAMPLE 8-15

Assessing common control in transactions between joint ventures

Three individuals, A, B, and C formed a joint arrangement, Company Y, in 20X5 that meets the criteria to be classified as a joint venture under IFRS 11. Company Y's activities are the evaluation and exploration of oil and gas reserves in a number of countries. A, B, and C formed another joint arrangement, Company Z, in 20X8 that meets the criteria to be classified as a joint venture under IFRS 11. Company Z transports the oil and gas extracted by Company Y to Western Europe. A, B, and C each hold a one-third interest in both Company Y and Company Z. The activities of Company Y and Company Z are governed by agreements that establish joint control in accordance with the definition in IFRS 11.

The joint venture partners have been advised that tax savings can be achieved if Company Y and Company Z were combined into a single tax group. As a result, Company Y acquired all of the shares of Company Z from A, B, and C in a share-for-share exchange.

Analysis

The two combining entities are controlled collectively by the same group of shareholders. The entities were previously under the joint control of A, B, and C. This is not the formation of a joint venture, but rather a reorganisation involving entities under common control. The combining entities are Company Y and Company Z. The joint venture partners jointly control both of the combining entities before and after the transaction because of the joint-control-sharing agreements in place.

Management has a choice of accounting treatment if this is the acquiring company's first common control business combination. The transaction can be accounted for using the acquisition method or using the predecessor values method. All of the requirements of IFRS 3 are applied if the acquisition method is used, including determination of the accounting acquirer. The assets and liabilities of Company Z are recognised in Company Y's consolidated financial statements using the carrying values in Company Z's financial statements if the predecessor method is used. This is because the joint venture partners did not prepare financial statements that included the two joint ventures prior to combining them. See BCG 8.3.5.1 for further guidance in these instances.

8.3.2 Transitory common control

For a transaction to qualify as a common control transaction, IFRS 3 requires that the combining entities or businesses are ultimately controlled by the same party or parties before and after the combination. The control must not be transitory. The reason for this condition is to prevent the use of "grooming transactions," whereby, for only a brief period immediately before the combination, the combining entities or businesses are under common control.

Examples 8-16 and 8-17 illustrate how to determine if common control is transitory.

EXAMPLE 8-16

Determining if common control is transitory

Two individuals, A and B, own competing grocery businesses, Company X and Company Y, respectively. A agreed to acquire B's business by acquiring all of Company Y's voting shares in his own name in exchange for 25% of his shares in Company X. Two months after this transaction, A transferred Company Y to Company X.

Analysis

This is not a business combination involving entities under common control. The common control of Company X and Company Y was transitory because Company X and Company Y came under common control shortly before the transaction to effect the transaction. Company X has acquired Company Y and should apply the acquisition method in its consolidated financial statements.

A reorganisation may involve the formation of a new entity to facilitate the sale of part of a group. The IFRIC considered whether this is a business combination under IFRS 3 if control of the new entity is transitory. The IFRIC clarified that when combining entities or businesses have been under common control for a period before the combination, control is not considered transitory [IFRIC Update March 2006, IFRIC Update July 2011]. A reorganisation within a group to facilitate a spin-off or an initial public offering is a business combination involving entities under common control. This is still the case when the parent loses control shortly after the transaction. This constitutes a disposal transaction. The entity has lost control of the business. The disposal may be an acquisition by another party or it may be a disposal to the wider market. The reorganisation that occurs before the disposal is not an acquisition under IFRS 3. It may be a business combination amongst entities under common control provided that more than one business is combined in the new entity.

EXAMPLE 8-17

Assessing if control is transitory in spin-off transactions

Company R is listed on the London Stock Exchange and operates bars, hotels, and casinos. The management of Company R plans to divide the company so that the bar business and the hotel and casino businesses are listed separately. A new entity, Company S, has been incorporated, and Company R will transfer the hotel and casino businesses to Company S in exchange for new Company S shares. Company R will then distribute the Company S shares pro-rata to the existing shareholders of Company R.

Analysis

This is a business combination involving entities under common control, because common control is not transitory. The combining entities are the hotel and casino businesses, which have been controlled by Company R in the period before and after the combination.

Management has a choice of accounting treatment because Company S has not established an accounting policy on accounting for common control business combinations. Company S can account for the business combination using the acquisition method or using the predecessor values method.

Company S cannot be the acquirer if the acquisition method is chosen. An acquirer must be identified among the hotel and casino businesses. The assets and liabilities of the hotel and casino businesses are recognised in Company S's consolidated financial statements using the carrying values in the financial statements of Company R if the predecessor values method is used.

8.3.3 Nature of the acquisition—group of assets or net assets versus business

Determining if a transfer between entities under common control constitutes the transfer of a group of assets or a business is critical. The transfer of a business accounted for under the predecessor values method will often result in the restatement of historical financial periods. The restatement is presented as if the entities were always combined, as further discussed in BCG 8.3.5.2. The acquisition of a group of assets or net assets should be accounted for as an **asset acquisition** under the requirements of IFRS 3.2(b), regardless of whether that acquisition is a common control transaction. Asset acquisitions are discussed further in BCG 9. The acquisition of a single asset is governed by other IFRS, for example, International Accounting Standard 16, *Property, Plant and Equipment* (IAS 16), or International Accounting Standard 38, *Intangible Assets* (IAS 38). Those standards would apply regardless of whether the transaction qualifies as a common control acquisition. The seller or transferor will account for the transaction under appropriate IFRS and may recognise a gain or loss on the transaction.

8.3.4 Business combinations versus reorganisations

It is not uncommon for a new parent company to be added to an existing group by setting up a new shell company that issues equity shares to the existing shareholders in exchange for the transfer of shares in the existing group, such that there is no change in the substance of the reporting entity. This may be done for a variety of reasons including taxation and profit distributions.

A new parent company added to an existing group is not an acquirer in a business combination. The transaction could be characterised as a reverse acquisition of the new company by the existing group if it was a business combination as defined by IFRS 3. However, IFRS 3 contains guidance on reverse acquisitions that states that "the accounting acquiree must meet the definition of a business for the transaction to be accounted for as a reverse acquisition" [IFRS 3.B19]. Therefore, the situation in which a new parent company is added to an existing group is not a business combination.

It can be argued that the transaction is a reorganisation of an existing entity, and that the substance of the reporting entity has not changed. The consolidated financial statements of the new entity are presented using the values from the consolidated financial statements of the previous group holding company. The equity structure—that is, the issued share capital—would reflect that of the new company, with other amounts in equity (such as revaluation reserve, retained earnings, cumulative translation reserves) being those from the consolidated financial statements of the previous group holding company. The resulting difference would be recognised as a component of equity. Local regulatory or legal requirements may specify how this difference is presented; for example, it may be referred to as a reorganisation reserve.

8.3.5 Predecessor values method

This section provides guidance on the accounting and reporting of common control transactions using the predecessor values method.

8.3.5.1 Basis of transfer

The predecessor values method requires the financial statements to be prepared using predecessor book values without any step up to **fair value**. There will likely be a difference between any consideration given and the aggregate book value of the assets and liabilities (as of the date of the transaction) of the acquired entity. This difference is recorded as an adjustment to equity. This may be recorded in retained earnings or as a separate reserve. No additional **goodwill** is created by the transaction.

The acquiree’s book values are generally those in the consolidated financial statements of the highest entity that has common control for which consolidated financial statements are prepared. This includes any goodwill relating to the acquiree that appears in those consolidated financial statements. IFRS does not contain the concept of pushdown accounting unlike U.S. GAAP. Pushdown accounting is not relevant in determining the basis of transfer. The values should be the same as those in the acquiree’s own books when the acquiree has been under common control since it was formed. The values in the consolidated financial statements should be used, including goodwill, when the acquiree was previously acquired in a business combination. Predecessor values should be adjusted to ensure uniform accounting policies. It will be necessary to use predecessor amounts from a lower level where no financial statements have been prepared at the highest level of common control.

Examples 8-18 and 8-19 illustrate how to determine the predecessor value in a common control transaction.

EXAMPLE 8-18

Determining predecessor values when consolidated financial statements are prepared

Company Y has owned 100% of Company D, a dairy products business, for many years. Company Y acquired 100% of Company M, another dairy products company, from a competitor for cash in 20X4. Management decided to combine the two dairy products businesses two years after the acquisition of Company M. Management transferred all voting shares of Company M to Company D for nominal consideration. Company D has an existing policy of applying the predecessor values method for a common control business combination in its consolidated financial statements.

Analysis

This is a business combination involving entities under common control. Management must apply a consistent accounting policy and therefore, Company D will use the predecessor values method for this transaction. The book values used to record the assets and liabilities are those in the consolidated financial statements of the highest entity that has common control when the predecessor values method is applied. Company D should recognise the assets and liabilities of Company M using the values recorded in the consolidated financial statements of Company Y. The book values of the transferred business are not used.

EXAMPLE 8-19

Determining predecessor values when consolidated financial statements are not prepared

Company B is a wholly owned subsidiary of Entity T, an unincorporated government agency that is not required to prepare financial statements. Company B has an existing policy of applying the predecessor values method for a common control business combination.

Entity T acquired all the voting shares in Company N in January 20X7 for cash. Entity T did not prepare consolidated financial statements and has never produced IFRS 3 fair value information regarding its acquisition of Company N. In January 20X8, Entity T transferred the shares in Company N to Company B.

Analysis

Company B's acquisition of Company N is a business combination involving entities under common control. The business combination should be recorded using the predecessor values method. The predecessor values that should be used in Company B's consolidated financial statements are those from Company N's separate financial statements. Company B should account for the transaction using the predecessor values from the date that Company N has been under common control of Entity T, which is January 20X7. See BCG 8.3.5.2 for further information.

8.3.5.2 Financial statement presentation

The consolidated financial statements can be presented using one of two alternative methods under the predecessor values method. The consolidated financial statements can incorporate the acquired entity's results as if both entities (acquirer and acquiree) had always been combined (or from the date either entity joined the group where such a date is later). The consolidated financial statements will reflect both entities' full year's results, even though the business combination may have occurred part way through the year. The corresponding amounts for the previous years also reflect the combined results of both entities, even though the transaction did not occur until the current year.

Alternatively, the consolidated financial statements can incorporate the acquired entity's results only from the date on which the transaction occurred. Consequently, the consolidated financial statements do not reflect the results of the acquired entity for the period before the transaction occurred. The corresponding amounts for the previous year are also not restated.

Once a presentation method has been adopted it should be applied consistently for any common control transactions as a matter of accounting policy. The local regulator or market practice may dictate whether the first or second method can be used in some jurisdictions.

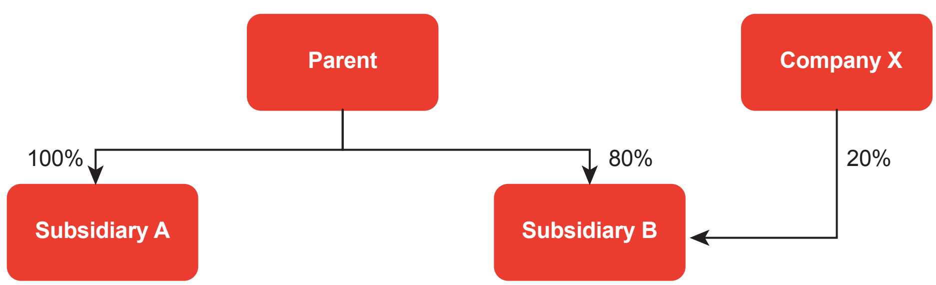
8.3.6 Noncontrolling interest in a common control business combination

IFRS 10 provides additional guidance on how to account for the noncontrolling interest. The application of this guidance in a business combination involving entities under common control is illustrated in Example 8-20.

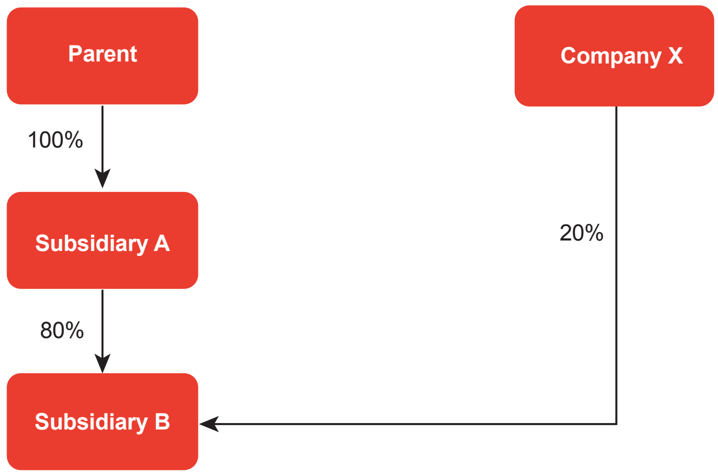
EXAMPLE 8-20

Acquisition of a noncontrolling interest in a common control business combination

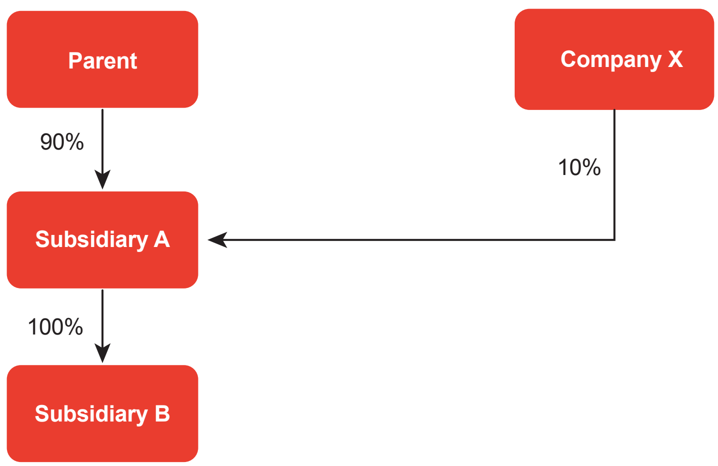
Parent owns 100% of Subsidiary A and 80% of Subsidiary B. Company X owns 20% of Subsidiary B.



Parent transfers its investment in Subsidiary B to Subsidiary A in a common control transaction.



Company X exchanges its 20% interest in Subsidiary B for a 10% interest in Subsidiary A in conjunction with the transaction.



Also assume the following additional facts:

	Fair value	Net book value
Subsidiary A	CU500	CU200
Subsidiary B	CU500	CU300

- Parent's basis in 100% of Subsidiary A is CU200.
- Parent's basis in 80% of Subsidiary B is CU240.
- In Parent's financial statements, Company X's noncontrolling interest in Subsidiary B is CU60.
- Fair value of 10% of Subsidiary A and Subsidiary B combined is CU100.

Parent's contribution of subsidiary B to subsidiary A

The transfer by Parent of its investment in Subsidiary B to Subsidiary A is a common control transaction that would have no impact on Parent's consolidated financial statements.

Subsidiary A's acquisition of company X's noncontrolling interest in subsidiary B in exchange for a 10 percent noncontrolling interest in subsidiary A

Subsidiary A acquires Company X's noncontrolling interest in Subsidiary B in exchange for a 10% noncontrolling interest in Subsidiary A. The transaction is accounted for as an equity transaction with the noncontrolling interest in the consolidated financial statements of Parent and would be recorded as follows:

NCI—subsidiary B	CU60[1]	
Equity/APIC—parent		CU10[2]
NCI—Subsidiary A		CU50[3]

[1] Elimination of Company X's noncontrolling interest in Subsidiary B.

[2] The net increase in Parent's equity/APIC (additional paid-in capital) in the consolidated financial statements as a result of the transaction with the noncontrolling interest is calculated as follows:

	Net book value	**20% NCI in Subsidiary B**	**10% NCI in Subsidiary A**	**Total adjustment**
Subsidiary A	CU200	—	CU20	CU20
Subsidiary B	CU300	CU(60)	30	(30)
Adjustment to parent's equity/APIC		CU(60)	CU50	CU(10)

The effect of the CU60 reduction in the noncontrolling interest in Subsidiary B and CU50 increase in the noncontrolling interest in Subsidiary A results in a net CU10 increase in Parent's equity/APIC in the consolidated financial statements.

[3] Recording of the new noncontrolling interest in Subsidiary A (consolidated net book value of CU500 x 10%).

The changes in the noncontrolling interest are accounted for at carrying values. The option to fair value the noncontrolling interest is only available at the date of a business combination.

Other considerations

There would be no entries to record in Parent's consolidated financial statements in the example above if Company X did not participate in the exchange (i.e., Company X maintained its 20% interest in Subsidiary B).

See BCG 6 for guidance and additional illustrative examples on how to account for transactions between the parent company and the noncontrolling interest.

8.3.7 *Accounting and reporting by the selling (contributing) entity*

When one party carries out a business combination involving entities under common control, another entity will have made a disposal. There is no specific guidance on how the selling (contributing) entity should account for the transfer of a business in a common control business combination. The selling entity in a business combination involving entities under common control may be required to prepare its own consolidated financial statements under IFRS.

The consolidated financial statements will not be affected if the contribution or sale is to one of the seller's own subsidiaries. There could be a contribution or sale to another party under common control that is not a subsidiary of the seller (e.g., a fellow subsidiary under a common parent). It will generally be appropriate to recognise a gain or loss on the sale based on the difference between the consideration received and the carrying value of the disposed business. The business that is disposed of should be deconsolidated only from the point that control is lost. "De-pooling" or retrospective presentation of the disposal is not appropriate under IFRS.

Chapter 9: Asset acquisitions

9.1 Chapter overview

BCG 1 addresses **business combinations** that are within the scope of the Standards and the difference between an acquisition of a **business** and an acquisition of an asset or group of assets. If an acquisition of an asset or group of assets does not meet the definition of a business, the transaction is accounted for as an asset acquisition. There are specific differences between the accounting for asset acquisitions and business combinations. An asset acquisition under both IFRS and U.S. GAAP does not result in the recognition of **goodwill;** and transaction costs are capitalised as part of the cost of the asset or group of assets acquired. Additionally, under IFRS, the recognition of deferred taxes in an asset acquisition is very different from that in a business combination. Generally, no deferred taxes are recognised for book/tax differences on asset acquisitions under IFRS. These and other differences are described further below.

9.2 Assets acquired in an exchange transaction

Assets are usually acquired through an exchange transaction, which can be a monetary or a nonmonetary exchange. This section discusses the accounting for assets acquired in an exchange transaction including the recognition and measurement under U.S. GAAP and IFRS.

9.2.1 Initial Recognition

An asset acquisition triggers the initial recognition of an asset acquired or liability assumed. Assets are usually acquired through an exchange transaction, which can be a monetary or a nonmonetary exchange. Assets surrendered are derecognised at the date of acquisition. If liabilities are incurred or **equity interests** are issued as the consideration for an acquisition of an asset or group of assets, those liabilities and equity interests are recognised at the date of acquisition [ASC 805-50-25-1].

Goodwill is not recognised in an asset acquisition. The presence of excess **consideration transferred** may indicate that not all assets acquired have been recognised or that there are **preexisting relationships** being settled with the transaction that should be accounted for separately. In the absence of evidence to the contrary, a particular set of assets and activities in which goodwill is present is presumed to be a business [ASC 805-10-55-9; IFRS 3.B12].

9.2.2 Initial measurement

Asset acquisitions are measured based on their cost to the acquiring entity, which generally includes transaction costs. An asset's acquisition cost or the consideration transferred by the acquiring entity is assumed to be equal to the **fair value** of the net assets acquired, unless contrary evidence exists. A gain or loss would be recognised by the **acquirer** if the fair value of nonmonetary assets given as consideration was different than their **carrying amounts** [ASC 805-50-30-1; IAS 16.24, 67]. A gain may be limited in situations where a nonmonetary asset, for which the readily determinable fair value exceeds the carrying amount, is transferred to an entity in exchange for a noncontrolling ownership interest in that entity and that ownership interest is accounted for under the equity method [ASC 845-10-30-26b; IAS 28.28].

If the consideration transferred is cash, measurement is based on the amount of cash paid to the seller as well as transaction costs incurred. Consideration given in the form of nonmonetary assets, liabilities incurred, or equity interests issued is measured based on either the cost to the acquiring entity or the fair value of the assets or net assets acquired, whichever is more clearly evident and, thus, reliably measurable [ASC 805-50-30-2; IAS 16.24; IAS 38.45].

There is a rebuttable presumption in IFRS 2 that the fair value of goods and services received can be reliably measured when consideration is given in the form of equity interests. The fair value of the equity interests issued as consideration can be used to determine the fair value of the consideration transferred only when this presumption is rebutted [IFRS 2.13].

9.2.2.1 Nonmonetary transactions accounting—U.S. GAAP

Certain asset acquisitions are within the scope of ASC 845-10. Most asset acquisitions involve exchanges of cash or other monetary assets or liabilities for the asset acquired. The amount of monetary assets or liabilities exchanged for nonmonetary assets generally provides an objective basis for measuring the fair value of the nonmonetary assets. Exchanges that involve little or no monetary assets or liabilities are commonly referred to as nonmonetary transactions.

An asset acquired in a nonmonetary exchange is generally recorded at fair value. However, an asset acquired must be measured at the recorded amount of the asset surrendered (i.e., carrying value) instead of the fair value of the asset surrendered if any of the following conditions apply [ASC 845-10-30-3]:

- **Fair value not determinable**—The fair value of neither the asset received nor the asset relinquished is determinable with reasonable limits. Fair value of a nonmonetary asset transferred to or from an enterprise in a nonmonetary transaction should be determined by referring to estimated realisable values in cash transactions of the same or similar assets, quoted market prices, independent appraisals, estimated fair values of assets or services received in exchange, and other available evidence. If one of the parties in a nonmonetary transaction could have elected to receive cash instead of the nonmonetary asset, the amount of cash that could have been received may be evidence of the fair value of the nonmonetary assets exchanged. Fair value should be regarded as not determinable within reasonable limits if major uncertainties exist about the realisability of the value that would be assigned to an asset received in a nonmonetary transaction accounted for at fair value.

- **Exchange transaction to facilitate sales to customers**—The transaction is an exchange of a product or property **held-for-sale** in the ordinary course of business for a product or property to be sold in the same line of business to facilitate sales to customers other than the parties to the exchange. For example, inventory for inventory exchanges are measured at their carrying value, unless they are for different classes of inventory (e.g., raw materials for finished goods).

- **Exchange transaction that lacks commercial substance**—The transaction lacks commercial substance. A nonmonetary exchange has commercial substance if the entity's future cash flows are expected to significantly change as a result of the exchange. The entity's future cash flows are expected to significantly change if either of the following criteria is met:

  - The configuration (risk, timing, and amount) of the future cash flows of the asset(s) received differs significantly from the configuration of the future cash flows of the asset(s) transferred.

  - The entity-specific value of the asset(s) received differs from the entity-specific value of the asset(s) transferred, and the difference is significant in relation to the fair values of the assets exchanged.

If any of these conditions apply, no gain or loss would be recorded in the exchange.

9.2.2.2 Nonmonetary transactions accounting—IFRS

The accounting under IFRS for nonmonetary exchanges is similar to that under U.S. GAAP. The cost of an item acquired in exchange for a nonmonetary asset or assets is measured at fair value unless (1) the exchange transaction lacks commercial substance or (2) the fair value of neither the asset received nor the asset given up is reliably measurable. If the acquired item is not measured at fair value, it is measured at the carrying amount of the asset surrendered [IAS 16.24].

Nonmonetary exchanges of items that are similar in nature and value are not measured at fair value and do not result in the recognition of gains and losses. This is often the case with commodities like oil or milk, where suppliers exchange or swap inventories in various locations to fulfill demand on a timely basis in a particular location. If the items exchanged are for dissimilar goods or services, the exchange is measured at fair value, resulting in the recognition of a gain or loss. An exchange is measured based on the fair value of the items received, adjusted by the amount of cash and cash equivalents transferred. When the fair value of the items received cannot be measured reliably, the exchange is measured based on the fair value of the items given up, adjusted by the amount of any cash or cash equivalents transferred [IAS 18.12].

9.2.3 Allocating cost (the fair value of consideration given)

The cost of acquiring a group of assets is allocated to the individual assets within the group based on the relative fair values of the individual assets. Fair value is measured in accordance with ASC 820 or IFRS 13, as applicable. Therefore, the fair value of the consideration transferred, including transaction costs, is generally allocated to the assets acquired and liabilities assumed based on their relative fair values [ASC 805-50-30-3]. However, if the fair values of the assets acquired and liabilities assumed are more reliably determinable, the cost of the transaction would be based on the fair values of the assets acquired and liabilities assumed [ASC 805-50-30-2; IAS 16.24; IAS 38.45]. No goodwill is recognised in an asset acquisition.

Example 9-1 demonstrates the allocation of cost in an asset acquisition.

EXAMPLE 9-1

Measurement of an asset acquisition

Company X acquires a custom special-purpose machine and a patent in exchange for consideration transferred of CU1,000 cash and a warehouse facility. The fair value of the warehouse facility is CU600 and its carrying value is CU100. The fair values of the special-purpose machine and patent are estimated to be CU750 and CU1,250, respectively. The special-purpose machine and patent relate to a product that has just recently been commercialised. The market for this product is developing and uncertain. Assume Company X incurred no transaction costs. (For illustrative purposes, the tax consequences on the gain have been ignored.)

Analysis

The cost of the asset acquisition is determined based on the fair value of the assets given, unless the fair value of the assets received is more reliably determinable. Company X concludes the fair value of the warehouse facility is more reliable than the fair value of the special-purpose machine and patent. The fair value of the consideration given is attributed to the individual assets acquired based on their relative fair values. Therefore, Company X would value the acquisition of the special-purpose machine and patent at CU1,600 (the total fair value of the consideration transferred). A CU500 gain is recorded by Company X for the difference between the fair value and carrying value of the warehouse facility. The special-purpose machine and patent are recorded at their relative fair values. The entry to record the transaction would be:

Machine	CU600[1]	
Patent	CU1,000[2]	
Cash		CU1,000[3]
Warehouse facility		CU100[4]
Gain on acquisition		CU500[4]

[1] The machine is recorded at its relative fair value ((CU750/CU2,000) x CU1,600 = CU600).

[2] The patent is recorded at its relative fair value ((CU1,250/CU2,000) x CU1,600 = CU1,000).

[3] Company X paid cash consideration of CU1,000.

[4] The carrying amount of the warehouse facility (CU100) is derecognised from the balance sheet and a gain is recorded for the difference between the carrying amount and the fair value at the date of derecognition (CU600 – CU100 = CU500).

9.2.4 *Accounting for an asset acquisition versus a business combination*

Figure 9-1 describes common areas where differences in accounting occur between an asset acquisition and a business combination.

Figure 9-1
Common differences between asset acquisition and business combination

Topic	Business combinations	Asset acquisition under U.S. GAAP	Asset acquisition under IFRS
Intangible assets including goodwill	Intangible assets are recognised at fair value if they meet the identifiable criteria. Goodwill is recognised as a separate asset[ASC 805-20-25-4 and ASC 805-30-30-1; IFRS 3.13, 32].	Intangible assets acquired in an asset acquisition are recognised in accordance with ASC 350. Goodwill is not recognised in an asset acquisition. Any excess consideration transferred over the fair value of the net assets acquired is reallocated to the identifiable assets[1] based on their relative fair values [ASC 805-50-30-3]. As discussed above, if the consideration transferred included nonmonetary assets, the cost of the acquired intangible assets is generally measured at fair value, and a gain or loss is recognised on the nonmonetary asset transferred [ASC 845-10-30-1].	Intangible assets acquired in an asset acquisition are recognised in accordance with IAS 38 and no goodwill is recognised. An intangible asset is measured initially at cost [IAS 38.24]. If the consideration transferred included nonmonetary assets, the cost of the acquired intangible assets is generally measured at fair value, and a gain or loss is recognised on the nonmonetary asset transferred [IAS 38.45].
Intangible assets used in research and development activities (referred to as in-process research and development or IPR&D)	Intangible research and development acquired in a business combination is measured at fair value using market-participant assumptions and is capitalised as an indefinite-lived asset [not available for use]. Capitalised research and development assets will be either impaired or amortised in future periods, depending on the ability of the acquirer to use the acquired research and development in the postcombination period.	IPR&D is expensed for asset acquisitions at the acquisition date if it has no alternative future use. However, the costs of intangibles that are purchased from others and have alternative future uses (in other research and development projects or otherwise) shall be accounted for as an intangible asset and amortisation of those intangible assets used in research and development activities is a research and development cost[ASC 730-10-25-2(c)].	An acquirer recognises the IPR&D project as an asset if it meets the definition of an intangible asset and its fair value can be measured reliably. This criterion is always considered to be satisfied for separately acquired IPR&D assets [IAS 38.25].

Topic	Business combinations	Asset acquisition under U.S. GAAP	Asset acquisition under IFRS
Acquired contingencies	Under U.S. GAAP, acquired contingencies should be recognised and measured at fair value if determinable at the acquisition date or during the measurement period using facts and circumstances that existed at the acquisition date. Otherwise, companies would typically account for the acquired contingencies in accordance with ASC 450. Under IFRS, an acquirer recognises all contingent liabilities assumed at fair value on the acquisition date if they represent a present obligation arising from past events and can be reliably measured [IFRS 3.23]. Under both U.S. GAAP and IFRS, subsequent changes in the value of acquired contingencies are recorded through earnings until settled.	Contingencies acquired in an asset acquisition are accounted for in accordance with ASC 450. Asset acquisitions are not subject to the requirement to initially assess whether the acquisition date fair value of acquired contingencies is determinable. Subsequent changes in the recorded ASC 450 amount are recorded through earnings.	Contingencies acquired in an asset acquisition are recognised only if they meet the recognition criteria in IAS 37. As such, a provision is recorded when (1) an entity has a present obligation (legal or constructive) as a result of a past event, (2) it is probable (more likely than not) that an outflow of resources embodying economic benefits will be required to settle the obligation, and (3) a reliable estimate can be made of the amount of the obligation. If these conditions are not met, no provision shall be recognised [IAS 37.14].
Transaction costs	In a business combination, transaction costs are expensed and not included as part of the consideration transferred [ASC 805-10-25-23; IFRS 3.53].	Transaction costs are generally a component of the consideration transferred to acquire the group of assets in an asset acquisition, and are capitalised as a component of the cost of the assets acquired in accordance with the applicable standards (e.g., CON 5 for property, plant, and equipment) [ASC 805-50-30-1;].	Transaction costs are generally a component of the consideration transferred to acquire the group of assets in an asset acquisition, and are capitalised as a component of the cost of the assets acquired in accordance with the applicable standards (e.g., IAS 16 for property, plant, and equipment) [IAS 16.16; IAS 38.27].

Topic	Business combinations	Asset acquisition under U.S. GAAP	Asset acquisition under IFRS
Deferred tax accounting	Deferred taxes are recorded on most temporary book/tax differences for assets acquired and liabilities assumed and tax attributes acquired in a business combination in accordance with ASC 740.	Deferred taxes are generally recorded on temporary book/tax differences in an asset acquisition using the simultaneous equations method in accordance with ASC 740-10-25-49 through 25-55. A reduction in the valuation allowance of the acquirer that is directly related to the asset acquisition will impact income tax expense. Further, any “negative goodwill” arising from the application of ASC 740-10-25-51(c) should first reduce the values assigned to the noncurrent assets, and any remaining deferred credit should be amortised to income tax expense in proportion to the realisation of the tax benefits that gave rise to the negative goodwill [ASC 740-10-35-5]. The tax law may provide for the acquirer’s tax on certain nonmonetary exchanges to be deferred and for the acquirer’s tax basis in the asset that was given up to carry over to the asset received. In those instances, a deferred tax liability may be recorded. See BCG 5.9 for further information.	IFRS prohibits recognition of deferred taxes for temporary differences that arise upon recording an asset or liability in a transaction that (1) is not a business combination and (2) affects neither accounting nor taxable income [IAS 12.15]. Accordingly, deferred taxes generally are not recognised for book/tax differences on asset acquisitions. The tax law may provide for the acquirer’s tax on certain nonmonetary exchanges to be deferred and for the acquirer’s tax basis in the asset that was given up to carry over to the asset received. In those instances, a deferred tax liability may be recorded. See BCG 5.9 for further information.

Topic	Business combinations	Asset acquisition under U.S. GAAP	Asset acquisition under IFRS
Assembled workforce	An assembled workforce does not qualify as an identifiable intangible asset to be recognised separately from goodwill [ASC 805-20-55-6; IFRS 3.B37].	An assembled workforce intangible asset may be recognised and measured at fair value at the acquisition date if it is part of the asset or group of assets acquired that do not constitute a business [CON 5]. However, if a workforce is present, the group of acquired assets may qualify as a business, in which case, the provisions of ASC 805 should be applied.	An entity usually has insufficient control over the expected future economic benefits arising from its workforce to meet the definition of an intangible asset [IAS 38.15]. A workforce generally does not qualify as an identifiable intangible asset. Additionally, if a workforce is present, the group of acquired assets may qualify as a business, in which case, the provisions of IFRS 3 should be applied.
Accounting for the classification of a lease	Classification of a lease contract as an operating or a capital lease is based on the contractual terms at the inception of the contract, unless the contract has been significantly modified [ASC 805-20-25-8; ASC 840-10-25-27; IFRS 3.17].	Classification of a lease contract should be reassessed by the new lessee [ASC 840-10-25-32].	Classification of a lease contract should be reassessed based on facts and circumstances, because no specific guidance is provided under IFRS.

Topic	Business combinations	Asset acquisition under U.S. GAAP	Asset acquisition under IFRS
Situations where the fair value of the assets acquired and liabilities assumed exceeds the fair value of consideration transferred (referred to as bargain purchases)	If the fair value of the assets acquired and liabilities assumed exceeds the fair value of the consideration transferred (taking into effect the fair value of any noncontrolling interest to be recorded and the fair value of the acquirer's previously held equity interests in the acquiree), a gain shall be recognised by the acquirer [ASC 805-30-25-2; IFRS 3.34].	Assets acquired and liabilities assumed are measured at the fair value of consideration transferred (unless the fair value of the assets acquired and liabilities assumed is more reliably determinable). Because the measurement principle for asset acquisitions continues to be based on cost, a gain is generally not recognised for a bargain purchase. Thus, we believe the bargain purchase element should be reflected as a reduction of the relative fair value of the nonmonetary long-lived assets acquired.	Assets acquired and liabilities assumed are measured at the fair value of consideration transferred (unless the fair value of the assets acquired and liabilities assumed is more reliably determinable). Because the measurement principle for asset acquisitions continues to be based on cost, a gain is generally not recognised for a bargain purchase. Thus, we believe the bargain purchase element should be reflected as a reduction of the relative fair value of the nonmonetary long-lived assets acquired.
Contingent consideration	Contingent consideration is recorded at fair value on the date of acquisition. Subsequent changes in the fair value of the contingent consideration not classified as equity are recorded through earnings until settled [ASC 805-30-25-5; IFRS 3.39].	Contingent consideration is generally recorded when probable and reasonably estimable. Subsequent changes in the recorded amount of the contingent consideration are recorded against cost [ASC 323-10-35-14A; ASC 360-10-30-1; ASC 450-20-25-2].	Contingent consideration is generally recorded at fair value on the date of purchase. An accounting policy election may be made to record the subsequent changes in fair value against cost [IAS 16] or in earnings [IFRS 9; IAS 39].

[1] Financial assets (excluding equity-method investments) and assets subject to recurring fair value impairment testing (e.g., indefi nite-lived intangible assets) would not be allocated a portion of the excess consideration. Increasing the accounting basis of these assets at acquisition would likely lead to an impairment at the next testing date.

See BCG 2 for further information on the accounting for a business combination.

9.2.5 Accounting after acquisition

The subsequent accounting for an asset or liability is based on the nature of the asset and liability, not the manner of its acquisition. The basis for measuring the asset or liability, whether cost or fair value, has no impact on the accounting of the asset or liability after acquisition [ASC 805-50-35-1].

9.2.6 *Acquisition of intangible assets disclosures*

Specific disclosures for intangible assets acquired in a transaction other than a business combination are required. U.S. GAAP companies should follow the disclosure requirements of ASC 350 with respect to intangible assets acquired in an asset acquisition [ASC 350-20-50-1 through 50-3].

IFRS companies should follow the disclosure requirements of IAS 38 with respect to intangible assets acquired in an asset acquisition [IAS 38.118–123].

Chapter 10: Accounting for tangible and intangible assets postacquisition—U.S. GAAP

10.1 Chapter overview

This chapter discusses the difficulties inherent in accounting for tangible and intangible assets in periods subsequent to a business combination or an **asset acquisition**. It includes guidance on how to (1) determine the appropriate lives; (2) determine the appropriate attribution of depreciation or amortisation; and (3) assess, calculate, and record **impairments** of these assets. This chapter also discusses ongoing challenges encountered in practice, including the determination of useful lives of renewable intangible assets. ASC 805 includes guidance for the identification and recognition of tangible and intangible assets acquired in a business combination. ASC 350 and ASC 360-10 provide guidance on the accounting for tangible and intangible assets subsequent to a business combination or asset acquisition. For tangible assets, ASC 360-10 should be applied. An entity's accounting for an intangible asset will differ depending on whether the asset's useful life is considered finite or indefinite. Long-lived intangible assets are subject to the impairment provisions of ASC 360-10; indefinite-lived intangible assets are subject to the provisions of ASC 350.

A long-lived asset (asset group) should be tested for recoverability by comparing the net carrying value of the asset or asset group to the undiscounted net cash flows to be generated from the use and eventual disposition of that asset (asset group) when events or changes in circumstances indicate that its carrying amount may not be recoverable. If the carrying amount of a long-lived asset (asset group) is not recoverable, the fair value of the asset (asset group) is measured and if the carrying amount exceeds the fair value, an impairment loss is recognised.

An indefinite-lived intangible asset should be tested for impairment annually and between annual tests ("interim tests") if events or changes in circumstances indicate that it is more likely than not that the asset is impaired.

The standard provides examples of events and circumstances that could affect significant inputs used to determine the fair value of the indefinite-lived intangible asset. The indefinite-lived intangible asset impairment standard allows an entity first to assess qualitative factors to determine if a quantitative impairment test is necessary. Further testing is only required if the entity determines, based on the qualitative assessment, that it is more likely than not that an indefinite-lived intangible asset's fair value is less than its carrying amount.

An entity can choose to perform the qualitative assessment on none, some, or all of its indefinite-lived intangible assets. An entity can also bypass the qualitative assessment for any indefinite-lived intangible asset in any period and proceed directly to the quantitative impairment test and then choose to perform the qualitative assessment in any subsequent period. When an entity bypasses the qualitative assessment or determines based on the qualitative assessment that it is more likely than not that the asset is impaired, an impairment test is performed by comparing the fair value of the indefinite-lived intangible asset to its carrying amount.

The key takeaways from this chapter are:

- **The guidance for tangible and intangible assets is found in ASC 350 and ASC 360-10.** Key provisions of ASC 805 and changes in other standards impact the postacquisition accounting for tangible and intangible assets acquired in a business combination.

- **An indefinite-lived intangible asset is not subject to amortisation unless its useful life is determined to be no longer indefinite. It is tested for impairment at least annually at the individual asset level.** Subject to an optional qualitative assessment, the indefinite-lived impairment test is performed by comparing the fair value of the asset to its carrying amount.

- **An entity has the option to first assess qualitative factors to determine if a quantitative impairment test is necessary.** An entity has the option to perform a qualitative assessment to determine whether a quantitative impairment test is necessary. Further quantitative testing is only required if an entity determines, based on the qualitative assessment, that it is more likely than not that an indefinite-lived intangible asset's fair value is less than its carrying amount.

- **An intangible asset that is subject to amortisation is tested for impairment in accordance with the ASC 360-10-35 impairment guidance.** Long-lived tangible and intangible assets impairment testing is a two-step process. The first step tests for recoverability by comparing net carrying value of the asset or asset group to the undiscounted net cash flows to be generated from the use and eventual disposition of that asset or asset group. If the assets are not recoverable and the carrying amount of a long-lived asset (asset group) exceeds its fair value, an impairment loss should be recognised.

- **Research and development intangible assets are initially treated as indefinite-lived.** Under ASC 805, intangible assets acquired in a business combination that are used in research and development activities are initially recognised and measured at fair value. After initial recognition, those assets shall be considered indefinite-lived and tested for impairment until the associated research and development activities are either completed, at which point a determination of the assets' useful lives and methods of amortisation should be made, or are abandoned.

- **Measuring assets that an acquirer intends to use in a way other than their highest and best use may result in additional amortisation expense and future impairment losses.** ASC 805 requires an entity to measure assets at fair value under ASC 820. This may lead to certain assets being assigned higher values based on market-participant assumptions rather than acquirer specific assumptions and result in additional amortisation expense in postacquisition periods. Additionally, potential future impairment losses may be more likely because the acquirer's use of assets may differ from their highest and best use.

- **ASC 805 impacts the postacquisition accounting for reacquired rights.** When an entity acquires a right it had previously granted to the acquired entity, the reacquired right should be recognised, measured, and amortised based on the remaining contractual term of the related contract, without considering expected renewals.

10.2 Determining the useful life of an asset

The useful life of a long-lived tangible or intangible asset is the period over which the asset is expected to contribute directly or indirectly to the future cash flows of an entity. The useful life is dependent upon a number of factors, the assessment of which can require a significant amount of judgment. In determining the useful lives of intangible assets, an entity should consider the following factors discussed in ASC 350, which also may apply to tangible assets:

- The expected use of the asset by the entity
- The expected useful life of another asset or a group of assets to which the useful life of the asset may relate
- Any legal, regulatory, or contractual provisions that may limit the useful life
- The entity's own historical experience renewing or extending similar arrangements (consistent with the intended use of the asset by the entity), regardless of whether those arrangements have explicit renewal or extension provisions; in the absence of that experience, the entity shall consider the assumptions that **market-participants** would use about renewals or extensions (consistent with the highest and best use of the asset by market-participants), adjusted for entity-specific factors
- The effects of obsolescence, demand, competition, and other economic factors (such as the stability of the industry, known technical advances, legislative action that results in an uncertainty or changing regulatory environment, and expected changes in distribution channels)
- The level of maintenance expenditures required to obtain the expected future economic benefits from the asset; for example, a material level of required maintenance in relation to the **carrying amount** of the asset may suggest a very limited useful life [ASC 350-30-35-3]

None of the above factors should be considered more presumptive than the other. Entities should consider all of the relevant facts and circumstances when estimating an asset's useful life. Useful lives should be evaluated each reporting period to determine whether facts and circumstances arise that may impact estimates of useful lives and therefore the remaining period of amortisation [ASC 350-30-35-9].

Question 10-1

Do the useful lives of long-lived tangible or intangible assets need to be reassessed if no impairment indicators exist or if the asset (asset group) passes step one of the impairment test?

PwC response

Reassessment of useful lives of intangible assets is required at least annually and should be performed whenever events or circumstances may indicate a revision to the useful life (presumably shorter) is warranted to reflect the remaining expected use of the asset. Although there is no explicit requirement to annually reassess the useful lives of long-lived tangible assets, useful lives of these assets should be reassessed whenever events or circumstances may indicate a revision to the useful life (presumably shorter) is warranted to reflect the remaining expected use of the asset.

An entity may also use factors beyond those noted above in determining an asset's useful life. For example, when considering the useful life of customer-related intangible assets, additional factors, such as the uncertainty of revenues dependent upon retention of key employees, the "churn" rate of customers, and the mobility of customer and employee bases should be taken into account.

Except for determining the useful lives of **reacquired rights**, which is specifically addressed in ASC 805, an entity should consider contract renewals or extensions, if applicable, in determining the useful life of an asset. However, ASC 350 does not distinguish between renewals or extensions that are at the entity's option and those that are at the option of other parties. Consideration should therefore be given to an entity's assumption of renewals or extensions that are at the option of the counterparty (e.g., a customer or a governmental body).

10.2.1 Indefinite-lived intangible assets

The useful life of an intangible asset should be considered indefinite if no legal, regulatory, contractual, competitive, economic, or other factors limit its useful life to the entity. The term indefinite, however, does not mean infinite or indeterminate [ASC 350-30-35-4].

All factors that are pertinent to whether an intangible asset has an indefinite life should indicate that there is no foreseeable limit to the period over which the asset is expected to contribute to the entity's cash flows. Support for such assertions may include inquiries of those individuals who are responsible for managing the intangible asset, discussions with valuation experts, and internal and external empirical data. All available evidence should be considered and based on historical and projected trends in demand, competition, technological change, and other economic factors affecting the entity and its industry.

It may be difficult to support an indefinite life, except for certain classes of intangible assets (e.g., Federal Communications Commission (FCC) licenses and trade names). For example, it would be rare for a customer-related intangible asset to have an indefinite life due to the frequency of customer turnover and changes in relationships.

In considering whether an intangible asset has an indefinite life, it may be important to consider how an entity determines the **fair value** of an intangible asset and assesses that asset for impairment (e.g., a forecasted deterioration in annual cash flows may be inconsistent with an **indefinite useful life** determination).

Indefinite-lived intangible assets should be reassessed each reporting period to determine whether events or circumstances continue to support an indefinite useful life [ASC 350-30-35-16]. See BCG 10.2.2 for further information on the accounting considerations when an asset that is not being amortised is subsequently determined to have a **finite useful life**.

Examples 10-1 and 10-2 illustrate the determination of useful lives.

EXAMPLE 10-1

Intangible asset determined to have an indefinite life

As part of ABC Company's purchase of XYZ Company, ABC recognises an intangible asset related to XYZ's registered trademark, which is used to distinguish a leading consumer product. The trademark has a remaining legal life of seven years, but is renewable every 10 years for minimal cost. ABC intends to continuously renew the trademark and evidence supports its ability to do so. Analysis of the product life cycle provides evidence that the trademarked product will generate cash flows for ABC for an indefinite period of time.

Analysis

The trademark may have an indefinite useful life because it is expected to contribute to cash flows indefinitely and the associated costs of renewal are not significant. Therefore, the trademark would not be amortised until its useful life is no longer indefinite. However, the trademark would need to be tested for impairment annually, or more frequently if events or changes in circumstances indicate that the asset might be impaired [ASC 350-30-35-18].

EXAMPLE 10-2

Intangible asset determined to have a finite life

As part of Entity B's acquisition of Entity M, Entity B recognises an intangible asset related to Brand K, a brand known for its association with the production of an economic alternative to carbon-based fuel. Management of Entity B has committed significant resources in support of Brand K and continued improvement of the underlying technology. There is significant competition in this technological area and therefore the technology is subject to constant change and improvement. Brand K does not have an established pattern of surviving changes in the underlying technology. The technology is not considered to be in-process research and development.

Analysis

Since the technology is subject to constant change and improvement, a significant discovery may make previously cutting-edge technology obsolete, resulting in reduced utilisation of the brand. Additionally, there is no evidence to support an assertion that Brand K would continue to exist beyond the life of the current underlying technology. These factors would likely make it difficult to conclude that the entity would benefit economically from the brand indefinitely. On the other hand, if Brand K had an established pattern of surviving changes in the underlying technology, Entity B may be able to support Brand K having an indefinite life.

10.2.2 Reclassification of intangible assets between indefinite-life and finite-life categories

When an entity subsequently determines that an indefinite-lived intangible asset has a finite useful life, the entity should test the asset for impairment as an indefinite-lived intangible asset prior to commencing amortisation [ASC 350-30-35-17]. The intangible asset should then be amortised over its estimated useful life and accounted for the same as other intangible assets subject to amortisation (including applying the impairment provisions of ASC 360-10). Conversely, if a long-lived intangible asset is subsequently determined to have an indefinite life, the entity should cease amortising the asset and test it for impairment as an indefinite-lived intangible asset. While the reclassification of an indefinite-lived intangible asset to a long-lived intangible asset may occur as a result of changes in circumstances, the reclassification of a long-lived intangible asset to an indefinite-lived intangible asset is expected to be rare.

10.2.3 Changes in useful lives or salvage values

A change in the estimated useful lives or salvage values of long-lived assets is a change in accounting estimate and should be accounted for prospectively in the period of change and future periods, as appropriate, in accordance with ASC 250-10. ASC 360-10-35-47 also emphasises this point with regard to assets to be abandoned. After considering whether those assets are impaired on a **held-and-used** basis, the useful life should be shortened based on management's current plans to dispose of the asset before the end of its original useful life and depreciation should be accelerated beginning when that determination is made. See BCG 10.4.3 for further information on to-be-abandoned assets. Further, when a long-lived asset (**asset group**) is tested for recoverability, it also may be necessary to review useful life estimates [ASC 360-10-35-22].

10.2.4 Renewable intangible assets

Under ASC 350-30-55-1C, an entity should consider its own historical experience in renewing or extending similar arrangements when developing its assumptions about renewals or extensions used to determine the useful life of an intangible asset; however, these assumptions should be adjusted for the entity-specific factors in ASC 350-30-35-3. In the absence of that experience, an entity should consider the assumptions that market-participants would use about renewals or extensions (consistent with the highest and best use of the asset by market-participants), adjusted for the entity-specific factors in ASC 350-30-35-3.

In some instances, there will be a difference between the useful life of the asset used for amortisation and the period of expected cash flows used to measure the fair value of the asset. However, these instances will likely be limited to situations in which the entity's own assumptions about the period over which the asset is expected to contribute to the future cash flows of the entity are different from the assumptions market-participants would use in valuing the asset. In those situations, it is appropriate for the entity to use its own assumptions regarding the useful life of the asset, because amortisation of a recognised intangible asset should reflect the period over which the asset will contribute both directly and indirectly to the expected future cash flows of the entity [ASC 350-30-55-1C].

10.2.5 Reacquired rights

An entity may, as part of a business combination, reacquire a right it had previously granted to the **acquiree** to use the **acquirer's** recognised or unrecognised intangible assets. Reacquired rights are recognised as intangible assets and measured based on the remaining contractual terms, excluding the effects of expected contractual renewals. After initial recognition, ASC 805 requires that such assets be amortised over the remaining contractual period of the contract in which the right was granted, excluding any subsequent renewals and extensions [ASC 805-20-30-20 and ASC 805-20-35-2]. In some cases, a reacquired right may be perpetual if there are no contractual renewals and the remaining contractual life is not limited. Such a reacquired right may have an indefinite useful life. See BCG 2.5.6.1 for further information on the determination of the value and useful life of reacquired rights.

10.2.6 Intangible assets used in research and developmental activities

As discussed in BCG 4, ASC 805 requires the recognition of both tangible and intangible research and development assets acquired in a business combination. This applies even if the intangible assets do not have an alternative future use. After initial recognition, tangible research and development assets are accounted for in accordance with their nature. On the other hand, research and development intangible assets should be considered indefinite-lived until the abandonment or completion of the associated research and development efforts [ASC 350-30-35- 17A]. If abandoned, the assets would be impaired. If the activities are completed, the acquiring entity would make a determination of the useful lives and methods of amortisation of those assets. Research and development expenditures that are incurred after the acquisition, including those for completing the **research and development activities** related to the acquired intangible research and development assets, are generally expensed as incurred.

Subsequent to a business combination, ASC 350 provides that acquired-in-process research and development intangible assets not be amortised; instead, they would be subject to an impairment assessment, at least annually. See BCG 10.4.4 for further information on impairment of intangible assets with indefinite useful lives. Further, if these intangible assets are temporarily idled, they should not be accounted for as abandoned, consistent with ASC 360-10-35-49.

This requirement makes it necessary for companies to track capitalised research and development projects for impairment testing purposes. As projects evolve (for instance, multiple projects are combined), such tracking will be necessary for companies to properly test for impairment and determine the point of completion or abandonment of a project. Furthermore, costs incurred after the acquisition related to acquired research and development intangible assets will likely be relevant in performing the impairment testing as they may impact the fair value of the assets. Impairment of acquired research and development intangible assets immediately after acquisition is possible but rare.

ASC 805 and ASC 820 significantly changed the valuation and accounting for indefinite-lived intangible research and development assets acquired in a business combination. As a result, the AICPA has issued the IPR&D Guide. The purpose of the IPR&D Guide is to provide a best practices publication addressing the financial reporting and emerging practice issues companies are dealing with in regards to research and development assets acquired in a business combination or an asset acquisition. Research and development intangible assets acquired or costs incurred outside of a business combination should be expensed, unless there is an alternative future use [ASC 730-10-25-1]. See BCG 9 for further information on research and development assets acquired outside of a business combination.

10.2.6.1 Enabling technology

The IPR&D Guide eliminates the concept of core technology and introduces the concept of enabling technology which is intended to have a narrower definition. Enabling technology is defined in the IPR&D Guide as follows:

Partial definition from IPR&D 6.51

Enabling technology: …underlying technology that has value through its continued use or reuse across many products or product families.

Examples of enabling technology provided in the AICPA Guide include a portfolio of patents, a software object library, or an underlying form of drug delivery technology. If enabling technology meets the criteria for recognition as an intangible asset, it could be a separate unit of account if it does not share the useful life, growth, risk, and profitability of the products in which it is used. The IPR&D Guide indicates that enabling technology will be recognised as a separate asset less frequently than core technology had previously been recognised, and that the introduction of enabling technology is not expected to significantly contribute to the amount of recognised goodwill. As a result, elements of value previously included in core technology likely will be recognised separately as identifiable intangible assets that increase the value of developed technology and/or an IPR&D asset.

10.3 Attribution

Determining the appropriate period and method to depreciate or amortise assets requires a certain amount of judgment and an understanding of the assets and their useful lives. Appropriate depreciation and amortisation methods should be considered for tangible and intangible assets, respectively.

10.3.1 Commencement and cessation of depreciation or amortisation

Depreciation or amortisation of an asset begins when the asset is available for its intended use. This is when the asset is in the location and condition necessary for it to operate in the manner intended by management. Depreciation or amortisation ceases when an asset is derecognised or when the asset is classified as **held-for-sale** [ASC 360-10-35-43]. Therefore, depreciation or amortisation generally does not stop when an asset is temporarily idled or if the asset's fair value exceeds its carrying value. However, an asset remaining idle for more than a short period of time may be an indicator of potential impairment or the need to reassess the asset's useful life.

Judgment is required in determining whether a productive asset is temporarily idled or permanently abandoned. An asset temporarily idled should not be accounted for as if abandoned. An asset is abandoned when it ceases to be used [ASC 360-10-35-47].

10.3.2 Depreciation of tangible assets

Depreciation accounting is defined as "a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less salvage value (if any), over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner" [ASC 360-10-35-4]. It requires adoption of a method of depreciation and estimation of the useful lives of the assets to be depreciated and related salvage value [ASC 360-10-35-4]. An estimate of useful life not only considers the economic life of the asset, but also the remaining life of the asset to the entity.

Several methods of depreciation exist, including straight-line method, accelerated methods (such as "sum-of-the-years-digits" and declining-balance methods), and units-of-production methods. Factors to be considered in selecting a method for a given asset may include determining if (1) the asset is subject to rapid obsolescence, (2) its deterioration is a function of time or usage, (3) its productivity declines with time, and (4) the cost of repairs and maintenance increases with time.

If justifiable and preferable, a change from one depreciation method to another (including a change from one accelerated method to another accelerated method) is a change in accounting estimate that is effected by a change in accounting principle [ASC 250-10-45-19]. Whether a change in the method of applying the principle of depreciation is preferable in the circumstances can be determined only on a case-by-case basis. An entity should evaluate both the method of depreciation and the remaining useful lives of its tangible assets as events and circumstances change. For example, when an asset is tested for recoverability, it also may be necessary to review both the method of depreciation and its estimated useful life. If an entity revises a tangible asset's estimated useful life, the carrying amount of the asset at that time should be depreciated on a prospective basis over its revised remaining useful life [ASC 250-10-45-17]. If an entity commits to a plan to abandon an asset before the end of its previously estimated useful life, depreciation estimates should be revised to reflect the use of the asset over its shortened useful life [ASC 360-10-35-47].

Income statement classification of depreciation should generally reflect the nature of the asset's use. An entity should disclose the amount of depreciation recorded for all periods presented [ASC 360-10-50-1].

10.3.3 Amortisation of intangible assets

An intangible asset that has a finite life should be amortised over its estimated useful life to the entity. If an intangible asset's useful life is determined to be finite, but the precise length of that life is not known, the intangible asset should be amortised over the entity's best estimate of the asset's useful life. The method of amortising an intangible asset should reflect the pattern in which the asset's economic benefits are consumed or otherwise used up. If such a pattern cannot reliably be determined, then a straight-line amortisation method should be used [ASC 350-30-35-6].

An entity should consider the nature of the amortisable intangible asset and its expected use when assessing if a pattern of consumption can be reliably determined or if the straight-line method will provide an appropriate method of amortisation. The valuation performed for purposes of measuring the intangible asset's fair value may also provide a reasonable starting point to discern the expected pattern of economic benefit of an intangible asset. For example, when an **income approach** is used to measure the fair value of a long-lived intangible asset, the projected cash flows may be the best indication of the pattern of economic benefit expected from the asset. Consideration should then be given to whether discounted or undiscounted cash flows should be used. Judgment should be applied in determining whether discounted or undiscounted cash flows better reflect the pattern of economic benefit the entity may expect to derive from the asset.

At times, it may appear that the manner in which the economic benefits of a finite-lived intangible asset's economic benefits are consumed falls toward the latter part of the asset's life. In these cases, that perception should be supported by an analysis that demonstrates that (1) the benefits received from consuming the asset are greater in the latter part of the asset's useful life and (2) cash flows generated from the asset are consistent with that belief. For example, a fixed-duration customer contract that is not likely to be renewed or extended may generate sales of increasingly larger quantities of a product through the expiration date of the contract. In this instance, the economic benefits are likely to be consumed toward the latter part of the asset's life. However, the patterns of consumption for many intangible assets are generally skewed toward the earlier years, so amortisation methods that result in greater amortisation expense in the later years are expected to be rare.

If justifiable and preferable, a change from one amortisation method to another is a change in accounting estimate that is effected by a change in accounting principle [ASC 250-10-45-19]. Whether a change in the method of applying the principle of amortisation is preferable in the circumstances can be determined only on a case-by-case basis.

Long-lived intangible assets should be amortised over their estimated useful lives to their **residual values**, if any. Residual value is the estimated fair value of the intangible asset at the end of the asset's useful life to the entity. An entity should assume that the residual value of a long-lived intangible asset is zero, unless at the end of the asset's useful life to the entity the asset is expected to continue to have a useful life to another entity and either (1) the entity has a commitment from a third party to purchase the asset at the end of its useful life, or (2) the residual value can be determined by reference to an exchange transaction in an existing market that is expected to exist at the end of the asset's useful life [ASC 350-30-35-8].

An entity should evaluate the remaining useful lives of its long-lived intangible assets each reporting period to determine whether events and circumstances warrant a revision to previous estimates. If an entity revises a long-lived intangible asset's estimated useful life, the unamortised cost of the asset should be amortised on a prospective basis as a change in accounting estimate over its revised remaining useful life [ASC 350-30-35-9].

Income statement classification of an intangible asset's amortisation should generally reflect the nature of the asset's use. For example, an entity that provides special monitoring services to its customers may have an acquired customer-relationship intangible asset. Classification of amortisation of the intangible asset in selling, general, and administrative expense may be most consistent with the nature of the asset because the intangible asset is not typically associated with providing the service to customers. On the other hand, an entity may have a patent intangible asset that is used in the production of its products. In this case, classification of the amortisation of the patent intangible asset in cost of sales (or as an inventory cost that is eventually recorded as cost of sales) may be most consistent with the nature of the asset, because it is directly associated with the production process.

10.3.4 Customer-based intangible assets

Some intangible assets recognised in a business combination derive their value from future cash flows expected from the customers of the acquired entity. Companies may also recognise this type of intangible asset when they acquire groups of customer accounts. Such assets are often measured using an income approach, which uses valuation techniques to convert future amounts (e.g., cash flows or earnings) to a single present value amount (discounted). This approach may also provide evidence as to the assets' useful lives and the pattern of economic benefit expected to be derived.

Typically, customer relationships within a large group of accounts may dissipate at a more rapid rate in the earlier periods than in later periods. In this circumstance, straight-line amortisation over an expected useful life of the group of accounts may overstate net earnings in earlier periods and understate such earnings in later periods. Therefore, customer-based intangible assets should generally be amortised systematically to allocate an amount over the periods expected to be benefited using the pattern of economic benefit. Management should evaluate whether the actual net cash flows from the acquired customer accounts differ (or are likely to differ) significantly from those underlying the original method of allocating the assets' cost, and revise accounting estimates when necessary.

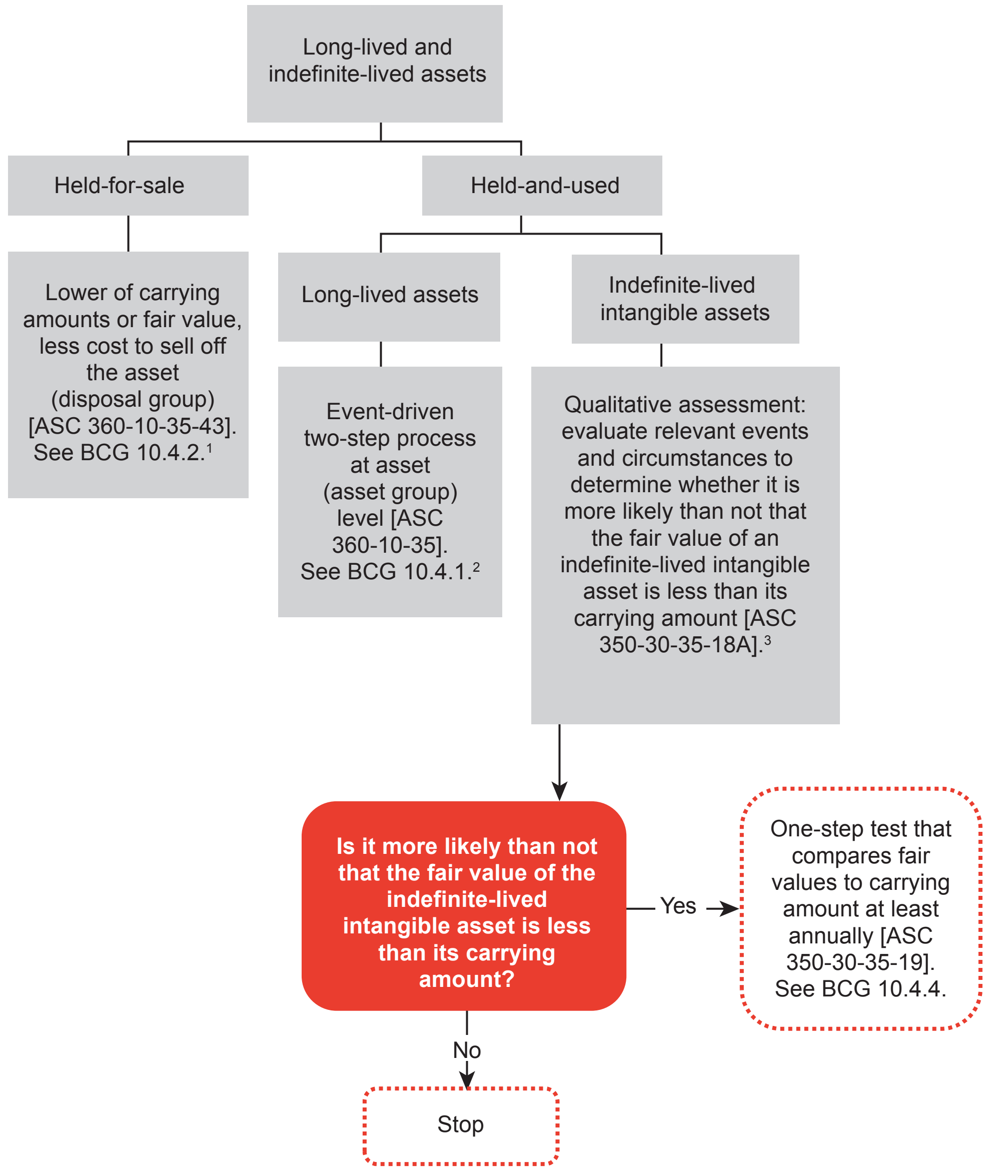
Although the attribution of the fair value of a customer-related intangible asset may best be reflected based on the pattern of economic benefit, we are aware that in the past the SEC staff has accepted a straight-line amortisation method over a shorter term if the pattern of usage or consumption associated with the asset is such that amortisation over a longer period of economic benefit would not differ materially from an accelerated method. For example, an intangible asset's useful life may have been estimated as ten years, with greater consumption in the earlier years of the asset's life. A straight-line amortisation method over a shorter period may be acceptable, provided it does not differ significantly from an accelerated method based on the 10-year life. Judgment should be applied in determining whether a straight-line method over a shorter term is appropriate.

10.4 Impairment of long-lived and indefinite-lived intangible assets

Developments and events after a business combination or an asset acquisition may result in a material and sustained decrease in the value of tangible and intangible assets, potentially leading to impairment. As defined in ASC 360-10, impairment is the condition that exists when the carrying amount of an asset (or asset group) exceeds its fair value. ASC 350 addresses impairment of indefinite-lived intangible assets. An indefinite-lived intangible asset is considered to be impaired when the asset's carrying amount is greater than its fair value. There are various approaches to determine whether an impairment should be recognised and, if so, how to measure and record such impairment in the financial statements. The identification of the applicable impairment approach is an important part of assessing and measuring an asset's impairment.

Long-lived assets are subject to two approaches for assessing asset impairments: (1) assets to be held-and-used and (2) assets to be disposed of by sale [ASC 360-10-5-4]. The chart in Figure 10-1 depicts the various impairment approaches based on the type and intended use of the assets.

Figure 10-1
Impairment approaches based on the type and intended use of the assets



[1] Any assets not covered by ASC 360-10 should first be adjusted in accordance with other applicable U.S. GAAP before testing the disposal group for impairment [ASC 360-10-35-39].

[2] Other than goodwill, any assets not covered by ASC 360-10 should first be adjusted in accordance with other applicable U.S. GAAP before testing the asset group for impairment [ASC 360-10-35-27].

[3] An entity has an unconditional option to bypass the qualitative assessment for any indefinite-lived intangible asset in any period and proceed directly to performing the quantitative impairment test. An entity may resume performing the qualitative assessment in any subsequent period.

The impairment approach for **goodwill** is discussed in BCG 11.

The impairment guidance for long-lived assets to be held-and-used includes (1) long-lived assets recorded by lessees under capital leases, (2) long-lived assets of lessors subject to operating leases, (3) proved oil and gas properties that are being accounted for using the successful efforts method, and (4) long-term prepaid assets. The impairment provisions of ASC 360-10-35 do not apply to (1) financial assets, (2) long-lived assets for which the accounting is prescribed in other applicable accounting guidance (e.g., deferred income taxes), and (3) long-lived assets for which the accounting is prescribed for certain specialised industries (including the record and music, motion picture, broadcasting, software, and insurance industries).

If management has not reached a final decision or has otherwise not met the held-for-sale requirements of ASC 360-10-45-9, the long-lived assets should continue to be classified as held-and-used. For instance, management might be exploring strategic alternatives for long-lived assets, including continuing to use the assets in a modified manner, abandoning the assets, or disposing of the assets through sale. In this situation, the assets should be classified as held-and-used for purposes of applying the impairment provisions of ASC 360-10-35 until the entity commits to a plan and meets the held-for-sale requirements.

10.4.1 Impairment of long-lived assets to be held-and-used

Long-lived tangible and intangible assets that an entity will continue to hold and use should be reviewed for impairment based on the ASC 360-10-35 impairment guidance. The first step in the impairment test is to determine whether the long-lived assets are recoverable as measured by comparing net carrying value of the asset or asset group to the undiscounted net cash flows to be generated from the use and eventual disposition of that asset or asset group. If the assets are recoverable, an impairment loss does not exist and no loss should be recognised even if the net book value of the long-lived assets exceeds their fair value. If the assets are not recoverable, an impairment loss would be recognised based on a determination of the asset or asset group's fair value.

Question 10-2

Must a company record an impairment charge when the fair value of property, plant, and equipment is less than its carrying amount?

PwC response

A company must perform step one of the impairment test under ASC 360-10, which is a recoverability test using undiscounted cash flows of the asset (asset group). Although a decrease in the fair value of long-lived assets may be a triggering event for an ASC 360-10 impairment test, this may not necessarily result in an ASC 360-10 impairment charge. Only if the asset (asset group) fails step one would the company progress to step two and calculate the amount, if any, of the impairment.

Under the held-and-used approach, the asset or asset group to be tested for impairment should represent the lowest level for which identifiable cash flows are largely independent of the cash flows of other groups of assets and liabilities. Net cash flows from one asset group may not be used to offset the net cash flows from an impaired asset group when those asset groups are not otherwise interrelated.

The determination of a company's asset groups involves a significant amount of judgment, and all relevant facts and circumstances should be considered. In making this determination, a number of company-specific operating characteristics may be assessed, including the interdependency of revenues between asset groups and shared cost structures.

Interdependency of revenue producing activities refers to the extent to which the revenues of a group of assets are dependent on or intermingled with the revenue producing activities of another group of assets. If relationships among revenue producing activities hinder an entity's ability to suspend the revenue producing activities of one group of assets because it would cause a significant adverse impact on the revenues generated by another group of assets, a higher level grouping that combines these interdependent revenue producing activities into one asset group may be necessary.

Interdependent revenues may sometimes result from an entity's operating structure or contractual requirements. ASC 360-10-55-36 provides an example of revenue interdependency caused by a contractual obligation. In the example, an entity operates a bus transportation business that provides service under a single contract with a municipality that requires minimum service on each of five separate routes. Assets devoted to serving each route and the cash flows from each route are discretely identifiable and measurable. One of the routes operates at a significant operating deficit that results in the inability to recover the carrying amounts of the route's dedicated assets. However, because the revenues of the other four routes depend upon continuing to operate the unprofitable route (i.e., the contract would not permit the bus transportation company to curtail any one of the bus routes), the five bus routes would be an appropriate level at which to group assets to test for and measure impairment.

The existence of a shared cost structure may be a factor to determine the appropriate level at which to group assets. Shared costs are costs incurred by the entity that relate to more than one group of assets and for which costs cannot be discretely identified for allocation to an applicable lower level asset group. If cash flows from a particular group of assets result from significant shared operations (e.g., shared sales force or manufacturing functions), it may be necessary to group assets at a higher level. However, the existence of shared service activities such as back-office support activities (e.g., a shared payroll function) would not necessarily require (or justify) grouping assets at a higher level, because in many instances, these types of services may not be considered significant.

Further, allocated direct costs would not typically be considered shared costs when assessing whether an entity should group assets at a higher level. For example, assume an entity is assessed an aggregate annual fee by the Environmental Protection Agency ("EPA") for its carbon emissions from operation of three production facilities (at a fixed rate per metric ton of carbon dioxide). The amount of the EPA fee, which can be allocated based on the carbon dioxide emitted by each of the entity's facilities, would be considered an allocated direct cost rather than a shared cost even though the annual EPA assessment is a single amount.

Certain assets may be used in vertically integrated operations; and the guidance does not specifically address how to measure cash flows resulting from intercompany purchase and sale transactions. Generally, such cash flows are determined based upon normal purchase prices paid to and sale prices received from third parties. However, where purchases from and sales to vertically integrated operations are significant, the appropriate level of independent, identifiable cash flows may not have been identified and it may be appropriate to consider whether the asset group should be identified at a higher level.

Question 10-3

How should shared assets be considered when performing step one of the ASC 360-10 impairment test?

PwC response

A company sometimes has certain long-lived assets that are shared among several asset groups (e.g., corporate headquarters). The recoverability of the shared assets depends on the net cash flows of the lower level asset groups as the shared assets do not have their own separately identifiable cash inflows. There may be multiple approaches that management could utilise to perform the impairment test for the shared assets. One approach would be to first test the lower level asset groups for impairment based on undiscounted cash flows, imputing an appropriate charge, if any, for the use of the shared assets. Then, based on the guidance in ASC 360-10-35-25, the excess undiscounted cash flows from the recoverability tests of the lower level asset groups would be accumulated. Cash flows attributable to the shared assets would equal the aggregated excess undiscounted cash flows of the lower level asset groups adding back any imputed charge for the use of the shared assets and reduced by any cash outflows directly attributable to the shared assets. If the carrying amount of the shared assets exceeds the undiscounted cash flows attributable to the shared assets, then step two of the ASC 360-10 impairment test would be required for the shared assets.

Question 10-4

How should a company think about the interaction of the assessment of recoverability and useful life of a long-lived asset?

PwC response

A long-lived asset may not be impaired based upon the performance of the recoverability test; however, changes in the estimate of the asset's useful life should be considered in light of the change in circumstances. A change in depreciable life may result in an acceleration of depreciation. Assume a company operates two chemical refineries that produce the same product, which is sold to the same group of customers. Both chemical refineries share the same group of suppliers. One plant is on the east coast and the second plant is on the west coast. Management has determined the two chemical refineries represent one asset group. During the current year, the company's management determined that production at the east coast plant should cease due to adverse economic conditions and they would ultimately recommend to the board of directors a permanent closure of the plant, which is required to be approved by the board of directors. In conjunction with the decision to cease production, management concluded the chemical refineries asset group should be tested for recoverability in accordance with ASC 360-10-35-21. Management determined that the asset group passed the recoverability test due to the significant continuing undiscounted cash flows at the west coast plant. The board of directors met on April 15, 20X0 (cease-use date), and approved the permanent closure of the east coast plant effective immediately.

Given the asset group passed the recoverability test and the board of directors' approval was required for the permanent closure of the east coast plant, April 15, 20X0, would be the earliest date the impairment for the plant closure could be recorded. However, the company should accelerate depreciation beginning when management determines the useful life is shortened which, depending on the facts and circumstances, will likely be before the board of directors' approval. Consideration of whether acceleration of depreciation is warranted at the time the asset group is tested for impairment is consistent with ASC 360-10-35-22 due to the fact management has determined the useful life of the east coast plant has been shortened significantly. Revising the depreciation in the current period is consistent with ASC 270-10-45-14 which indicates a change in an accounting estimate should be accounted for in the period in which the change in estimate is made.

10.4.1.1 When to test long-lived assets for impairment

A long-lived asset or asset group that is held-and-used should be tested for recoverability whenever events or changes in circumstances indicate that the carrying amount of the asset or asset group may not be recoverable. The following are examples of such events or changes in circumstances (sometimes referred to as impairment indicators):

- Significant decrease in the market price of a long-lived asset (asset group)
- Significant adverse change in the extent or manner in which a long-lived asset (asset group) is being used or in its physical condition
- Significant adverse change in legal factors or in the business climate that could affect the value of a long-lived asset (asset group), including an adverse action or assessment by a regulator
- Accumulation of costs significantly in excess of the amount originally expected for the acquisition or construction of a long-lived asset (asset group)

- Current-period operating or cash flow loss combined with a history of operating or cash flow losses, or a projection or forecast that demonstrates continuing losses associated with the use of a long-lived asset (asset group)

- Current expectation that, more likely than not, a long-lived asset (asset group) will be sold or otherwise disposed of significantly before the end of its previously estimated useful life [ASC 360-10-35-21]

The above impairment indicators are examples and should not be considered the only indicators. If an entity identifies additional impairment indicators for its specific operations, those indicators should also be considered. In the absence of a specific indicator, management may initiate impairment testing any time it believes an impairment may exist.

If an entity believes an impairment may exist, it should determine whether the asset or asset group is impaired in accordance with ASC 360-10. However, an impairment loss is recognised only if the carrying amount of a long-lived asset or asset group is not recoverable and exceeds its fair value [ASC 360-10-35-17]. The carrying amount of a long-lived asset or asset group that is held-and-used is not considered recoverable if the carrying amount exceeds the sum of the undiscounted cash flows expected to result from the use and eventual disposition of the asset or asset group (commonly referred to as the recoverability test).

10.4.1.2 Estimates of future cash flows used in the recoverability tests

Cash flows used in the recoverability test may differ from the cash flows used in measuring the fair value of the asset or asset group. The recoverability test is based on undiscounted cash flows expected to result from the entity's use and eventual disposition of the asset or asset group, rather than on market-participant assumptions that would be used in measuring the asset's fair value. Therefore, cash flows used in the recoverability test should be based on an entity's own assumptions about how it intends to use the asset or asset group. Estimating cash flows for purposes of a recoverability test is subjective and requires significant judgment. Estimates of future cash flows should be reasonable in relation to the assumptions used to develop other information the entity uses for comparable periods, such as internal budgets and projections, accruals related to incentive compensation plans, or information communicated to others [ASC 360-10-35-30]. Additionally, key assumptions such as price and volume levels should consider expected changes in market conditions. Projections of expected future cash flows should include:

- All cash inflows expected from the use of the long-lived asset or asset group over its remaining useful life, based on its existing service potential (i.e., taking into account the asset's cash-flow-generating capacity and physical output capacity, but excluding future capital improvements and other expenditures that would increase the service potential of the asset)

- Any cash outflows necessary to obtain those cash inflows, including future expenditures to maintain the asset. The cash outflows should include costs attributable to the asset group based on the nature of the expense rather than who incurs it (i.e., an expense related to the asset group incurred at the corporate level)

- Cash flows associated with the eventual disposition, including selling costs, of the long-lived asset(s) that would typically represent the salvage value of those assets. If the asset group constitutes a **business**, the proceeds from eventual disposition may include the terminal value of the business (although such terminal value may be less than that used for business valuation purposes, because it would reflect only the value associated with maintaining the existing service potential of the business)

Question 10-5

Should the undiscounted cash flows in step one of the ASC 360-10 impairment test include cash inflows from any salvage or residual value?

PwC response

In accordance with ASC 360-10-35-29, projections of expected future cash flows should include cash flows associated with the eventual liquidation or disposition of the long-lived asset/asset group.

Question 10-6

How is residual value of a long-lived asset group determined in step one of the ASC 360-10 impairment test?

PwC response

Step one of the ASC 360-10 impairment test is intended to test the recoverability of the long-lived asset group as a whole, not just the primary asset. As such, there may be assets used with the primary asset that continue to have value at the end of the life of the primary asset. While the undiscounted cash flow period is limited to the life of the primary asset, step one of the impairment test should also consider the residual value from the liquidation or sale of the asset group at the end of the primary asset's useful life when other assets in the asset group have a remaining economic life. This calculation would need to consider how to maximise the value of the asset group at the end of the undiscounted cash flow period. The residual value may be estimated using discounted cash flows to determine the sales value of the long-lived asset group at the end of the undiscounted cash flow period. When the long-lived asset group constitutes a business, the residual value may need to be estimated using a pricing multiple or discounted cash flows, both adjusted to exclude growth beyond the existing service potential of the asset group. The calculated residual value would be added to the undiscounted cash flows over the life of the primary asset and compared to the carrying value of the asset group.

Question 10-7

How does determining the terminal value under the ASC 350 impairment test differ from determining the residual value under the ASC 360-10 impairment test?

PwC response

The terminal value calculation in the ASC 350 impairment test reflects the value that the reporting unit is expected to generate at the end of the discrete projection period (assumed to be in perpetuity because business enterprises are generally assumed to have perpetual lives). In ASC 360-10, residual value is represented by the cash flows associated with the eventual disposition, including selling costs, of the long-lived asset(s). If the asset group constitutes a business, the proceeds from eventual disposition may include the terminal value of the business, although such terminal value may be less than that used for business valuation purposes because it will reflect only the value associated with maintaining the existing service potential of the business through the life of the primary asset. Additionally, discount rates or other assumptions may differ as the ASC 350 terminal value measurement commences at the point in time when projections reflect the maturity of the business and future long-term growth levels have been reached, whereas the residual value calculated in the ASC 360-10 impairment test is as of the end of the remaining useful life of the primary asset, which may be a different point in time.

The remaining useful life of a group of assets over which cash flows can be considered should be based on the remaining useful life of the “primary asset” of the group. A primary asset is the principal long-lived tangible asset being depreciated or the intangible asset being amortised that is the most significant component asset from which the asset group derives its cash-flow-generating capacity [ASC 360-10-35-31]. The primary asset cannot be land, an indefinite-lived intangible asset, or an internally generated intangible asset that has been expensed as incurred.

Therefore, a primary asset is generally the asset that has the longest remaining useful life, would require the greatest level of investment to replace, and without which some or all of the other assets of the group might not have been acquired by the entity.

If the primary asset is not the asset of the group that has the longest remaining useful life, estimates of future cash flows for the group should be based on the assumption that the group will be sold at the end of the remaining useful life of the primary asset [ASC 360-10-35-32]. Cash flow estimates should include cash flows associated with future expenditures necessary to maintain the service potential of the asset or asset group (e.g., repairs and maintenance and replacements). Accordingly, budgets that contemplate major capital expansion rather than maintenance and replacements generally should not be used as the cash flow estimate in assessing impairment.

Question 10-8

How are cash flows from new customer relationships that are anticipated to arise after the test date considered when performing step one of the ASC 360-10 impairment test?

PwC response

Recorded customer relationship assets are generally included in an asset group which includes other long-lived assets. If servicing the new customer relationships does not require an increase in the service potential of the asset group, the cash flows from the new customer relationships would be included when performing step one of the ASC 360-10 impairment test. However, if the new customer relationships require an increase of the asset group's service potential, it would not be appropriate to include the cash flows from the new customer relationships when performing step one of the ASC 360-10 impairment test.

Question 10-9

How is the undiscounted cash flow period for step one of the ASC 360-10 impairment test determined when the primary asset is a group of customer relationships recognised as a single customer relationship asset?

PwC response

When the primary asset is a recognised customer relationship asset, the undiscounted cash flow period would be the remaining useful life of the recognised customer relationship asset. For example, if at the impairment test date, the remaining estimated useful life of the recognised customer relationship was two years, then the undiscounted cash flow period would also be two years, even if the company has added new customers after the acquisition date. A company would then need to determine the residual value for the asset group at the end of two years (see Question 10-10, below).

Question 10-10

How would the undiscounted cash flows (including residual value) be computed for an asset group in which the primary asset is a group of customer relationships recognised as a single customer relationship asset?

PwC response

Assuming the same facts as the example in the answer to Question 10-9, during the two-year undiscounted cash flow period the company would consider the cash flows from the customers that exist at the impairment test date (which comprise both the remaining acquired customers and the customers added in the period from the acquisition date to the impairment test date), as well as cash flows from expected new customers during the undiscounted cash flow period (two years) that are able to be supported by the existing service potential of the asset group.

The residual value of the asset group would include the cash flows associated with the eventual disposition of the entire asset group at the end of the two-year undiscounted cash flow period. This may include value related to new customers after the two-year period and after the impairment test date that could be supported by the asset group's existing service potential. For new customers added during the undiscounted cash flow period and for the residual value determination, the reasonableness of the assumption about the addition of new customers would need to be evaluated.

Question 10-11

How should the recoverable amount of a long-lived asset group be determined when the primary assets are leasehold improvements?

PwC response

When the primary assets are leasehold improvements, the undiscounted cash flow period would be the remaining useful life of the leasehold improvements, which would generally correspond with the remaining term of the lease. If there is a lease renewal period, there may be multiple approaches that management could utilise to determine the residual value of the asset group. One approach would consider the cash flows generated by the asset group during the renewal period. For example, assume leasehold improvements are the primary assets of the asset group, which includes a five-year lease with one five-year renewal period. In performing the step one recoverability test at the end of the first year of the lease, the cash flows would include (1) the undiscounted cash flows over years two through five of the lease, and (2) the residual value determined based on the cash flows expected during the renewal period, discounted to year five of the lease (the end of the undiscounted cash flow period). The sum of the cash flows would then be compared to the carrying amount of the asset group.

If the carrying amount of the asset group is not recoverable, the long-lived assets of the group, including leasehold improvements, would be written down to fair value. Because the continued use of the leasehold improvements demonstrates the presence of service potential, only in unusual situations would the fair value of the leasehold improvements be considered zero while being used.

Question 10-12

How should an increase in expected utilisation of an asset group be considered when testing the group for recoverability under ASC 360-10?

PwC response

ASC 360-10 requires that only the existing service potential of an asset group on the test date be considered when testing an asset group for recoverability. Estimates of cash flows that arise from an increase in utilisation of existing assets of the group that do not require an increase in existing service potential of the asset group may be included in management's estimate of undiscounted cash flows. For example, assume an asset group in which the primary asset is a plant operating at 70 percent of capacity. Management's assumption that future cash flows would increase as a result of an increase in the utilisation of the plant to 80 percent due to new orders would be appropriate provided management can support the reasonableness of its assertion of increased utilisation. Conversely, if the increase in the utilisation would require an increase in the existing service potential of the asset group (e.g., major expansion of the plant), the inclusion of the incremental cash flows in management's estimate of undiscounted cash flows would not be appropriate.

Cash flow projections should exclude interest payments associated with long-term debt included within the asset group as these cash flows relate to the capitalization of the entity, not its operations. The concept here is that similar asset groups should not yield different results in the recoverability test due to different capital structures.

Payments associated with other long-term obligations, such as environmental liabilities or litigation claims, should be considered in the cash flow estimates. However, we believe the inclusion or exclusion of liabilities and the related cash flows should not result in a different conclusion in the recoverability test. The intent of ASC 360-10-35 is to prepare an apples-to-apples comparison of cash flows to the asset group being tested. Therefore, when the cash flows are equal to the recorded liability, the result of the recoverability test would not be different if both the liability and related cash outflows were excluded from the analysis. In situations where the cash outflows exceed the recorded liability due to the liability being discounted, we believe that this excess portion of the cash outflows represents accretion and should be excluded from the gross cash outflows when testing for recoverability.

If alternative courses of action to recover the carrying amount of a long-lived asset or asset group are under consideration, or a range is estimated for the amount of possible future cash flows, the likelihood of those possible outcomes should be considered. Therefore, the use of an expected cash flow approach may be appropriate, because it uses a set of cash flows that, in theory, represents the probability-weighted average of all possible cash flows. On the other hand, the use of a single set of cash flows from a range of possible estimated amounts may be appropriate in certain circumstances. Whichever method of estimating cash flows is used, it should be applied consistently to asset groups with similar uncertainties and cash flow streams. See CON 7 and ASC 820-10-55-4 through 55-20 for additional guidance on these techniques.

Cash flow estimates used to test the recoverability of an asset or asset group that is under development shall be based on the expected service potential of the asset when development is substantially complete. Those estimates should include cash flows associated with all future expenditures necessary to develop or complete the asset, including interest payments that will be capitalised as part of the cost of the asset.

ASC 360-10 is silent as to whether estimates of expected future net cash flows for the recoverability test should include or exclude income tax effects. Ordinarily, such calculations are performed on a pretax basis. However, there may be unusual situations in which incremental tax effects directly attributable to a specific asset should be considered in assessing an asset's recoverability. Examples might include low-income-housing tax credits or shale oil tax credits. Such tax attributes should be included in the recoverability test if tax effects are important to the assets' economics.

Question 10-13

How should an entity's consideration of a potential bankruptcy filing impact its projected cash flows in an ASC 360-10 impairment test?

PwC response

Cash flow forecasts utilised in the impairment test may extend beyond the expected bankruptcy filing date. However, appropriate consideration must be given to the factors that might lead to the bankruptcy filing, as well as the impact the filing would have on the company's future operations. For example, if the company is having difficulty financing its operations, and if customers are unwilling to purchase from, or suppliers are unwilling to sell to, the company in bankruptcy, these facts would impact the cash flow projections being used to test the assets for impairment. Furthermore, it may be appropriate for the company to consider multiple possible cash flow scenarios utilising the probability-weighted approach as illustrated in Example 2 in ASC 360-10-55. One of the potential scenarios would likely reflect the company's sale or liquidation in the event that it does not receive the necessary financing.

Question 10-14

Does the existence of a going concern opinion limit the cash flow projections used in the impairment test to one year?

PwC response

The cash flow forecasts can extend beyond one year to reflect the life of the primary asset. The going concern paragraph indicates the financial statements have been presented assuming the company will continue as a going concern and do not reflect any adjustments that might result from the outcome of this uncertainty (i.e., they are not prepared on a liquidation or other basis of accounting). Therefore, the cash flow projections should consider a period greater than one year. Similar to the example in the answer to Question 10-13, appropriate consideration must be given to the factors that gave rise to the going concern conclusion in preparing the cash flow projections. If the company has plans to change its strategic direction or focus as a result of the financial circumstances, the useful lives of the assets and the expected cash flows may need to be reevaluated.

10.4.1.3 Measuring an impairment loss for assets held-and-used

The carrying amount of the asset being tested for impairment is its cost, net of accumulated depreciation or amortisation. If an asset group is being assessed for impairment, then the carrying values and cash flows of all assets and liabilities comprising the asset group must be aggregated for the impairment recoverability test (i.e., step one). The value of current assets and liabilities, such as trade receivables and payables, and other assets and liabilities typically excluded from the scope of ASC

360-10-35 (e.g., receivables and intangible assets with indefinite lives) should be included in the carrying amount of an asset group being tested for impairment. Similarly, the cash effects of the current assets and liabilities and other assets and liabilities should be included in the cash flows of the asset group being tested.

ASC 360-10-35-17 indicates that an impairment loss shall be measured as the amount by which the carrying amount of a long-lived asset exceeds its fair value. ASC 360-10-35-23 indicates that for purposes of recognition and measurement of an impairment loss, long-lived assets should be grouped with other assets and liabilities at the lowest level for which identifiable cash flows are largely independent of the cash flows of other assets and liabilities. Some have looked to ASC 360-10-35-23 to suggest that differences between the fair values and carrying values of assets and liabilities of the asset group other than long-lived assets to be held-and-used should impact the impairment loss for those long-lived assets.

We believe that the intent of ASC 360-10-35 is to measure the impairment of the long-lived assets and, therefore, for purposes of determining the amount of the impairment loss, the loss should be measured by comparing the fair value of long-lived assets subject to impairment testing within the scope of ASC 360 to their net carrying amount.

Examples 10-3 and 10-4 below illustrate the concept of measuring a potential impairment loss.

EXAMPLE 10-3

Measuring a potential impairment loss—loss recognised

An entity owns a construction facility in Europe that is a distinct business that qualifies as an asset group under ASC 360, as the European business has separately identifiable cash flows that are largely independent of the cash flows of the entity's other assets and liabilities. Included in the asset group are long-lived assets consisting of PP&E, an intangible customer relationship asset, and a patent. The carrying amount of the asset group is more than its undiscounted future cash flows. As a result, the entity failed the recoverability test (step one) of the impairment test under ASC 360-10-35-17 and proceeded to step two, as shown below (CUs in thousands):

Impairment determination and measurement (step two)

	Carrying amount	Fair value	Difference
PP&E	CU600	CU100	CU(500)
Customer relationship	200	300	100
Patent	0	100	100
Total	CU800	CU500	CU(300)

Analysis

Following the approach in the paragraph immediately preceding this example, an impairment loss of CU300,000 would be recognised since the long-lived assets include PP&E, an intangible customer relationship asset, and a patent (i.e., the aggregate carrying amount of CU800,000 exceeds the aggregate fair value by CU300,000). Although the carrying amount of the PP&E is more than its fair value by CU500,000, only a CU300,000 impairment should be recorded and allocated to PP&E. None of the impairment should be allocated to the customer relationship asset or patent because their carrying amounts should not be written down below their individual fair values, since their fair values were determinable.

EXAMPLE 10-4

Measuring a potential impairment loss—no loss recognised

Assume the same fact pattern as example 10-3 above (i.e., the entity failed the recoverability test), except the fair value of the patent is CU450,000 (CUs in thousands):

Impairment determination (step two)

	Carrying amount	Fair value	Difference
PP&E	CU600	CU100	CU(500)
Customer relationship	200	300	100
Patent	0	450	450
Total	CU800	CU850	CU50

Analysis

Although the carrying amount of the PP&E is more than its fair value by CU500,000, no impairment should be recognised since the aggregate carrying amount of the asset group is less than its fair value by CU50,000.

Long-lived assets may include property subject to nonrecourse debt. The fair value of the property should be assessed without regard to the nonrecourse provisions. If the carrying amount of the property that reverts back to the lender is less than the amount of nonrecourse debt extinguished, a gain on extinguishment would be recognised at that time. For example, assume an entity borrows CU5 million from a bank on a nonrecourse basis to purchase a building. For simplicity, assume the building is the only long-lived asset in an asset group. Also assume that three years later the asset group is tested for impairment and fails the recoverability test. At that time, the building's carrying amount is CU4.7 million, fair value is CU2 million, and the balance of the loan due to the lender is CU3.7 million. An impairment charge of CU2.7 million should be recorded even though the debt is nonrecourse to the entity (i.e., it would not be appropriate to limit the impairment charge to CU1 million based on an assumption the building owner could transfer ownership of the building to the bank in satisfaction of the nonrecourse debt). If the building owner subsequently defaults on the debt six months later and transfers ownership of the building to the lender, assuming the carrying amount and fair value of the building are still CU2 million and the carrying amount of the loan is CU3.7 million, a gain of CU1.7 million would be recognised by the entity on the extinguishment of the debt.

If an income approach is used to measure the fair value of the asset or asset group, the cash flows should be based on market-participant assumptions, rather than an entity's own assumptions about how it intends to use the asset or asset group. Therefore, cash flows used in the recoverability test may differ from the cash flows used in measuring the fair value of the long-lived assets. See BCG 7 for further guidance regarding fair value measurements. Because the continued use of a long-lived asset demonstrates the presence of service potential, it would be unusual that the fair value of a long-lived asset would be zero while it is still being used.

If an impairment loss is recognised, that loss should be included in income from continuing operations before income taxes and within income from operations, if such an amount is presented. After recognition of an impairment loss, the adjusted carrying amount of a long-lived asset becomes that asset's new accounting basis. Subsequent reversal of a previously recorded impairment loss is prohibited. The adjusted carrying amount of the long-lived asset should be depreciated or amortised over the asset's remaining useful life. See BCG 10.3 for further information on depreciation of tangible assets. The useful life of the asset should be reassessed to ensure that the remaining useful life is appropriate.

Question 10-15

When a company has failed step one of the ASC 360-10 impairment test, may an estimate of the impairment loss be recorded in the current reporting period subject to finalisation of the step two test in the next reporting period by analogy to ASC 350-20-35-18 through 35-19?

PwC response

ASC 360-10 requires that all steps of the impairment test be completed in the period in which a triggering event occurs.

Question 10-16

How does the application of ASC 820-10 impact step two of the long-lived asset impairment test?

PwC response

Step two of the long-lived asset impairment test requires that the fair value of the long-lived assets be determined when calculating the amount of any impairment loss. Therefore, the fair value definition of ASC 820-10 must be applied. Fair value of the long-lived assets will need to be determined from the perspective of a market-participant considering, among other things, appropriate discount rates, multiple valuation techniques, the most advantageous market, and assumptions about the highest and best use of the long-lived assets.

In addition, in determining the fair value of long-lived assets for purposes of recording the impairment loss, the allocated impairment loss should not reduce the carrying amount of an individual long-lived asset below its fair value whenever that fair value is determinable without undue cost and effort [ASC 360-10-35-28].

Question 10-17

In step two of the ASC 360-10 impairment test, should the fair value of a long-lived asset group consider unrecognised long-lived assets?

PwC response

The fair value should take into account both recognised and unrecognised long-lived assets. For example, unrecognised customer relationships that are part of the asset group should be considered when determining the fair value of the long-lived assets if it is reasonable that a market-participant would ascribe value to them.

10.4.1.4 Order of impairment testing for long-lived assets held-and-used

If goodwill and held-and-used long-lived assets (asset group) of a reporting unit are tested for impairment at the same time, the impairment testing should be performed in the following order:

- Test other assets (e.g., accounts receivable, inventory) under applicable guidance, and indefinite-lived intangible asset(s) under ASC 350.
- Test long-lived assets (asset group) under ASC 360-10.
- Test goodwill of a reporting unit that includes the aforementioned assets under ASC 350 [ASC 360-10-35-27].

The carrying values are adjusted, if necessary, for the result of each test prior to performing the next test. This order differs from the held-for-sale approach discussed in BCG 10.4.2.1, which prescribes that goodwill be tested for impairment prior to the **disposal group**. The order of assessment may impact the recorded amount of any goodwill impairment loss.

10.4.1.5 Allocating a held-and-used impairment loss

An impairment loss that results from applying ASC 360-10 should reduce only the carrying amount of a long-lived asset(s) of the asset group. The impairment of other assets would be covered by other standards (e.g., goodwill and indefinite-lived intangible assets would be determined under the guidance of ASC 350). The loss should be allocated to the long-lived assets of the group on a pro rata basis using the relative carrying amounts of those assets, except that the loss allocated to an individual long-lived asset should not reduce the carrying amount of that asset below its fair value whenever that fair value is determinable without undue cost and effort [ASC 360-10-35-28]. If certain assets ultimately are to be abandoned within the asset group, it is not appropriate to allocate the entire held-and-used impairment loss to those assets being abandoned, even though the adjusted carrying value of those assets may be in excess of their fair values at the impairment date. Further, when an asset is tested for recoverability, it may be necessary to review both the method of depreciation and its estimated useful life. Example 10-5 provides an example from ASC 360-10-55-20 through 55-22 of determining the allocation of a held-and-used impairment loss.

EXAMPLE 10-5

Allocating a held-and-used impairment loss

An entity owns a manufacturing facility that, together with other assets, is tested for recoverability as a group. In addition to long-lived assets (Assets A–D), the asset group includes inventory, which is reported at the lower of cost or market in accordance with ASC 330, and other current assets and liabilities that are not covered by ASC 360-10. The CU2.75 million aggregate carrying amount of the asset group is not recoverable and exceeds its fair value by CU600,000. In accordance with ASC 360-10-35-28, the impairment loss of CU600,000 would be allocated as shown below to the long-lived assets of the group (CUs in thousands):

Asset group	Carrying amount	Pro rata allocation factor	Allocated loss	Adjusted carrying amount
Current assets	CU400			CU400
Current liabilities	(150)			(150)
Asset A	590	24%	CU(144)	446
Asset B	780	31	(186)	594
Asset C	950	38	(228)	722
Asset D	180	7	(42)	138
Subtotal	2,500	100%	(600)	1,900
Total	**CU2,750**		**CU(600)**	**CU2,150**

If the fair value of an individual long-lived asset of an asset group is determinable without undue cost and effort and exceeds the adjusted carrying amount of that asset after an impairment loss is allocated initially, the excess impairment loss initially allocated to that asset would be reallocated to the other long-lived assets of the group. For example, if the fair value of Asset C is CU822,000, the excess impairment loss of CU100,000 initially allocated to that asset (based on its adjusted carrying amount of CU722,000) would be reallocated as shown below to the other long-lived assets of the group on a pro rata basis using the relative adjusted carrying amounts of those assets (CUs in thousands):

Long-lived assets of asset group	Adjusted carrying amount	Pro rata reallocation factor	Reallocation of excess loss	Revised carrying amount
Asset A	CU446	38%	CU(38)	CU408
Asset B	594	50	(50)	544
Asset D	138	12	(12)	126
Subtotal	1,178	100%	(100)	1,078
Asset C	722		100	822
Total	**CU1,900**		**CU0**	**CU1,900**

10.4.2 *Impairment of long-lived assets to be disposed of by sale*

If an entity meets all of the criteria below, a long-lived asset or the related disposal group should be classified as held-for-sale and not depreciated or amortised. That asset or disposal group should be measured at the lower of its carrying amount or fair value less cost to sell. An impairment loss is recognised for any initial or subsequent write-down of the asset or disposal group to its fair value, less cost to sell. Any subsequent increase in the asset's or disposal group's fair value, less cost to sell, should be recognised, but not in excess of the cumulative loss previously recognised [ASC 360-10-35-40]. That is, the asset or disposal group should not be written up above its carrying amount as of the date it was classified as held-for-sale.

An entity must meet certain criteria to classify and account for a long-lived asset or disposal group as held-for-sale. The criteria are:

- Prior to the date of the financial statements, management, having the authority to approve the action, commits to a plan to sell the asset (disposal group). The plan should specifically identify all major assets to be disposed of; significant actions to be taken to complete the plan, including the method of disposition and location of those activities; and the expected date of completion. If board of director approval for a plan of disposal is required by company policy or sought by management, a commitment date generally cannot be established until such approval has been obtained. Similarly, if shareholder approval is not required, but management elects to obtain it prior to disposal, commitment to a plan of disposal cannot occur until shareholder approval has been obtained. However, if management and the board of directors control a majority of the voting shares then approval by management and the board of directors is sufficient as shareholder approval would be considered perfunctory. When formal approval of a sale is required to be obtained from a third party (for example, a governmental agency or a lender) the nature and likelihood of the third party approval should be considered in determining whether management has the ability to commit to a disposal plan. Routine approvals do not normally impact the consideration of whether the company will meet the ASC 360-10-45-9(a) criterion. In situations where such approval could extend the period required to complete the sale beyond one year, it may still be appropriate to classify the disposal group as held-for-sale if a firm purchase commitment is probable within one year (see Example 9 of ASC 360-10-55-45). However, in a bankruptcy arrangement, due to the increased power of the bankruptcy court or creditors' committee, management may not have the level of authority to approve the sale of assets. This authority may be with the bankruptcy court or creditors' committee. Therefore, the held-for-sale criteria may not be met if this approval has not been obtained.

- The asset (disposal group) is available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such assets (disposal groups); in other words, there is no operational requirement to use the asset. An example where an asset may not be considered available for immediate sale exists when a company is selling a manufacturing site and a backlog of orders exists. If the company were selling the site as well as the customer orders, the available for immediate sale criterion would be met; however, if the sale would not take place until the company completed fulfilling the orders, the available for immediate sale criterion would not be met.

- An active programme to locate a buyer, and other actions required to complete the plan to sell the asset (disposal group), have been initiated.

- The sale of the asset (disposal group) is probable (the term "probable" being consistent with the meaning associated with it in ASC 450-20-20 and refers to a future sale that is "likely to occur"), and transfer of the asset (disposal group) is expected to qualify for recognition as a completed sale within one year (except as permitted by ASC 360-10-45-11). However, if an entity were planning on entering into a sale-leaseback for more than a minor portion of a property, this criterion would not be met.

- The asset (disposal group) is being actively marketed for sale at a price that is reasonable in relation to its current fair value.

- Actions required to complete the plan indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn [ASC 360-10-45-9].

Costs to sell a disposal group include incremental direct costs to transact the sale and represent the costs that result directly from and are essential to a sale transaction that would not have been incurred by the entity had the decision to sell not been made. These types of costs may vary depending on the transaction but generally include legal fees, brokerage commissions, and closing costs that must be incurred before legal title can be transferred. Costs to sell generally exclude holding costs such as insurance, property taxes, security, and utilities while the disposal group is held-for-sale. The deferral of costs to sell is not appropriate as such costs do not meet the definition of an asset.

Classification of the disposal group on the balance sheet may include long-lived assets, as well as other assets that are not within the scope of ASC 360-10, such as accounts receivable and inventory. The carrying amounts of any assets that are not within the scope of ASC 360-10, including goodwill, that are included in a disposal group classified as held-for-sale shall be adjusted in accordance with other applicable GAAP prior to measuring the fair value less cost to sell of the disposal group, and these assets shall continue to be measured in accordance with other applicable GAAP until the disposal is completed. Liabilities directly associated with those assets that will be transferred in the transaction should be included in the disposal group. The disposal group should also include items associated with accumulated other comprehensive income, including a cumulative translation adjustment which is considered part of the carrying amount of the disposal group [ASC 830-30-45-13]. An outstanding debt obligation should not be included in the disposal group unless the debt will be assumed by the buyer in the transaction. In other words, if the debt obligation is required to be repaid as a result of the sale transaction, the debt should not be classified as part of the disposal group.

In some situations, the difference between the carrying amount of the disposal group and the group's fair value less cost to sell may exceed the carrying amount of long-lived assets in the disposal group. For example, if the carrying amount of the disposal group is CU100, and fair value less cost to sell is CU75, there is an implicit CU25 impairment. Assume the carrying amount and fair value of the long-lived assets in the disposal group are CU20 and zero, respectively. In this case, the SEC indicated in a speech by one of their staff members that there are two acceptable interpretations of the literature for accounting for the impairment charge on the held-for-sale date. The first method interprets ASC 360-10-35-43 as redefining the **unit of account** as the disposal group; thus a loss should be recognised to record the disposal group at the lower of its carrying amount or its fair value less cost to sell. The impairment charge would be CU25 on the held-for-sale date. The second method interprets ASC 360-10-35-40 as limiting the loss to the carrying amount of the long-lived assets, because only long-lived assets are within the scope of ASC 360-10. Using this approach, the impairment charge would be CU20 on the held-for-sale date.

The SEC staff also noted that issuers should clearly disclose where the amounts are reflected in the financial statements and whether additional losses are expected.

The SEC staff discussion relates to measurement of disposal groups classified as held-for-sale under ASC 360-10. If the asset group is held for use, the impairment loss would be limited to the carrying amount of the long-lived assets and the impairment loss cannot reduce the carrying amount of the long-lived assets below their fair value [ASC 360-10-35-23].

Question 10-18

Should a held-for-sale impairment loss recorded by the parent be reflected by a subsidiary?

PwC response

The parent would measure the subsidiary at fair value less cost to sell under the held-for-sale approach assuming that all of the held-for-sale criteria were met. If separate financial statements of the subsidiary are prepared, the subsidiary should perform an impairment test of its long-lived assets on a held-and-used basis and assess for their recoverability if a triggering event has occurred. A recoverability test is based on cash flows on an undiscounted basis over the remaining life of the asset group, not fair value. The difference in the basis of accounting by the parent and the subsidiary may result in an impairment being recorded on the parent's financial statements while an impairment might not exist at the subsidiary level.

Question 10-19

Should a company present its entire ownership interest in the assets and liabilities of a wholly-owned subsidiary (that constitutes a business) to be sold as held-for-sale when it plans to retain an equity investment in that business?

PwC response

ASC 810 provides accounting and reporting guidance for changes in the ownership interest of a subsidiary when control is lost. Upon the sale, the company ceases to have a controlling financial interest in the business and the parent-subsidiary relationship ceases to exist. Therefore, the company will derecognise the net assets of the business upon sale and record its equity investment at fair value. In these circumstances, the company would reclassify all of its interest in the disposal group's assets and liabilities as held-for-sale as of the date the criteria in ASC 360-10-45-9 through 45-11 were met. This is in contrast to reclassifying only a pro rata portion of each of the business's balance sheet line items to the "held-for-sale" line item(s) in the company's consolidated balance sheet.

Question 10-20

Should deferred taxes be included in the carrying amount of a disposal group classified as held-for-sale?

PwC response

It depends. According to ASC 360-10-15-4, a disposal group represents assets to be disposed of together as a group in a single transaction and liabilities directly associated with those assets that will be transferred in the transaction. A determination of whether deferred tax assets and liabilities should be included in the disposal group depends on whether the buyer will in fact be acquiring tax attributes and succeeding to the tax bases of assets and liabilities and, therefore, be acquiring tax benefits (assets) or assuming tax liabilities (otherwise known as "inside" basis difference). While the determination ultimately depends on the terms of the sale and the provisions of the relevant tax law in the applicable jurisdiction, in general, sales of asset groups in the form of the sale of the shares of a corporation would result in the tax bases of assets and liabilities and tax attributes carrying over to the buyer. A sale of an asset group which is structured as the sale of assets and liabilities will result in the buyer establishing a new tax basis in those assets and liabilities.

If the sale is structured as a sale of stock, deferred taxes associated with any book-tax basis differences in the assets and liabilities of the disposal group will usually be assumed by the buyer and should therefore be included in the carrying amount of the disposal group because the deferred taxes meet the definition of assets to be disposed of or liabilities to be transferred (included in the definition of a disposal group in ASC 360-10-15-4).

It is also worth noting that a decision to sell the shares of a subsidiary could require the recognition of additional deferred taxes associated with the difference between the seller's carrying amount of the subsidiary's net assets in the financial statements and its basis in the shares of the subsidiary (otherwise known as "outside" basis difference). Because those deferred taxes will remain with, and be settled by the seller, they would not be included in the held-for-sale asset group. Refer to ASC 740-30-25-10 for further guidance regarding the recognition of any temporary difference related to the outside basis difference.

If the sale is structured as an asset sale, the seller will usually retain and settle or recover the deferred tax assets and liabilities (i.e., any inside basis differences will reverse in the period of sale and become currently deductible by or taxable to the seller). Therefore, in an asset sale, deferred taxes should usually not be included in the carrying amount of the assets and liabilities that are held-for-sale because they will not be transferred to the buyer (i.e., they are not part of the disposal group as defined in ASC 360-10-15-4).

10.4.2.1 Order of impairment testing for long-lived assets held-for-sale

The carrying amounts of any assets that are not covered by ASC 360-10, including indefinite-lived intangible assets and goodwill, that are included in a disposal group should be adjusted in accordance with other applicable GAAP before measuring the disposal group's fair value less cost to sell [ASC 360-10-35-39].

An entity should perform impairment testing in the following order:

- Test other assets (e.g., accounts receivable, inventory) under applicable guidance, and indefinite-lived intangible asset(s) under ASC 350

- Test goodwill for impairment under ASC 350

- Test the disposal group for impairment under ASC 360-10 [ASC 360-10-35-39]

The carrying values are adjusted, if necessary, for the result of each test prior to performing the next test. This order is different than that applied for assets to be held-and-used as described in BCG 10.4.1.4. The order of assessment may impact the amount of goodwill impairment loss.

10.4.2.2 Commitment to a plan of sale after the balance sheet date

An entity may commit to sell a long-lived asset or asset group shortly after its balance sheet date, but before issuance of its financial statements. For example, assume a company with a calendar year-end meets the held-for-sale criteria in January of the following year and has not yet issued its previous year's financial statements. In these situations, the long-lived asset(s) should continue to be classified as held-and-used at the balance sheet date. Therefore, an entity would not retroactively reclassify a long-lived asset from held-and-used to held-for-sale as a result of a decision to sell an asset after the balance sheet date.

However, a sale of a long-lived asset for a loss shortly after an entity's balance sheet date should be carefully evaluated as it may indicate that an impairment existed at the balance sheet date as events or circumstances arising after the balance sheet date are often an affirmation of conditions that existed at the balance sheet date. Depending on the significance of the asset in relation to the overall asset group and the facts and circumstances surrounding the sale of the asset, it may be necessary to test the asset or asset group under the held-for-use approach at the balance sheet date. If required to be tested for recoverability, estimates of future cash flows should reflect all available information based on facts and circumstances as of the balance sheet date, including the likelihood of the sale of the related asset or asset group. Furthermore, disclosures should be considered if an entity determines that no impairment existed at the balance sheet date, but the asset or asset group is sold for a loss shortly after year-end.

10.4.2.3 Changes to a plan of sale

Based on a change in circumstances that were previously considered unlikely, an entity may have a change to a plan of sale and decide not to sell a long-lived asset or asset group previously classified as held-for-sale. At the time the decision is made, the long-lived asset or asset group should be reclassified as held for use. Further, the long-lived assets reclassified should be measured at the lower of (1) their carrying amount before the asset was classified as held-for-sale (adjusted for any depreciation or amortisation expense that would have been recognised had the assets continued to be classified as held for use), or (2) the fair value at the date of the subsequent decision not to sell. Any adjustment to the carrying amount based on reclassifying the long-lived assets to held for use should be reflected in the income statement within continuing operations in the period the decision is made not to sell.

10.4.2.4 Changes in held-for-sale classification after one year

Repeated delays in the sale of an asset or disposal group may raise questions as to whether the held-for-sale criteria have been met. However, ASC 360-10-45-11 grants certain exceptions to the one-year requirement as there may be events or circumstances beyond an entity's control that extend the period required to complete the sale of an asset or disposal group. An exception to the one-year requirement applies in the following situations in which such events or circumstances arise:

- If at the date an entity commits to a plan to sell a long-lived asset (disposal group), the entity reasonably expects that others (not a buyer) will impose conditions on the transfer of the disposal group that will extend the period required to complete the sale and (1) actions necessary to respond to those conditions cannot be initiated until after a firm purchase commitment is obtained and (2) a firm purchase commitment is probable within one year. (Example 9 of ASC 360-10-55 illustrates this situation.)

- If an entity obtains a firm purchase commitment and, as a result, a buyer or others unexpectedly impose conditions on the transfer of a long-lived asset (disposal group) previously classified as held-for-sale that will extend the period required to complete the sale and (1) actions necessary to respond to the conditions have been or will be timely initiated and (2) a favourable resolution of the delaying factors is expected. (Example 10 of ASC 360-10-55 illustrates this situation.)

- If during the initial one-year period, circumstances arise that previously were considered unlikely and, as a result, a long-lived asset (disposal group) previously classified as held-for-sale is not sold by the end of that period and (1) during the initial one-year period the entity initiated actions necessary to respond to the change in circumstances, (2) the asset (disposal group) is being actively marketed at a price that is reasonable given the change in circumstances, and (3) the other criteria in ASC 360-10-45-9 are met. (Example 11 of ASC 360-10-55 illustrates this situation.)

If at any time the criteria for held-for-sale classification are no longer met (except the permitted exceptions discussed above), a long-lived asset or disposal group classified as held-for-sale should be reclassified as held-and-used. See BCG 10.4.2.3 for further information on changes to a plan of sale.

10.4.3 Impairment of long-lived assets to be disposed of other than by sale

Long-lived assets to be disposed of other than by sale should be classified as held-and-used until disposal. Examples include (1) an asset distributed to owners in a spin-off, or (2) an asset expected to be abandoned or exchanged in a nonmonetary transaction that will be based on the recorded amount of the asset relinquished.

If an entity commits to a plan to abandon a long-lived asset before the end of its previously estimated useful life, the entity should revise its future depreciation or amortisation to reflect the use of the asset over its shortened remaining useful life. Therefore, while the broader asset group may not fail the recoverability test, adjustment of the useful life of the to-be-abandoned asset may still be necessary [ASC 360-10-35-47]. A long-lived asset to be abandoned is disposed of when it ceases to be used. For example, a defensive asset is not considered abandoned as the entity receives an ongoing benefit from the defensive asset. Further, a temporarily idled asset is also not considered abandoned as the asset will be used in the future.

Example 10-6 illustrates the accounting for an asset that an entity plans to abandon.

EXAMPLE 10-6

Asset that an entity plans to abandon

Company A has machines used in its manufacturing process that it plans to abandon when the upgraded replacement machines are placed in service. No proceeds are expected upon abandonment. The original machines were placed in service three years ago and were being depreciated on a straight-line basis over 10 years, with no salvage value expected at the end of 10 years. Abandonment cannot occur prior to the December 20X8 receipt and installation of the replacement machines. Management had begun reevaluating the efficiency of the original machines in early 20X7. It had included in its 20X8 capital expenditures budget, which was finalised and approved in June 20X7, an estimated amount for new machines. The existing machines, when grouped with other assets at the lowest level of identifiable cash flows, were not impaired on a held-and-used basis throughout this period.

Analysis

Because the machines will remain in use through December 20X8, the assets should not be considered abandoned. The assets are not impaired on a held-and-used basis so no impairment loss should be recognised at the time Company A decides to abandon the machines. However, because Company A plans to abandon the assets before the end of their previously estimated useful lives of 10 years, the useful lives of the assets should be adjusted in June 20X7, when Company A committed to a plan to abandon the machines. As a result, Company A would depreciate the remaining carrying amounts of the machines over their revised useful lives of approximately 18 months.

If a long-lived asset is to be disposed of in an exchange or a distribution to owners in a spin-off, and if that exchange or distribution is to be accounted for based on the recorded amount of the nonmonetary asset relinquished, the asset should continue to be accounted for as held-and-used until it is exchanged or distributed. If an entity tests that asset for recoverability while it is classified as held-and-used, the estimates of future cash flows that are used in that test should be based on the use of the asset for its remaining useful life, assuming that the exchange or distribution transaction will not occur. In addition to any impairment losses an entity is required to recognise while the asset is classified as held-and-used, an impairment loss, if any, should be recognised when the asset is disposed of if the carrying amount of the asset exceeds the asset's fair value [ASC 360-10-35-47 through 35-49, ASC 360-10-45-15, ASC 360-10-40-4].

The donation of an asset or disposal group is also considered to be a disposal by other than sale and would follow the held-and-used model until disposal [ASC 360-10-45-15]. A charitable contribution is an example of a donation of an asset.

Question 10-21

What is the difference between a split-off and spin-off transaction and how does this determination impact a long-lived asset(s) impairment test?

PwC response

A split-off transaction occurs in a non-pro rata distribution to shareholders, which is akin to a sale. A non-pro rata split-off is required to be accounted for at fair value, which is supported by ASC 845-10 regarding a corporate plan of reorganisation. A spin-off transaction is a pro rata distribution to shareholders required to be accounted for at historical cost under both ASC 360-10-40-4 and ASC 845-10.

Since a split-off transaction is similar to a sale transaction, the long-lived asset(s) impairment test should be performed in accordance with the held-for-sale guidance at the time the long-lived asset(s) are classified as held-for-sale assuming all the criteria in ASC 360-10-45-9 have been met. Accordingly, the split-off transaction is required to be recorded at fair value at that date.

In a spin-off transaction, the long-lived assets should continue to be classified as held-and-used until they are disposed of [ASC 360-10-45-15]. At the time of disposal, the carrying amount of the long-lived assets should be compared to their fair value and if the carrying amount of the long-lived assets exceeds their fair value, an impairment loss should be recognised.

10.4.4 Impairment of intangible assets with indefinite useful lives

An indefinite-lived intangible asset is considered to be impaired when the asset's carrying amount exceeds its fair value. An entity may first assess qualitative factors to determine whether it is necessary to perform a quantitative impairment test [ASC 350-30-35-18A]. If determined necessary, the quantitative impairment test should be used to identify a potential impairment and measure an impairment loss, if any.

ASC 350 does not provide guidance on the timing of annual impairment tests for indefinite-lived intangible assets. However, similar to goodwill impairment testing, current practice is to test an indefinite-lived intangible asset for impairment at the same time each year. Unlike a change in an annual goodwill impairment test date, the SEC staff has stated that it will not require a preferability letter if a registrant changes its impairment test date for indefinite-lived assets because ASC 350 does not require the test to be performed at the same time each year. Any change in the testing date for an indefinite-lived intangible asset should not result in more than one year elapsing between impairment tests, nor should such a change be made to avoid recognising an impairment loss. Different indefinite-lived intangible assets may be tested for impairment at different times of the year.

An impairment loss that an entity recognises for an indefinite-lived intangible asset should be reported as a component of income from continuing operations before income taxes or discontinued operations, as appropriate. The impairment loss should be included in the subtotal "income from operations" if presented. After an impairment loss is recognised, the adjusted carrying amount of the indefinite-lived intangible asset will become its new accounting basis. Subsequent reversal of a previously recognised impairment loss is prohibited [ASC 350-30-35-14].

10.4.4.1 The indefinite-lived intangible asset impairment test

The indefinite-lived intangible asset impairment standard allows an entity first to assess qualitative factors to determine whether events and circumstances indicate that it is more likely than not (that is, a likelihood of more than 50 percent) that an indefinite-lived intangible asset is impaired (i.e., the asset's carrying amount exceeds its fair value). If it is more likely than not that the asset is impaired, the entity must calculate the fair value of the asset, compare the fair value to its carrying amount, and record an impairment charge, if the carrying amount exceeds fair value. If an entity concludes that it is not more likely than not that the asset is impaired, no further action is required.

Question 10-22

Does the option to apply the qualitative assessment of the indefinite-lived intangible asset impairment test change how an entity would determine whether they need to perform an event-driven interim test?

PwC response

The qualitative assessment under the indefinite-lived intangible asset impairment test does not change guidance on when to test indefinite-lived intangible assets for impairment. An indefinite-lived intangible asset should be tested for impairment annually and between annual tests ("interim tests") if events or changes in circumstances indicate that it is more likely than not that the asset is impaired (and therefore a quantitative assessment of impairment is required). The standard provides examples of events and circumstances that could affect significant inputs used to determine the fair value of the indefinite-lived intangible asset.

10.4.4.2 The qualitative indefinite-lived intangible asset impairment assessment

Indefinite-lived intangible assets must be tested for impairment annually, or more frequently if events or changes in circumstances indicate that the asset might be impaired [ASC 350-30-35-18]. An entity is permitted to first assess qualitatively whether it is necessary to perform the quantitative impairment test.

In evaluating whether a quantitative test is necessary, an entity first assesses whether it is more likely than not that an asset is impaired (i.e., the asset's carrying amount exceeds its fair value). In making this qualitative assessment, an entity should consider the totality of all relevant events or circumstances that could affect the significant inputs used to determine the fair value of an indefinite-lived intangible asset. Examples of such events and circumstances include:

- **Macroeconomic conditions** such as deterioration in general economic conditions, limitations on accessing capital, fluctuations in foreign exchange rates, or other developments in equity and credit markets.

- **Industry and market considerations** such as a deterioration in the environment in which an entity operates, an increased competitive environment, a decline in market-dependent multiples or metrics (in both absolute terms and relative to peers), or a change in the market for an entity's products or services due to the effects of obsolescence, demand, competition, or other economic factors (such as the stability of the industry, known technological advances, legislative action that results in an uncertain or changing business environment, and expected changes in distribution channels).

- **Cost factors** such as increases in raw materials, labor, or other costs that have a negative effect on future expected earnings and cash flows.

- **Overall financial performance** such as negative or declining cash flows or a decline in actual or planned revenue or earnings compared with actual and projected results of relevant prior periods.

- **Relevant entity-specific events** such as changes in management, key personnel, strategy, or customers; contemplation of bankruptcy; or litigation.

- **Legal, regulatory, contractual, political, business, or other factors**, including asset-specific factors.

These examples are not all-inclusive. An entity should consider other relevant events and circumstances that could affect the significant inputs used to determine the fair value of an indefinite-lived intangible asset. For example, an entity should not ignore a sustained decrease in the entity's share price, as changes in share price may be particularly relevant when testing an asset that is critical to an entity's operating and financial performance, such as a certain trade name, distribution right, or license. During its assessment, an entity should also consider each adverse factor as well as any positive and mitigating events and circumstances, including the difference between the asset's fair value and carrying amount if determined from its most recent fair value calculation (i.e., "cushion") as well as any changes to the carrying amount of the asset.

Entities should place more weight on those events and circumstances that most significantly affect an indefinite-lived intangible asset's fair value. None of the individual examples of events and circumstances are intended to represent stand-alone triggering events that would necessarily require an entity to calculate the fair value of an indefinite-lived intangible asset. Similarly, the existence of positive and mitigating events and circumstances would not represent a rebuttable presumption that an entity should not perform the quantitative impairment test.

If an entity determines that it is not more likely than not that the indefinite-lived intangible asset is impaired, management is required to make a positive assertion about its conclusion reached and the events and circumstances taken into consideration to reach that conclusion.

10.4.4.3 Selecting an indefinite-lived intangible asset for the qualitative assessment

An entity can choose to perform the qualitative assessment on none, some, or all of its indefinite-lived intangible assets. An entity can bypass the qualitative assessment for any asset in any period and proceed directly to the quantitative impairment test, and then perform the qualitative assessment in any subsequent period. The selection of assets on which to perform the qualitative assessment is not an accounting policy decision that needs to be followed consistently every period. Therefore, an entity should tailor its use of the qualitative assessment based on specific facts and circumstances for each asset.

A qualitative assessment alone may not be sufficient to support a more likely than not assertion when certain adverse factors are present. In other cases, the qualitative assessment may not be cost effective compared to performing the quantitative impairment test. For example, an entity that already has an efficient and robust process in place for determining the fair value of its assets may prefer to bypass the qualitative assessment and proceed directly to the quantitative impairment test rather than implement additional processes and internal controls for performing the qualitative assessment.

The qualitative assessment will be most appropriate when there is significant cushion based on a recent fair value measurement and no significant adverse changes have since occurred. See BCG 10.4.4.4 for further information on considering the results of prior fair value measurements in the qualitative assessment. Conversely, a qualitative assessment alone may not be cost effective or efficient for an asset whose fair value approximated its carrying amount in a recent fair value calculation. The lack of cushion in this situation results in the fair value inputs being highly sensitive to adverse factors such as changes in actual and forecasted cash flows, tax rates, and discount rates. In certain cases, it may be difficult to apply the qualitative impairment test to IPR&D assets since, given the nature of the assets, they are subject to frequent and significant changes in fair value. Entities therefore may decide to test IPR&D assets for impairment using the quantitative test.

Question 10-23

What processes would an entity be expected to have in place to support a conclusion reached as a result of applying a qualitative assessment for its indefinite-lived intangible asset?

PwC response

An entity should make a positive assertion about its conclusion reached and the events and circumstances taken into consideration in performing a qualitative assessment. Therefore, in most cases a robust process with supporting documentation will be needed to support an entity's conclusion that the quantitative impairment testing is not necessary.

Generally, entities that plan to use the qualitative assessment should consider developing a comprehensive process to:

- Determine which factors are the key drivers of the significant inputs of each asset's fair value and monitor changes in those factors.

- Identify the internal and external sources of information needed to monitor the relevant factors for each asset. Consider whether analyst and other external information are consistent with management's assessment of events and circumstances that could affect the significant inputs used in calculating an asset's fair value.

- Consider the amount of "cushion" from the most recent fair value calculation and evaluate both positive and adverse events and circumstances since that analysis. Underperformance relative to budget or prior expectations may suggest a quantitative impairment test is warranted.

- Monitor changes in other market-based metrics that could affect the significant inputs used in calculating an asset's fair value, including changes in the discount rate.

- Evaluate and weigh the impact of adverse and mitigating factors based on the extent those factors affect the comparison between fair value and carrying amount.

- Consider if, and how frequently, a quantitative impairment test should be performed for the purpose of "refreshing" the baseline valuation.

- Affirmatively consider and document the qualitative assessment which includes consideration of the factors identified from the entity's process and the basis for its conclusion. Generally, the greater the extent of analysis needed to assert that no further testing is necessary, the greater the extent of documentation that should be prepared.

Question 10-24

In what circumstances might an entity choose to bypass the qualitative assessment, and proceed directly to the quantitative impairment test for its indefinite-lived intangible asset?

PwC response

The standard provides entities with the flexibility to tailor their use of the qualitative assessment based on asset specific facts and circumstances. For example, an entity may conclude that the qualitative assessment would be cost effective for certain of its indefinite-lived intangible assets but not for others. An entity's decision to use the qualitative assessment is not an accounting policy election that needs to be followed consistently every period.

Although certain indefinite-lived intangible assets, such as in-process research and development assets, are not precluded from application of the qualitative impairment assessment, the fair value of these assets often is affected by significant uncertainties such as regulatory approval that are outside the entity's control and are related to characteristics specific to the asset. As a result, entities should apply judgment in determining whether it is more appropriate to bypass the qualitative impairment assessment and apply the quantitative impairment test to these assets instead.

Question 10-25

How much cushion between an indefinite-lived intangible asset's fair value and its carrying amount is required to allow an entity to consider a qualitative impairment test?

PwC response

There are no bright lines. The test is qualitative and should consider all facts and circumstances impacting the asset's fair value, including the length of time elapsed since the last fair value calculation, the impact of adverse mitigating and positive qualitative factors, as well as current year changes in the asset's carrying amount. All else being equal, an asset with a significant cushion is more likely to allow an entity to start with a qualitative assessment than an asset with little or no cushion.

10.4.4.4 Considering the results of prior fair value measurements in the qualitative assessment

The amount of cushion, if any, between the fair value and the carrying amount of the asset from a prior fair value measurement is a critical factor in the qualitative assessment. However, an entity should not look solely at the amount of cushion from a recent fair value measurement to determine whether to perform a qualitative assessment. An entity must first determine whether the assumptions and projections underlying the previous fair value measurement are still reasonable in the current period. For example, using the multiperiod excess earnings method of valuation (see BCG 7), an entity's actual results for the current year combined with updated current forecasts may differ from the entity's prior year forecasts used in the valuation model. The significance of the differences may indicate that the projections used for the last fair value calculation were too aggressive and that less weight should be given to the apparent cushion from the prior valuation. Conversely, more weight would likely be given to a prior cushion amount when actual results are consistent with or more favorable than results used in the recent fair value calculation projections.

Question 10-26

How many years can an entity use a previously-measured fair value of an indefinite-lived intangible asset as a basis for assessing the extent of cushion between an asset's fair value and its carrying amount?

PwC response

There are no bright lines. A determination of the appropriate length of time between quantitative measurements of the fair value of an asset is a matter of judgment. Some entities may choose to establish policies requiring assets' fair values to be reassessed periodically. Even with such a policy, an entity may still need to determine an asset's fair value more frequently than the policy requires if events and circumstances indicate a quantitative impairment test is appropriate.

10.4.4.5 *Periodically refreshing an asset's fair value*

Entities should consider periodically "refreshing" an asset's fair value calculation. The more time that has elapsed since a recent fair value calculation, the more difficult it may be to support a conclusion based solely on a qualitative assessment. The frequency with which an entity refreshes its fair value calculation for an asset will depend on a variety of factors, including how much cushion existed in the last fair value calculation, the current operating environment, the current market environment for similar assets and any changes in carrying amount of an asset.

10.4.4.6 *Entity's assertion in annual assessment*

An entity should make a positive assertion about its conclusions reached and factors considered if it determines as part of its annual qualitative assessment that the quantitative impairment test is unnecessary. Therefore, while the level of documentation will vary based on facts and circumstances specific to each asset, the entity should clearly document the conclusions reached and factors considered in an annual test.

10.4.4.7 *The quantitative impairment test*

If an entity bypasses the qualitative assessment or determines from its qualitative assessment that an indefinite-lived intangible asset is more likely than not impaired, a quantitative impairment test should be performed. The quantitative impairment test compares the fair value of an indefinite-lived intangible asset with the asset's carrying amount. If the fair value of the indefinite-lived intangible asset is less than the carrying amount, an impairment loss should be recognised in an amount equal to the difference [ASC 350-30-35-18]. As discussed in BCG 10.4.5, an entity may be able to combine certain indefinite-lived intangible assets into a single **unit of accounting** for impairment testing purposes.

10.4.5 *Unit of accounting for indefinite-lived intangible assets*

Some entities may acquire indefinite-lived intangible assets in separate transactions, but collectively use the individual assets in a manner that suggests they represent one asset. For example, an entity may acquire contiguous easements in separate transactions to support the development of a single gas pipeline. ASC 350-30-35-21 through 35-28 addresses the circumstances under which separately recorded indefinite-lived intangible assets should be combined into a single unit of accounting for purposes of impairment testing. Under ASC 350-30-35-21 through 35-28, separately recorded indefinite-lived intangible assets, whether acquired or internally developed, should be combined into a single unit of accounting for impairment testing if those assets are operated as a single asset and, as such, are essentially inseparable from one another. However, the unit of accounting cannot represent a group of indefinite-lived intangible assets that collectively constitute a **business**. Further, the unit of accounting should include only indefinite-lived intangible assets and cannot be tested in combination with long-lived intangible assets or goodwill.

Determining whether two or more indefinite-lived intangible assets are essentially inseparable is a matter of judgment that depends upon the relevant facts and circumstances. ASC 350-30-35-23 and 35-24 provide a list of indicators (see table below) that an entity should consider in making a determination about whether to combine intangible assets for impairment testing purposes. None of the indicators should be considered presumptive or determinative [ASC 350-30-35-22].

Combined	Not combined
The intangible assets were acquired to construct or enhance a single asset (i.e., they will be used together).	Each intangible asset generates cash flows independent of any other intangible asset (as would be the case for an intangible asset licensed to another entity for its exclusive use).
Had the intangible assets been acquired in the same acquisition, they would have been recorded as one asset.	If sold, each intangible asset would likely be sold separately. A past practice of selling similar assets separately is evidence, indicating that combining assets as a single unit of accounting may not be appropriate.
The intangible assets as a group represent the highest and best use of the assets (e.g., they yield the highest price if sold as a group).	The entity has adopted or is considering a plan to dispose of one or more intangible assets separately.
The marketing or branding strategy provides evidence that the intangible assets are complementary as that term is used in ASC 805-20-55-18.	The intangible assets are used exclusively by different ASC 360-10 asset groups.
	The economic or other factors that might limit the useful economic life of one of the intangible assets would not similarly limit the useful economic lives of other intangible assets combined in the unit of accounting.

If it is determined that indefinite-lived intangible assets that were previously tested for impairment separately can now be combined into a single unit of accounting, those assets should be tested separately for impairment prior to being combined. Also, when (1) the unit of accounting used to test indefinite-lived intangible assets for impairment is contained in a single **reporting unit**, and (2) a goodwill impairment loss for that reporting unit must be measured, an entity should use that same unit of accounting and the associated fair value for the indefinite-lived intangible assets in performing step two of the goodwill impairment test.

The unit of accounting is determined from the reporting entity's perspective based on the indicators above. A consolidated entity's unit of accounting may include indefinite-lived intangible assets that are recorded in the separate financial statements of the entity's consolidated subsidiaries. As a result, an impairment loss that is recognised in the **consolidated financial statements** may differ from the sum of the impairment losses, if any, that are recognised in the separate financial statements of the entity's subsidiaries.

Example 10-7 illustrates the determination of the unit of accounting for trade names.

EXAMPLE 10-7

Unit of accounting—trade names

Company Y purchases Company A, an international vacuum cleaner manufacturer, which sells vacuums under a well known trade name. The operations of Company A are conducted through separate legal entities in three countries, and each of those legal entities owns the registered trade name used in that country. When the business combination was recorded, Company Y recorded three separate intangible trade name assets, because separate financial statements are required to be prepared for each separate legal entity. There are separate identifiable cash flows for each country, and each country represents an ASC 360-10 asset group. Each intangible trade name asset was deemed to have an indefinite life. A single brand manager is responsible for the combined trade name, the value of which is expected to be recovered from the worldwide sales of Company A's products.

Analysis

The three separately recorded trade name assets should be combined into a single unit of accounting for purposes of testing the acquired trade name for impairment at the consolidated reporting level. The three registered trade names were acquired in the same business combination and, absent the requirement to prepare separate financial statements for subsidiaries, would have been recorded as a single asset. The trade name is managed by a single brand manager. If sold, Company Y would most likely sell all three legally registered trade names as a single asset.

10.4.5.1 Unit of accounting for intangible assets used in research and development activities

The determination of the appropriate unit of accounting will impact the postacquisition accounting for IPR&D, including impairment assessments and the determination of amortisation periods and/or useful lives. Determining the appropriate unit of accounting for valuing and recognising intangible assets used in research and development activities may be especially complex when such activities may ultimately benefit various jurisdictions and/or versions of a product.

One common approach is to record separate "jurisdictional" assets for a research and development activity that will benefit various jurisdictions or versions, while another approach is to record a single "global" asset. Factors to consider in making this determination may include:

Jurisdictional asset:

- The nature of the activities and costs necessary to further develop the project are not substantially the same.

- The risks associated with the further development of the project are not substantially the same.
- The amount and timing of benefits expected to be derived in the future from the developed asset(s) are not substantially the same.
- Based on historical experience and current intent, once completed, the product (if ever transferred) would not be transferred as a single asset.
- The manner in which the product will be advertised and sold will not be substantially the same.

Global asset:

- The development of the project will occur centrally and the company only intends to incur a small portion of development costs to obtain approvals in future jurisdictions.
- Based on historical experience (or expectations), the risks associated with the further development of the IPR&D project are substantially the same. For example, the development of the project will occur centrally and the company only intends to incur a small portion of the total development costs to obtain approval within each regulatory jurisdiction towards the later stages of testing.
- Advertising and selling costs will be managed from the perspective of a global brand, not the individual jurisdictions where the product is sold.
- The amount and timing of benefits expected to be derived in the future from the developed asset(s) and the expected economic life of the developed assets are substantially the same.
- Based on historical experience and current intentions, once completed, the compound (if ever transferred) would be transferred in one worldwide arrangement.

None of these factors are individually determinative, and the assessment should be based on the facts and circumstances specific to each situation.

Example 10-8 illustrates making a determination of whether acquired in-process research and development should be measured and recognised as a single asset or multiple assets.

EXAMPLE 10-8

Unit of account

Company C acquired Company D, which is accounted for as an acquisition of a business. At the acquisition date, Company D was pursuing completion of an in-process research and development project that, if successful, would result in a drug for which Company C would seek regulatory approval in the United States and Japan. This research and development project is in the later stages of development but is not yet complete. The nature of the activities and costs necessary to successfully develop the drug and obtain regulatory approval for it in the two jurisdictions are not substantially the same. If approved, the respective patent lives are expected to be different as well. In addition, Company C intends to manage advertising and selling costs separately in both countries. Lastly, Company C has determined that any future sale of the in-process research and development assets would likely involve two different buyers.

Analysis

The acquired in-process research and development project would likely be recorded as two separate "jurisdictional" in-process research and development assets. While there may be other factors to consider, Company C's assessment may lead it to believe that the development risks, the nature of the remaining activity and costs, the risk of not obtaining regulatory approval, and expected patent lives for the acquired in-process research and development are not substantially the same in both countries. Finally, Company C intends to manage the drug separately, including separate advertising and selling costs in each country.

10.5 Assets that an acquirer does not intend to actively use, including defensive assets

ASC 805 requires an entity to recognise and measure an asset acquired in a business combination at its fair value based on the asset's highest and best use by market-participants, irrespective of whether the acquirer intends to use the asset in the same manner [ASC 805-20-30-6]. For example, an entity may acquire a trade name and decide to actively use it only for a short period of time, given its plan to rebrand the existing products sold under that trade name with its own trade name. An entity must consider market-participant assumptions in measuring an asset's fair value. Acquirers will need to consider how others might use these assets, as well as how these assets might benefit other assets acquired, or those they already own.

Future impairment losses or higher depreciation charges in earlier periods may result because the acquirer's use of an asset may differ from the asset's highest and best use as determined by reference to market-participants. Additionally, there could be other postacquisition issues associated with measuring an asset based on its highest and best use (rather than an entity's intended use). See BCG 7 for further discussion of potential issues associated with the use of market-participant assumptions, and the valuation techniques and approaches utilised.

A defensive asset is an intangible asset that an entity does not intend to actively use, but intends to prevent others from using. Notwithstanding the lack of active use by the buyer, ASC 805 requires that fair value be determined through the lens of a market-participant. In November 2008, the EITF concluded the following:

- A defensive asset should be considered a separate unit of accounting. This means that a defensive asset should be accounted for as an individual asset and should not be grouped with the acquirer's existing asset(s) whose value it may enhance.

- The useful life of a defensive asset should reflect the acquiring entity's consumption of the defensive asset's expected benefits. The consumption period should be the period over which the defensive asset is expected to contribute directly or indirectly to the acquiring entity's future cash flows.

- Classification of a **defensive intangible asset** as an indefinite-lived intangible asset would be rare, as the value will likely diminish over a period of time.

- A defensive intangible asset cannot be considered immediately abandoned following its acquisition.

As the value of many defensive assets will likely diminish over a period of time, judgment will be required to determine the period over which the defensive asset will either directly or indirectly contribute to the acquirer's cash flows. Generally, the period over which a defensive intangible asset diminishes in fair value is an acceptable proxy for the period over which the reporting entity expects a defensive intangible asset to contribute directly or indirectly to the future cash flows of the entity. The amortisation method used should reflect the pattern in which the fair value of a defensive intangible asset diminishes over time. For example, if the defensive asset acquired is a brand name, consumer preferences for the acquired asset may result in continuing value even if the brand is not being actively marketed. Further, the absence of the brand name in the marketplace will likely indirectly benefit other brand names (e.g., increase revenues) of the acquirer. However, the value of the defensive asset will likely diminish over time.

As applicable, defensive assets need to be tested for impairment under the provisions of ASC 350 or ASC 360-10, depending on whether the asset is deemed an indefinite-lived or finite lived intangible asset. If fair value needs to be determined for purposes of an impairment assessment, the defensive asset's fair value will be based on market-participant assumptions at that time and not acquirer specific assumptions.

An acquired asset that an acquirer does not intend to actively use and does not intend to prevent others from using is not a defensive asset. An example could be a customised software program internally developed by the target. Similar to other market-participants, the acquirer may only plan to use the program for a short transition period until the target company is successfully transitioned to the acquirer's existing software system. The acquirer's initial measurement of the customised software program is based on it likely having limited value and a short economic life, since the acquired asset will only generate value to the acquirer and to market-participants over the transitional period. This type of an acquired asset would not be considered a defensive asset.

10.6 Financial statement presentation and disclosure guidance

ASC 350-30-50-1 through 50-3A and ASC 350-20-50-1 through 50-2A include presentation and disclosure requirements for intangible assets. ASC 360-10-45-5 through 45-15, ASC 360-10-50-2, ASC 205-20-45-10, and ASC 205-20-50-1 through 50-3 include presentation and disclosure requirements for long-lived assets. For public entities, Article 5-02 of Regulation S-X provides disclosure requirements for intangible assets that are in excess of five percent of total assets and for accumulated amortisation of intangible assets.

Chapter 11: Accounting for goodwill postacquisition—U.S. GAAP

11.1 Chapter overview

Generally, the **acquirer** in a **business combination** is willing to pay more for a **business** than the sum of the **fair values** of the individual assets and liabilities because of other inherent value associated with an assembled business. In addition, synergies and other benefits that are expected from combining the activities of the acquirer and **acquiree** are often drivers for paying an amount greater than the fair value of the underlying assets and liabilities. The resulting excess of the aggregate of (1) the **consideration transferred**, as measured in accordance with ASC 805, which generally requires the use of **acquisition-date** fair value; (2) the fair value of any **noncontrolling interest** in the acquiree; and (3) in a **business combination achieved in stages**, the acquisition-date fair value of the acquirer's **previously held equity interest** in the acquiree, over the net of the acquisition-date amounts of the **identifiable** assets acquired and the liabilities assumed, as measured in accordance with ASC 805, is recognised as **goodwill**. This chapter addresses the accounting for goodwill after an acquisition, including goodwill recognised by **not-for-profit entities** (ASC 958-805-35) and **private companies** applying ASU 2014-02, *Accounting for Goodwill*.

Under ASC 350, goodwill is not amortised. Rather, an entity's goodwill is subject to periodic **impairment** testing. ASC 350 requires that an entity assign its goodwill to **reporting units** and test each reporting unit's goodwill for impairment at least on an annual basis and between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount.

An entity is permitted to first assess qualitative factors to determine whether the two-step goodwill impairment test is necessary. Further testing is only required if the entity determines, based on the qualitative assessment, that it is more likely than not that a reporting unit's fair value is less than its carrying amount. Otherwise, no further impairment testing is required. An entity has the option to bypass the qualitative assessment for any reporting unit in any period and proceed directly to step one of the two-step goodwill impairment test. This would not preclude the entity from performing the qualitative assessment in any subsequent period.

When an entity bypasses the qualitative assessment or determines based on the qualitative assessment that further testing is necessary, a two-step goodwill impairment test is performed to identify potential impairment and measure an impairment loss, if any. The first step (step one) of the two-step goodwill impairment test compares a reporting unit's fair value to its **carrying amount**. If the carrying amount of a reporting unit is positive and exceeds the reporting unit's fair value, the second step of the impairment test (step two) must be completed to measure the amount of the reporting unit's goodwill impairment loss, if any. If the carrying amount of a reporting unit is zero or negative, the second step is performed if it is more likely than not that goodwill is impaired.

To perform step one of the two-step goodwill impairment test, an entity must:

- Identify its reporting units

- Assign assets and liabilities to its reporting units
- Assign all goodwill to one or more of its reporting units
- Determine the fair value of those reporting units to which goodwill has been assigned

If a reporting unit fails step one (i.e., the reporting unit's carrying amount exceeds its fair value), step two requires an assignment of the reporting unit's fair value to the reporting unit's assets and liabilities, using the acquisition method accounting guidance in ASC 805, to determine the implied fair value of the reporting unit's goodwill. The implied fair value of the reporting unit's goodwill is then compared with the carrying amount of the reporting unit's goodwill to determine the goodwill impairment loss to be recognised, if any.

In January 2014, The FASB and the Private Company Council (PCC) issued ASU 2014-02, *Accounting for Goodwill* (the "goodwill alternative"). The goodwill alternative represents a fundamental overhaul of the existing accounting model for goodwill. Under the goodwill alternative, a nonpublic entity is able to amortise goodwill on a straight-line basis over a period of ten years or over a shorter period if the company demonstrates that another useful life is more appropriate. Goodwill would be subject to impairment testing at either an entity-wide level or a reporting unit level but only upon the occurrence of a triggering event. This chapter addresses the U.S. private company goodwill alternative in Section 11.8. All other sections of this chapter address the accounting for goodwill by entities not applying this alternative.

The key takeaways from this chapter are:

- **For most entities, goodwill is not amortised but is instead tested for impairment at least annually at the reporting unit level.** Subject to an optional qualitative assessment, the goodwill impairment test is a two-step process. In the first step (step one) a company compares the reporting unit's fair value to its carrying amount. If the fair value is less than the carrying amount, a company performs step two to measure the implied fair value of goodwill and the amount of goodwill impairment, if any. If a company has a reporting unit with a zero or negative carrying amount, it proceeds directly to performing step two if it determines that it is more likely than not that a goodwill impairment exists. The amount of goodwill impairment is measured as the excess of its carrying amount over its implied fair value.

- **An entity has the option to first assess qualitative factors to determine whether the two-step goodwill impairment test is necessary.** An entity has the option to perform a qualitative assessment to determine whether it is more likely than not that a reporting unit's fair value is less than its carrying amount. An entity has the option to bypass the qualitative assessment for any reporting unit in any reporting period and proceed directly to step one of the two-step impairment test.

- **The implied fair value of goodwill is measured in a manner consistent with the acquisition method for business combinations.** When performing step two, a company measures the implied fair value of goodwill as the excess of the reporting unit's fair value over the amounts assigned to its net identifiable assets and liabilities (recognised and unrecognised) measured on the same basis as in a business combination. This allocation process is performed only for purposes of determining the implied fair value of the reporting unit's goodwill to measure for impairment.

- **Purchases and sales of noncontrolling interests do not affect goodwill unless control is lost.** After a controlling interest is obtained, subsequent purchases or sales of a noncontrolling interest which do not result in a change in control are recorded as equity transactions. A difference between the consideration paid or received and the carrying amount of the noncontrolling interest is recorded as equity (additional paid-in capital). The recorded amounts for assets, including goodwill, and liabilities will not change.

- **Private company goodwill alternative -** An eligible company which elects to adopt the goodwill alternative will be able to apply a simplified impairment test but will also be required to amortise goodwill.

11.2 Identify reporting units

The **unit of accounting** for goodwill is at a level of the entity referred to as a reporting unit. Goodwill is assigned to specific reporting units for purposes of the annual or interim impairment assessment and, therefore, identification of an entity's reporting units is the cornerstone of goodwill impairment testing.

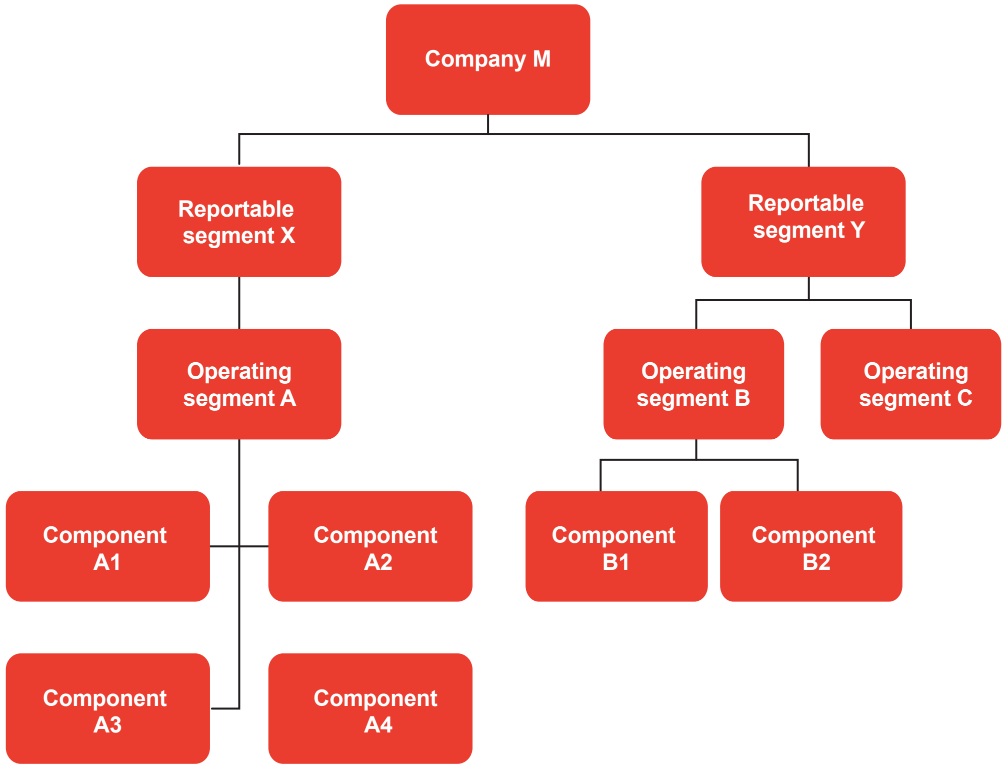
A reporting unit is the same as, or one level below, an operating segment as defined in ASC 280-10-50-1. Therefore, although ASC 280-10 may allow for the aggregation of operating segments into reportable segments based on similar economic characteristics, an entity's reportable segments are not relevant in the determination of its reporting units.

One level below an operating segment is referred to as a **component**. A component of an operating segment is required to be identified as a reporting unit if the component is a business for which discrete financial information is available and segment management regularly reviews the operating results.

Once components are identified, an entity would consider whether any components of an operating segment should be aggregated into one or more reporting units based on whether the components have similar economic characteristics.

Figure 11-1 visually summarises an example of a company's reporting structure that is used to determine its reporting units and will be referred to throughout section 11.2.

Figure 11-1
Reporting structure used to determine reporting units



11.2.1 *Operating segments as the starting point for determining reporting units*

Operating segments, not reportable segments, are the basis for the determination of reporting units. ASC 280-10 defines an operating segment as a portion of an enterprise:

- That engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same enterprise)
- Whose operating results are regularly reviewed by the enterprise's chief operating decision maker (CODM) to make decisions about resources to be allocated to the segment and assess its performance
- For which discrete financial information is available [ASC 280-10-50-1]

For example, using the reporting structure of Company M in Figure 11-1, reportable segments X and Y are not relevant to the determination of reporting units. Instead, the determination should begin with operating segments A, B, and C. It is important not to confuse reportable segments with operating segments because this may result in the misapplication of ASC 350-20 and improper goodwill impairment testing.

Entities that are not required to report segment information are nonetheless required to determine their reporting units and test goodwill for impairment at the reporting unit level [ASC 350-20-35-38]. Those entities therefore must still apply the guidance in ASC 280-10 to determine their operating segments for purposes of establishing their reporting units.

11.2.2 Reporting unit may be an operating segment or one level below

Whether an operating segment should further be divided into components is based on the entity's internal reporting structure (i.e., its management organisation and its financial resource allocation and reporting), which is consistent with the determination of operating segments. For this reason, reporting units may vary significantly from organisation to organisation and are generally not comparable, even among competitors. Determining reporting units is a matter of judgment based on entity-specific facts and circumstances.

A component of an operating segment is a reporting unit if the component constitutes a business for which discrete financial information is available and is regularly reviewed by segment management [ASC 350-20-35-34]. Segment management is not intended to be equivalent to the CODM, as defined in ASC 280-10. Instead, segment management usually reports to the CODM.

Two or more components of an operating segment, which would qualify as reporting units on their own as discussed in the preceding paragraph, should be aggregated and deemed a single reporting unit if the components have similar economic characteristics [ASC 350-20-35-35]. For instance, in Figure 11-1, Company M's possible reporting units would be components A1 through A4, B1, and B2, and operating segment C, before considering whether any components should be combined.

ASC 350-20 does not specifically address situations in which one or more components of an operating segment qualify as a reporting unit (or reporting units) while the remaining components do not qualify. In establishing the reporting unit(s) of such an operating segment, an entity will need to apply judgment to determine how the remaining elements that do not qualify as a component should be considered, keeping in mind that all of an entity's goodwill must be assigned to its reporting units.

11.2.2.1 Discrete financial information and business requirement for components

For a component of an operating segment to be a reporting unit, it must be a business (as defined in ASC 805) for which discrete financial information is available. The term discrete financial information, for purposes of determining if a component is a reporting unit, has the same meaning as when used to determine operating segments under ASC 280-10. The guidance states that such financial information can consist of as little as capsule operating information (e.g., revenues and gross margins), provided that the CODM (segment management for reporting units) regularly reviews the operating results of the business. Furthermore, it is not necessary for an entity to have assigned assets and liabilities at the component level to conclude that a component may constitute a reporting unit (i.e., a balance sheet is not required to qualify as a component) [ASC 350-20-55-4].

11.2.3 Components are combined if economically similar

Two or more components of an operating segment that have similar economic characteristics should be aggregated into a single reporting unit [ASC 350-20-35-35]. For purposes of evaluating economic characteristics of a component of an operating segment, the following criteria for aggregating operating segments in ASC 280-10 should be considered:

- Similar financial performance (such as similar long-term average gross margins)
- The nature of the products and services
- The nature of the production processes
- The type or class of customer for the products and services
- The methods used to distribute the products or provide the services
- If applicable, the nature of the regulatory environment [ASC 280-10-50-11]

ASC 350-20-55 provides implementation guidance, stating that while all of these factors from ASC 280-10 need to be considered in the analysis of economic similarity, the FASB did not intend that every factor be met to demonstrate the economic similarity of the components. Furthermore, ASC 350-20-55 provides a list of other factors that an entity should consider in determining economic similarity. The following additional factors, as well as any other relevant factors, should be considered when evaluating economic similarity:

- The manner in which an entity operates its business and the nature of those operations
- Whether goodwill is recoverable from the separate operations of each component business or from two or more component businesses working in concert
- The extent to which the component businesses share assets and other resources, as might be evidenced by extensive transfer pricing mechanisms
- Whether the components support and benefit from common research and development projects

Assessing whether two or more components of an operating segment have similar economic characteristics is a matter of judgment that depends on specific facts and circumstances. The assessment should be more qualitative than quantitative. This is a notable difference from assessing the economic similarities of operating segments for aggregation into a reportable segment where quantitative measures may be more important. In addition, when a component extensively shares assets and other resources with other components of the operating segment, it may indicate that the component either is not a business or may be economically similar to those other components.

11.2.4 Aggregation of components across operating segments is not permitted

Components that share similar economic characteristics but are part of different operating segments may not be combined into a single reporting unit. This is of notable significance for entities whose operating segments are organised on a geographic basis. Such organisations are precluded from aggregating components in different geographic operating segments, even if they are economically similar. For example, in Figure 11-1, components A1 and B1 could not be combined into a single reporting unit, even if they have similar economic characteristics because they are part of different operating segments.

11.2.5 Periodic reassessment of reporting units

As discussed in BCG 11.4.4, an entity may need to reassign goodwill to reporting units when the entity's reporting structure changes. However, ASC 350-20 does not specifically address whether an entity should periodically reassess the economic similarity of the components of its operating segments to determine whether aggregation or disaggregation of components continues to be appropriate when determining its reporting units. Generally, significant changes in the economic characteristics of components or reorganisation of an entity's reporting structure may result in a reassessment of the affected operating segment and its components to determine whether reporting units need to be redefined. When such a reassessment leads an entity to redefine previously determined reporting units, goodwill should be reassigned to the reporting units affected using the relative fair value approach, based on the fair values of the affected reporting units as of the date of the reassessment [ASC 350-20-35-45].

11.2.6 Summary of impact of reporting levels on determining reporting units

Figure 11-2 provides a summary of the various reporting levels that may exist within an entity and how the reporting levels are used in determining an entity's reporting units.

Figure 11-2

Reportable segment versus operating segment versus component

Term and definition	Use in determining reporting units
Reportable segment	
▫ The reporting level that is disclosed for financial reporting purposes. ▫ Operating segments may be aggregated into one or more reportable segments if they meet specified criteria. ▫ An operating segment could be a reportable segment if an entity does not aggregate its operating segments for reporting purposes [ASC 280-10-50-10 through 50-19].	▫ Not applicable unless a reportable segment is an operating segment. Reporting units must be at the operating segment level or one level below the operating segment.
Operating Segment	
▫ Engages in business activities from which it may earn revenues and incur expenses. ▫ Discrete financial information is available. ▫ Operating results are regularly reviewed by the CODM to allocate resources and assess performance [ASC 280-10-50-1].	An operating segment will be a reporting unit if: ▫ All of its components have similar economic characteristics. ▫ None of its components is a reporting unit. ▫ It comprises a single component. Note: Unlike a component, as described below, an operating segment need not constitute a business to be deemed a reporting unit.

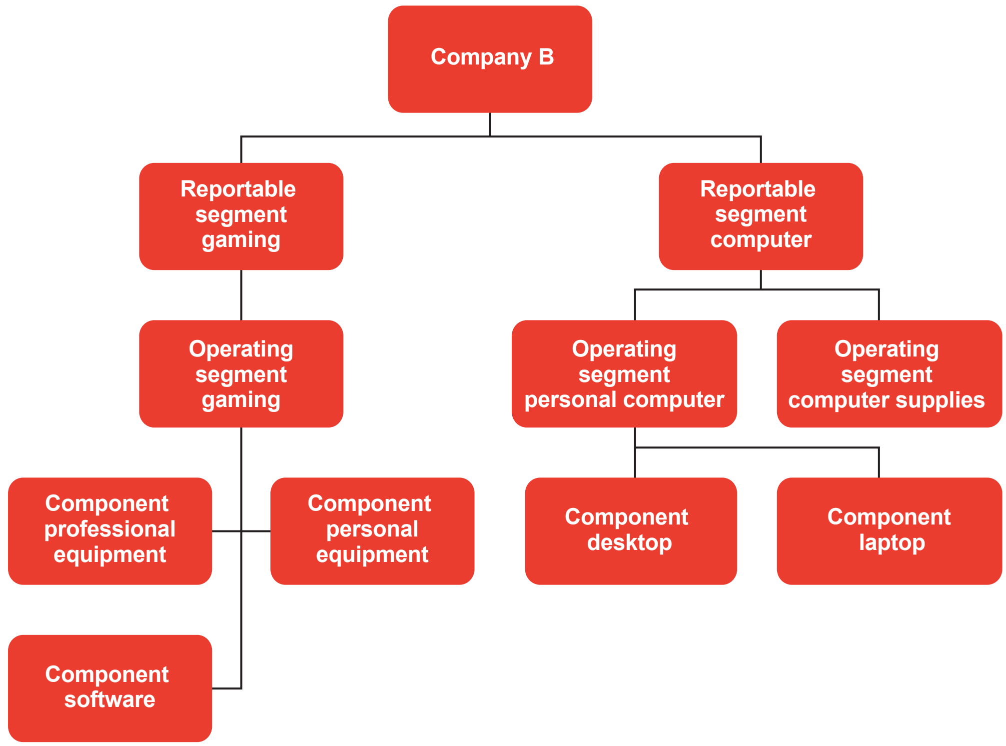
Term and definition	Use in determining reporting units
Component	
◻ One level below an operating segment [ASC 350-20-20; ASC 350-20-35-33 through 35-38; ASC 350-20-55].	A component may be a reporting unit if: ◻ The component constitutes a business for which discrete financial information is available. ◻ Segment management regularly reviews the component's operating results. However, components of an operating segment should be aggregated into a single reporting unit if they have similar economic characteristics, as defined by ASC 350-20-55.

Example 11-1 provides an example of the identification of reporting units.

Example 11-1

Identification of reporting units

Assume Company B manufactures, markets, and sells electronic equipment, including computers and gaming equipment for professional (e.g., casinos and gaming halls) and personal use. Company B's CEO has been identified as the CODM and, on a monthly basis, receives, among other information, divisional income and cash flow statements for each operating segment, as well as sales on a product line basis. Based on the organisational structure of the company and information used to assess performance and resource allocation, management identified the following structure:



For segment reporting, Company B reports "Gaming" as a reportable segment and aggregates its two computer-related operating segments into a reportable segment "Computer." Two of the three operating segments have various components that are businesses for which discrete financial information is available, and segment management regularly reviews the operating results of the businesses. Company B will have at least three reporting units (operating segments "Gaming," "Personal Computer," and "Computer Supplies"), and might have as many as six reporting units (five components and the operating segment "Computer Supplies").

Analysis

Company B has analysed the economic characteristics of the identified components and concluded that:

- Component "Professional Equipment" is not economically similar to the components "Personal Equipment" and "Software."

- Components "Personal Equipment" and "Software" of the Gaming operating segment should be aggregated into a single reporting unit because they have similar economic characteristics.

- The economic similarities between "Personal Computer's" components "Desktop" and "Laptop" are not sufficient for them to be aggregated, so these components are separate reporting units.

- The "Personal Equipment" and "Software" components share very similar economic characteristics with the "Desktop" component. Despite these similarities, the "Desktop" component must be treated separately because it resides in a different operating segment than components “Personal Equipment” and “Software.”

- Operating segment “Computer Supplies” is a reporting unit because it does not have individual components.

Company B’s analysis of its reporting structure indicates that the entity has five reporting units: “Professional Equipment,” “Personal Equipment and Software,” “Desktop,” “Laptop,” and “Computer Supplies.”

11.3 Assigning assets and liabilities to reporting units

To apply the provisions of the goodwill impairment test (as further discussed in BCG 11.5), an entity needs to assign the appropriate assets and liabilities to the respective reporting units. Assets and liabilities are required to be assigned to a reporting unit if both of the following criteria are met:

- The asset will be employed in or the liability relates to the operations of a reporting unit.

- The asset or liability will be considered in determining the fair value of the reporting unit [ASC 350-20-35-39].

Assigning assets and liabilities to reporting units inherently involves judgment. The objective of the assignment of identifiable assets and liabilities to a reporting unit is to achieve symmetry (i.e., an “apples to apples” comparison) between the assets and liabilities that are assigned to the reporting unit and the net assets that are considered in the determination of a reporting unit’s fair value. To achieve this symmetry, it is critical for the entity to (1) understand the factors behind and drivers of a reporting unit’s fair value, and (2) employ a methodology for assigning assets and liabilities to a reporting unit that is reasonable, supportable, and consistent with how it determines the reporting unit’s fair value.

A reporting unit should be assigned all of the assets and liabilities necessary to operate as a business because it is those net assets that will generate the cash flows used to determine the fair value of the reporting unit. However, the assignment of assets and liabilities does not need to result in a full balance sheet for an operating segment or component to qualify as a separate reporting unit. An operating segment does not need to constitute a business to be a reporting unit. Once an entity has established an appropriate methodology for assigning assets and liabilities to a reporting unit, it should apply it consistently from period to period.

The process of assigning assets and liabilities to reporting units is only for the purpose of impairment testing and the resulting information is usually not reflected in the actual ledgers or financial statements of the entity. Such information is usually maintained on separate detailed schedules as part of the accounting records that support the financial statement balances and conclusions reached as a result of impairment testing.

11.3.1 Assigning assets and liabilities relating to multiple reporting units

Some assets or liabilities may be employed in or relate to the operations of multiple reporting units. This may include **intangible assets**, such as trade names, technology, patents, and customer lists; tangible assets, such as shared manufacturing facilities; or liabilities, such as debt and pension obligations for active employees. In developing a reasonable and supportable methodology to assign such assets and liabilities to reporting units, an entity may consider the relative benefit received by the different reporting units or the relative fair values of the different reporting units. Other criteria may include specific measurable relationships. In the case of some pension items, for example, a pro rata assignment based on payroll expense might be used [ASC 350-20-35-40].

An entity's methodology to assign to reporting units those assets and liabilities that are employed in multiple reporting units should be consistent and established in tandem with how the entity determines the reporting units' fair values. An entity normally should base its determination of a reporting unit's fair value on assumptions that **market participants** would use to estimate fair value. These assumptions include the likely structure of a sale of that reporting unit, and whether (and if so how) an asset employed in multiple reporting units would be included in the transaction. If the asset would not be included in the sale but its continued use would be necessary to maximise the value of the reporting unit, the cash flow projections used to estimate the fair value of the reporting unit may need to include a cash outflow representing the payment at fair value for the continued use of the asset (similar to a rental or usage fee). This would be the case even if the entity does not presently have intercompany charges for the usage across reporting units.

Conversely, if the asset is included in the reporting unit, it may be necessary to include cash inflows as payments at fair value from the entity's other reporting units that use the asset. The objective is to ensure that the approach to assigning assets and liabilities to reporting units is consistent with how the fair value of the reporting unit is determined. Otherwise, an entity may determine inappropriately that it has passed or failed step one of its goodwill impairment test.

Question 11-1

If a company has multiple reporting units, how should pension assets and liabilities be allocated to its reporting units?

PwC response

The objective is to ensure that the approach of assigning assets and liabilities to reporting units is consistent with how the fair value of the reporting unit would be determined. In making this assessment, it is necessary to understand the assumptions a market participant would make in determining the fair value of the reporting unit and whether it is likely that the pension asset or liability would be included in a transaction to sell the reporting unit. The allocation of pension expense to reporting units does not automatically mean that pension assets and liabilities should also be allocated to reporting units. For example, if a reporting unit participates in a multi-employer plan, pension expense would be allocated to the reporting unit; however, no pension asset or liability would be allocated to the reporting unit as a pension asset or liability would not transfer to an acquirer in a sale of the reporting unit.

Example 11-2 illustrates a method for assigning the carrying amount of an intangible asset employed in multiple reporting units.

EXAMPLE 11-2

Assignment of an intangible asset employed in multiple reporting units

An entity owns an acquired trade name that is used by several of its reporting units. The entity is determining the appropriate assignment of the trade name's recorded amount to the reporting units that use the name. The entity may not sell that trade name if the entity were to sell only one of the reporting units to a market participant. Rather, in exchange for a royalty on future product sales, the entity might grant an acquirer the right to continue using the trade name. The entity has determined that the assignment should be driven by the assumptions applied in establishing the fair value of the reporting units.

Analysis

It is likely that an estimate of the reporting unit's fair value would be based on the assumption that the trade name will be licensed to the acquirer instead of sold. Therefore, the entity generally would not assign to the reporting unit a portion of the trade name's carrying amount. Instead, a royalty at fair value would be imputed as a cash outflow of the reporting unit that uses the trade name for purposes of determining the reporting unit's fair value. Further, assuming the trade name is not a corporate asset but is assigned to another reporting unit, that reporting unit to which it is assigned would impute royalty income as a cash inflow from the reporting unit that is using the trade name.

In certain circumstances, depending on the facts, there may be other methods to performing this assignment, such as assigning based on the relative fair values of the reporting units or benefits received by the reporting units. In determining whether the carrying amount of an asset that is used in multiple reporting units should be assigned to one or more reporting units, an entity will need to evaluate the relevant facts and circumstances in light of how the fair values of its reporting units are being estimated.

11.3.2 Assigning corporate assets and liabilities

Assets and liabilities that an entity considers part of its corporate-level assets and liabilities should be assigned to a specific reporting unit if the criteria discussed in BCG 11.3 are met. When corporate-level assets and liabilities relate to several or all of the entity's reporting units, they are usually not assigned to specific reporting units. Pursuant to the guidance of ASC 350-20, not all assets and liabilities of an entity need to be assigned to specific reporting units. However, if corporate items are included and reflected in the fair value of a reporting unit, they may need to be assigned to that unit. This may include balances arising from pension plans, taxes, and general debt obligations. In instances where a reporting unit benefits from the corporate items, but such items are not assigned to the reporting unit, the determination of the reporting unit's fair value should consider the fair value of the use of the corporate-level assets and liabilities.

11.3.3 *Interaction between assigning assets and liabilities to reporting units and segment reporting*

An entity must include in its segment disclosures those assets that are included in the measure of a segment's assets, as used by the CODM [ASC 280-10-50-20 through 50-29]. ASC 350-20 does not affect ASC 280 and does not require that all of the assets that an entity assigns to reporting units for purposes of goodwill impairment testing be reflected in an entity's reported segment assets. Thus, an entity should report its segment assets in accordance with the guidance in ASC 280. In addition to ASC 280's segment disclosure requirements, however, an entity is required to disclose the carrying amount of goodwill for each of its reportable segments and a detailed reconciliation of the changes in those amounts for each period [ASC 350-20-50-1].

11.3.4 *"Full" allocation for entities with a single reporting unit*

Generally, an entity is not required to assign all of its assets and liabilities to its reporting units. However, for entities that are narrowly focused in their operations and that identify only one operating segment and one reporting unit, it is difficult to assert that any **corporate assets** or liabilities were not involved with the single reporting unit's operations. In that case, all of the entity's assets and liabilities would be included in that reporting unit for the purpose of goodwill impairment testing.

11.3.5 *Guidance for specific balance sheet components*

The following are some considerations in determining whether certain assets and liabilities should be assigned to a reporting unit based on whether (1) the asset will be employed in, or the liability relates to, the operations of a reporting unit, and (2) the asset or liability will be considered in determining the fair value of the reporting unit [ASC 350-20-35-39].

- **Working capital**: Companies generally include a working capital balance in the valuation of their reporting units. When comparing a reporting unit's carrying amount to its fair value, it is important to understand the working capital assumptions used in the fair value measurement to ensure they are consistent with the entity's assignment of working capital to the reporting unit when determining its carrying amount. Similarly, intercompany accounts may reflect the working capital of a reporting unit and need to be considered when determining the fair value and carrying amount of a reporting unit.

- **Cash/cash equivalents**: Entities may maintain cash that is not related to a specific reporting unit as a corporate asset. Generally, corporate-level cash would not be assigned or allocated to an entity's reporting units. On the other hand, an entity would assign cash to the related reporting unit if the entity considered the cash in determining the fair value of the unit. Because the carrying amount of cash and cash equivalents would be expected to approximate fair value, its assignment to reporting units generally would not have an impact on the goodwill impairment test, as long as it had been appropriately considered in the fair value of the reporting unit.

- **Investments**: Determining whether investments in debt and equity securities (including equity-method investments) should be assigned to and included in the carrying amount of reporting units may be challenging. Investments maintained at a corporate level generally would not be employed in the operations of a reporting unit and therefore would not be assigned to reporting units. In some cases, however, investments may be an integral part of the operations of a reporting unit. In those cases, if an entity demonstrates that its investments would likely be transferred to a market participant if the reporting unit were to be sold, it may be appropriate to assign investments to the reporting unit and consider them in determining the reporting unit's fair value.

- **Debt**: An entity should assign debt to the reporting unit if that debt relates directly to the operations of the unit and is likely to be transferred to a market participant if the reporting unit were to be sold. For example, debt issued to construct a manufacturing plant and secured by the plant would typically be assigned to the reporting unit that includes the plant because the debt is specific to the plant and would likely be assumed by an acquirer of the reporting unit. On the other hand, an entity would not typically assign general corporate debt to its reporting units. An entity should evaluate intercompany debt to determine if it should be treated in a manner similar to external debt.

- **Contingent consideration**: Determining whether a contingent consideration obligation or asset should be assigned to and included in the carrying amount of reporting units may be challenging. If the reporting unit is obligated to pay contingent consideration or the right to receive contingent consideration is held by the reporting unit, the contingent consideration generally would be assigned to that reporting unit. It would also be appropriate to include intercompany contingent consideration obligations or assets in a reporting unit's carrying amount if an acquiring market participant would assume that obligation or asset.

- **Deferred taxes other than for net operating losses (NOLs)**: The deferred taxes originating from **temporary differences** related to the reporting unit's assets and liabilities should be included in the carrying amount of the reporting unit, regardless of whether the fair value of the reporting unit is determined by assuming it would be sold in either a **taxable** or **nontaxable transaction** [ASC 350-20-35-7].

Question 11-2

If a company has a valuation allowance on deferred tax assets and files a consolidated tax return, should the valuation allowance be assigned to its reporting units in step one of the goodwill impairment test?

PwC response

If a company files a consolidated tax return and has established a valuation allowance against its deferred tax assets at the consolidated level, it should allocate the valuation allowance to each reporting unit based on the deferred tax assets and liabilities assigned to each reporting unit. It would not be appropriate for the company to evaluate each reporting unit on a "separate" return basis and thereby assess the need for a valuation allowance for each individual reporting unit.

- **Deferred taxes arising from NOLs**—ASC 350-20 does not address whether **deferred tax assets** arising from NOL and credit **carryforwards**, which are not related to particular assets or liabilities of a reporting unit, should be assigned to a reporting unit. However, entities should consider whether the fair value of the reporting unit reflects any benefit that may be received from the carryforwards. Usually, in a taxable transaction, the fair value of the reporting unit would not include a benefit from the preexisting carryforwards because a market participant acquirer would not be entitled to retain the predecessor entity's tax credit or NOL carryforwards. In such a case, deferred tax assets arising from the carryforwards would not be assigned to the reporting unit.

Examples 11-3 and 11-4 illustrate when deferred tax assets arising from NOLs would be assigned to reporting units.

EXAMPLE 11-3

Assignment of deferred tax assets arising from NOLs to a reporting unit

Assume that one of Company A's reporting units is a separate legal entity, Sub X. Sub X has generated NOL and tax credit carryforwards for which Company A has recognised deferred tax assets. No valuation allowance is deemed necessary because Sub X is expected to generate future taxable income sufficient to realise the carryforward benefits. Company A believes that it would be feasible to sell the shares of Sub X in a nontaxable transaction, which would allow the transfer of Sub X's NOL and tax credit carryforwards. In addition, Company A believes that market participants would base their estimates of the fair value of Sub X on a nontaxable transaction, and Company A has determined that it would receive the highest economic value if it were to sell Sub X in a nontaxable transaction.

Analysis

In this fact pattern, the deferred tax assets related to Sub X's NOL and tax credit carryforwards would meet the criteria in ASC 350-20-35-39 through 35-40 (i.e., the deferred tax assets will be employed in the operations of the reporting unit and considered in determining the fair value of the reporting unit). Therefore, the deferred tax assets should be included in the carrying amount of the reporting unit.

EXAMPLE 11-4

No assignment of deferred tax assets arising from NOLs to a reporting unit

Assume that Company B has NOL and tax credit carryforwards for which it has recognised deferred tax assets. Company B's NOL and tax credit carryforwards can only be used at the consolidated level because Company B's reporting units are not separate legal entities and none of those reporting units could be sold in a nontaxable transaction. Therefore, in determining the fair value of its reporting units, Company B assumes that its reporting units would be sold in taxable transactions that do not provide for the transfer of tax attributes, such as NOLs and tax credit carryforwards, to a market participant acquirer.

Analysis

In this fact pattern, Company B would not assign the deferred tax assets for the NOL and tax credit carryforwards to its reporting units because they do not meet the criteria in ASC 350-20-35-39 through 35-40.

- **Cumulative translation adjustments**—Under ASC 830, an entity records a cumulative translation adjustment (CTA) as part of its accumulated other comprehensive income when it translates the financial statements of a foreign **subsidiary** that has a functional currency that differs from the entity's reporting currency. When testing the goodwill of a reporting unit for impairment, the question arises as to whether the carrying value of the reporting unit should include the CTA associated with the reporting unit. We believe the carrying amount of the reporting unit should include assets and liabilities at their currently translated amounts (i.e., the balance of the net assets, excluding the amount recorded as CTA in equity).

Example 11-5 illustrates the consideration of CTA in reporting units.

EXAMPLE 11-5

Consideration of CTA in reporting units

Assume that a foreign subsidiary that is a reporting unit has the following balances after currency translation by its U.S. parent company (in millions):

	Dr/(Cr)
Total assets (including goodwill of CU300)	CU1,000
Total liabilities	(750)
Total net assets	CU250
Paid-in capital and retained earnings	CU(200)
Cumulative translation adjustment	(50)
Total equity	CU(250)

Analysis

The carrying amount of this reporting unit for purposes of step one of the goodwill impairment test would be CU250 million, which represents the net assets of the reporting unit at their currently translated amounts. For step two of the goodwill impairment test, the carrying amount of the reporting unit's goodwill would be at the translated amount of CU300 million, and the implied fair value of goodwill would be determined based on the reporting unit's fair value at the impairment testing date.

11.4 Assigning all recorded goodwill to one or more reporting units

Goodwill that is acquired in a business combination must be assigned to one or more reporting units as of the **acquisition date** [ASC 350-20-35-41]. Goodwill is assigned to the reporting units that are expected to benefit from the synergies of the business combination, regardless of whether other assets or liabilities of the acquired entity are also assigned to those reporting units. An entity's methodology for determining the amount of acquired goodwill to assign to a reporting unit should be reasonable, supportable, and applied in a consistent manner [ASC 350-20-35-41]. In addition, the methodology should be consistent with the objectives of the approaches described in ASC 350-20-35-42 to 43. ASC 350-20-42 to 43 describes two approaches an entity might follow when assigning goodwill to reporting units: an **acquisition method** approach and a "with and without" approach. The use of any approach to assigning goodwill is dependent on facts and circumstances.

In the simplest of acquisitions, a new reporting unit will be created in connection with an acquisition and the assets and liabilities of the acquired entity will be assigned to the new reporting unit. If no synergies with other existing reporting units are expected from the acquisition, all the goodwill arising from the acquisition would be assigned to the new reporting unit.

Many times, though, the specific assets and liabilities of an acquired entity will be assigned to one or more of the acquiring entity's existing reporting units and, perhaps, new reporting units that are created in connection with the acquisition. If the assets and liabilities that are assigned to reporting units constitute businesses, the goodwill arising from the acquisition may be assigned to the reporting units based on the excess of the fair values of the individual businesses acquired over the fair value of the sum of the individual assets acquired and liabilities assumed that are assigned to the reporting units. This is considered an acquisition method approach.

In some business combinations, synergies may be expected to be realised by existing reporting units that are not assigned any of the acquired assets or assumed liabilities. When synergies are expected in one or more of the entity's other reporting units, the entity may assign goodwill to the reporting units expecting to benefit from the synergies using a with-and-without approach. The with-and-without approach generally considers the fair value of the existing reporting unit before and after the acquisition in determining the amount of goodwill to assign to that reporting unit.

Examples 11-6 and 11-7 illustrate these two approaches for purposes of assigning goodwill to reporting units.

EXAMPLE 11-6

Acquisition method approach

Company X acquires Company Y for CU1,500. The fair value of the identifiable net assets acquired is CU1,000. Company X assigns the identifiable net assets of the acquired entity with fair values of CU200 and CU800 to new Reporting Units A and B, respectively. The net assets assigned represent businesses whose fair values are CU500 and CU1,000, respectively. No other reporting units are expected to benefit from acquisition-related synergies.

Analysis

Goodwill is assigned to Reporting Units A and B as follows:

	Reporting Unit A	Reporting Unit B	Total acquisition
Fair value of acquired businesses	CU500	CU1,000	CU1,500
Fair value of identifiable net assets assigned to reporting units (excluding goodwill)	(200)	(800)	(1,000)
Goodwill assigned	CU300	CU200	CU500

EXAMPLE 11-7

With-and-without approach

Company X acquires Company Y for CU1,500. The fair value of the identifiable net assets acquired is CU1,000. The acquiring entity includes the entire acquired business in a new reporting unit—Reporting Unit D. Although existing Reporting Unit C has not been assigned any of the acquired assets or assumed liabilities, the acquiring entity expects Reporting Unit C to benefit from synergies related to the acquisition (e.g., Reporting Unit C is expected to realise higher sales of its products because of access to the acquired entity's distribution channels).

Analysis

Goodwill is assigned to Reporting Units C and D as follows:

	Reporting Unit C	Reporting Unit D	Total acquisition
Fair value of acquired entity			CU1,500
Fair value of identifiable net assets (excluding goodwill)		CU1,000	(1,000)
Fair value of unit C with acquisition	CU2,000		
Fair value of unit C without acquisition	(1,900)		
Goodwill assigned	CU100	CU400	CU500

The application of this approach must reflect a reasonable assignment among the reporting units.

Although it is expected that most entities will use one of the approaches noted above to assign goodwill upon an acquisition, an entity may also employ other methods when assigning goodwill to its reporting units, provided that the allocation methodology is reasonable, supportable, and does not result in the immediate impairment of goodwill. See BCG 11.5.6.3 for further information. Further, an entity's chosen methodology should be consistent with the basis for and method of determining the purchase price of an acquired entity and any synergies that management expects from the acquisition.

11.4.1 Determination and recognition of goodwill in partial acquisitions

Goodwill is the residual element in a business combination and cannot, by itself, be determined and measured. In the acquisition of 100 percent of a business, goodwill results from comparing the fair value of the consideration transferred for the acquired business with the aggregate amounts assigned to the acquired identifiable net assets. In acquisitions of a **controlling interest** but less than all of the ownership interests in the entity (**partial acquisitions**), ASC 805 requires that the acquired net assets be recognised at their fair value, regardless of the ownership percentage acquired. Goodwill is then determined as the aggregate fair value of (1) the consideration transferred, (2) the noncontrolling interest, and (3) in a **step acquisition**, the previously held **equity interest** less the recognised amount of the identifiable net assets of the acquired entity measured based on the acquisition method guidance of ASC 805.

Example 11-8 illustrates the full goodwill recognition method for partial acquisitions prescribed in ASC 805.

EXAMPLE 11-8

Goodwill in a partial acquisition

Company A obtains control of Company B by purchasing 80 percent of the equity interests in Company B for total consideration of CU800 million. The net aggregate value of Company B's identifiable assets and liabilities measured in accordance with ASC 805 is determined to be CU700 million, and the fair value of the noncontrolling interest is determined to be CU200 million.

Analysis

The acquirer recognises at the acquisition date (1) 100 percent of the identifiable net assets, (2) the noncontrolling interest at fair value, and (3) goodwill measured as the excess of (a) over (b) below:

a. The aggregate of (1) the consideration transferred measured in accordance with ASC 805, which generally requires acquisition-date fair value; (2) the fair value of any noncontrolling interest in the acquiree; and (3) in a business combination achieved in stages, the acquisition-date fair value of the acquirer's previously held equity interest in the acquire

b. The net of the acquisition date amounts of the identifiable net assets acquired, measured in accordance with ASC 805 (in millions):

Fair value of the consideration transferred	CU800
Fair value of the noncontrolling interest	200[1]
Fair value of previously held equity interest	n/a
Subtotal (a)	1,000
Fair value of 100% of the identifiable net assets (b)	(700)[2]
Goodwill recognised (a – b)	CU300[3]

[1] As more fully described in BCG 6.4.4 and BCG 7, the fair value of the noncontrolling interest may not merely be an extrapolation of the consideration transferred for the controlling interest; therefore, the fair value of the noncontrolling interest may have to be independently measured.

[2] The value of 100 percent of the identifiable net assets of Company B measured in accordance with ASC 805.

[3] The full amount of goodwill is recognised.

n/a—not applicable in this example, as this is not a step acquisition.

11.4.2 *Goodwill attributable to controlling and noncontrolling interests*

In partial acquisitions, goodwill is recognised for the controlling and the noncontrolling interests. Any future impairment loss will need to be attributed to the controlling and the noncontrolling interests on a rational basis [ASC 350-20-35-57A]. See BCG 11.5.9.1 through 11.5.9.2 for examples of acceptable methods of attributing any impairment loss.

Example 11-9 continues the previous Example 11-8 and illustrates a rational method of attributing goodwill to the controlling and noncontrolling interests for purposes of allocating a goodwill impairment loss. See BCG 11.5.9.1 for further information.

EXAMPLE 11-9

Goodwill attributable to controlling and noncontrolling interests

Continuing with Example 11-7, the total goodwill of CU300 million would be attributed as follows (in millions):

Fair value of the noncontrolling interest	CU200
Noncontrolling interest's share of the recognised net assets	(140)[1]
Goodwill attributable to the noncontrolling interest	CU60
Fair value of the consideration transferred	CU800
Controlling interest's share of the recognised net assets	(560)[2]
Goodwill attributable to the controlling interest	CU240

[1] The noncontrolling interest's share of the recognised net assets acquired represents the noncontrolling ownership interest multiplied by the acquisition-date amounts of the net assets acquired, measured in accordance with ASC 805 (20% x CU700).

[2] The controlling interest's share of the recognised net assets acquired represents its ownership interest multiplied by the acquisition-date amounts of the net assets acquired, measured in accordance with ASC 805 (80% x CU700).

11.4.3 *Determination of fair value for the noncontrolling interest*

While the fair value of the ownership interest acquired by the acquirer may be determined based on the consideration transferred, the determination of the fair value of the noncontrolling interest in transactions when less than all the outstanding ownership interests are acquired may present certain challenges to the acquirer. The consideration transferred for the controlling interest may provide an indication of the fair value of the noncontrolling interest; however, an acquirer will need to consider factors that might cause this not to be the case. For example, an acquirer will need to consider the impact of any **control premium** that may be included in the amounts transferred for the controlling interest or further synergies that may be achievable in obtaining **control**. In some situations, the fair value of the noncontrolling interest may need to be established through other valuation techniques and methods. See BCG 6.4.4 and BCG 7.8 for further information on these techniques and methods.

11.4.4 Reassignment of goodwill as an acquirer's reporting structure changes

As an entity's operations evolve over time (through acquisitions, disposals, and/or reorganisations), the entity will be required to track its reporting units' goodwill, as well as the reporting units' other assets and liabilities, to facilitate goodwill impairment testing.

When an entity reorganises its reporting structure in a manner that changes the composition of one or more of its reporting units, the entity should first reassign assets and liabilities (excluding goodwill) to the reporting units affected. Goodwill should then be reassigned to the affected reporting units by using a relative fair value approach that is similar to the approach that an entity would use when a portion of a reporting unit is to be disposed of [ASC 350-20-35-45]. See BCG 11.6 for further information. As a result, the amount of goodwill that is allocated to each reporting unit is determined based on the relative fair values of (1) the elements transferred and (2) the elements remaining within the original reporting unit(s).

Events affecting a reporting unit, such as a change in the composition or carrying amount of its net assets due to a reorganization, may trigger the need to perform a goodwill impairment test. An entity should establish that a change in composition of net assets or reorganisation did not otherwise prevent recognition of an impairment that existed prior to the change or reorganisation. It would not be appropriate for an entity to reorganise its reporting structure simply to avoid an impairment charge. Examples 11-10 and 11-11 illustrate the reassignment of goodwill.

EXAMPLE 11-10

Basic principle of goodwill reassignment

Company X transfers a portion of Reporting Unit A's operations into two newly formed reporting units, B and C, in connection with a corporate restructuring. The fair value of the transferred operations was determined to be CU50 million, with CU20 million assigned to the operations transferred to Reporting Unit B and CU30 million to operations associated with Reporting Unit C. The fair value of the remaining elements in Reporting Unit A is CU150 million. Total goodwill assigned to Reporting Unit A before the restructuring was CU40 million.

Analysis

The goodwill reassignment would be as follows (CUs in millions):

	Reporting Unit A	Reporting Unit B	Reporting Unit C	Total
Fair values	CU150	CU20	CU30	CU200
Relative fair value	75%	10%	15%	100%
Goodwill	CU30	CU4	CU6	CU40

EXAMPLE 11-11

Reassignment of goodwill when reporting structure changes

Company Z has 2 reporting units, Reporting Unit 1 and Reporting Unit 2, with goodwill of CU1 million and CU2 million, respectively. Company Z reorganises its business and creates a new reporting structure. As a consequence, operations in Reporting Unit 1 are transferred into 4 newly created reporting units (Reporting Unit A, Reporting Unit B, Reporting Unit C, and Reporting Unit D). A small portion of operations in Reporting Unit 2 are transferred to Reporting Unit D and the remainder of Reporting Unit 2 is renamed Reporting Unit E. The relative fair values of the operations transferred due to the restructuring are as follows:

New Reporting Units	A	B	C	D	E
Relative fair value transferred from reporting unit 1	40%	40%	15%	5%	
Relative fair value transferred from reporting unit 2				10%	90%

Analysis

As a result of the change in the composition of its reporting structure, Company Z is required to reassign its goodwill using a relative fair value approach that is similar to the approach an entity would use when a portion of a reporting unit is to be disposed of (see ASC 350-20-35-45).

In accordance with the guidance in ASC 350, Company Z should first reassign assets and liabilities (excluding goodwill) from legacy reporting units, Reporting Unit 1 and Reporting Unit 2, to the new reporting units. Then, goodwill should be reassigned to the new reporting units using the relative fair value approach. Therefore, the amount of goodwill that is allocated to each new reporting unit is determined based on the relative fair values in the legacy reporting units of (1) the elements transferred and (2) the elements remaining within the original reporting unit(s). The goodwill of each reorganised reporting unit should be separately reallocated to the new reporting units (i.e., goodwill should not be aggregated for each reorganised reporting unit before the reallocation).

In this case, CU1 million of goodwill from Reporting Unit 1 should be reallocated to Reporting Units A, B, C, and D based on the relative fair value of operations transferred from Reporting Unit 1 (i.e. 40%, 40%, 15%, and 5%, respectively). CU 2 million of goodwill from Reporting Unit 2 should be allocated to Reporting Unit D and Reporting Unit E based on relative fair values of 10% and 90%, respectively.

New Reporting Units	A	B	C	D	E	Total
Goodwill reallocation of Reporting Unit 1	400,000	400,000	150,000	50,000		1,000,000
Goodwill reallocation of Reporting Unit 2				200,000	1,800,000	2,000,000
Total	400,000	400,000	150,000	250,000	1,800,000	3,000,000

When reporting units are reorganised subsequent to the period-end, but prior to the issuance of the financial statements, the reporting structure in place at period-end should be used to perform goodwill impairment testing.

11.4.5 *Translation of goodwill denominated in a foreign currency*

Acquisition accounting adjustments attributable to a foreign entity, but recorded in the **parent's** accounting records, need to be considered in the translation process as if those adjustments were pushed down and recorded at the foreign entity level.

Example 11-12 illustrates the translation of goodwill assigned to a foreign entity.

EXAMPLE 11-12

Translation of goodwill assigned to a foreign entity

During the period, Company A acquired Business X in Europe, whose functional currency is the Euro. On the acquisition date, goodwill was determined to be t100 million, which was the equivalent of CU150 million, and was recorded at the parent level and not pushed down to Business X's general ledger. At period-end, the t/CU exchange rate is 1.25 (1t for 1.25CU).

Analysis

In translating Business X's assets and liabilities at period-end for the purpose of preparing Company A's consolidated financial statements, the t100 million goodwill determined at the acquisition date would be recorded as CU125 million with a corresponding charge to other comprehensive income of CU25 million.

After goodwill assigned to foreign entities is translated to the reporting currency, any associated changes in the goodwill balance should be assigned to the reporting units where the respective goodwill resides.

Example 11-13 illustrates an acceptable method to assign a change in goodwill due to foreign exchange effects.

EXAMPLE 11-13

Change in goodwill due to foreign exchange effects

Assume from Example 11-10 that Company A assigned Business X to Reporting Unit 1 but determined that t20 million of its goodwill was synergistic to Reporting Unit 2 and, accordingly, assigned t80 million to Reporting Unit 1, and t20 million to Reporting Unit 2 at the acquisition date. Both reporting units reside in Europe and have the Euro as their functional currency.

Analysis

The CU25 million decrease in goodwill resulting from foreign currency translation as determined in Example 11-10 would be assigned to the reporting units, CU20 million (CU25 x t80 / (t20 + t80)) to Reporting Unit 1 and CU5 million (CU25 x t20 / (t20 + t80)) to Reporting Unit 2.

11.4.6 *Documentation to support goodwill assignment*

ASC 350-20-35-41 requires that the methodology used to determine the assignment of goodwill to a reporting unit be reasonable, supportable, and applied in a consistent manner. ASC 350-20-35-40 addresses how an entity should consider assigning assets used in multiple reporting units to its reporting units. ASC 350-20-35-40 also requires that the basis for and method of determining the fair value of an acquiree and other related factors (such as the underlying reasons for the acquisition and management's expectations related to dilution, synergies, and other financial measurements) be documented at the acquisition date.

11.4.7 *Other considerations*

Two items that may impact the amount of recorded goodwill assigned to one or more reporting units include (1) subsequent changes in assets and liabilities recognised from acquisitions completed prior to the adoption of ASC 805 that may continue to impact goodwill and (2) the impact of litigation stemming from a business combination.

11.4.7.1 *Subsequent resolution of certain matters arising from acquisitions recorded prior to the adoption of ASC 805 that may continue to impact goodwill*

The accounting for changes in assets and liabilities that arose from business combinations consummated prior to the adoption of ASC 805 is not specifically addressed in ASC 805, except for income tax uncertainties and reductions in the valuation allowance recognised at the acquisition date for deferred tax assets, which are recognised through the income statement even if related to an acquisition consummated prior to the adoption of ASC 805. See BCG 5 for further information. The accounting for the resolution of certain matters arising from acquisitions recorded prior to the adoption of ASC 805 is summarised below.

Resolution of contingent consideration

Under ASC 805, resolution of a contingent consideration arrangement in an amount different from that recorded at the acquisition date will be reflected in earnings or within equity if the arrangement is equity classified. See BCG 2.6.4.1 for further information. However, the resolution of a contingent consideration arrangement for business combinations accounted for under prior standards will generally be recorded as additional goodwill subsequent to the adoption of ASC 805.

Liabilities for exit activities

Previously, liabilities for exit activities planned in connection with a business combination could be established as an additional cost of the acquisition under EITF 95-3, *Recognition of Liabilities in Connection with a Purchase Business Combination* (EITF 95-3), if certain conditions were met. Subsequent reductions of such liabilities when the original estimate of the liability exceeded the ultimate cost expended were usually recorded as an adjustment to goodwill, irrespective of when the adjustment was made. Conversely, subsequent increases to the original estimate of such liabilities were generally recorded in earnings.

ASC 805 eliminated this guidance and companies must now account for any exit activities, including those arising in connection with a business combination, using the guidance in ASC 420, which addresses the recognition and measurement of accruals for exit activities. For business combinations, exit activities stemming from the acquisition should be recorded through earnings in accordance with ASC 420. However, liabilities previously established under EITF 95-3 will not be eliminated upon the adoption of ASC 805, and the subsequent accounting for the difference, if any, between the ultimate cost of the exit plan and the original amount recorded as a liability will not change (i.e., reductions are recorded against goodwill and increases are generally recorded in earnings).

Tax benefits of nonqualified share-based payment awards

As more fully described in BCG 3 and FSP 17, entities were not permitted to recognise deferred tax assets at the acquisition date for replacement share-based payment awards prior to the adoption of ASC 805. Instead, any tax deduction resulting from the exercise of an award was recognised as an adjustment to the cost of the acquisition (i.e., usually as a reduction of goodwill) to the extent of the fair value of the award recognised at the acquisition date.

Under ASC 805, a deferred tax asset is recorded at the acquisition date related to the tax benefit derived from recording the fair value of nonqualified share-based payment awards (i.e., awards that would typically result in a tax deduction) that are issued as part of the consideration transferred for the acquiree. If the tax deduction received by the acquirer upon the exercise of stock options or vesting of restricted shares is greater than the sum of the fair value of the award added to the purchase price plus the cumulative book compensation cost recorded by the acquirer, the tax benefit related to the excess tax deduction (i.e., windfall) should be recorded as an adjustment to additional paid-in capital. If the tax deduction received by the acquirer upon exercise of stock options or vesting of restricted shares is less than the sum of the fair value of the award added to the purchase price plus the cumulative book compensation cost recorded by the acquirer, the resulting difference (i.e., shortfall) should be charged first to additional paid-in capital, to the extent of the acquirer's pool of windfall benefits. Any remaining shortfall would be recognised in income tax expense. Windfalls and shortfalls generated from **replacement awards** would impact the acquirer's pool of windfall tax benefits as determined in accordance with ASC 718.

As a result, with the adoption of ASC 805, adjustments are no longer made to goodwill for the subsequent income tax effects of replacement awards issued in an acquisition recorded under ASC 805. However, the realisation of tax benefits for replacement awards issued for acquisitions recorded prior to the adoption of ASC 805 will continue to be recognised based on previous practice, which in most cases is through goodwill by analogy to EITF 00-23, *Issues Related to the Accounting for Stock Compensation under APB Opinion No. 25 and FASB Interpretation No. 44* (EITF 00-23), Issue 29.

11.4.7.2 Litigation stemming from a business combination

Generally, any economic consequences of legal claims between the acquirer and the former **owners** of the acquiree in a business combination should be reflected in earnings of the acquirer in the postcombination period.

The SEC indicated in a speech by one of their staff members that the settlement of litigation regarding the acquisition price should only be accounted for as an adjustment to the initial acquisition accounting in situations where there is a clear and direct link between the litigation and the acquisition price. For example, litigation initiated by the acquirer seeking the enforcement of escrow or escrow-like arrangements, such as those that specify the requirement of a minimum amount of working capital as of the closing date in an acquired business, may establish a clear and direct link to the acquisition price. In contrast, litigation between the acquirer and the acquiree asserting that one party misled the other party as to the value of the acquiree or that a provision of the acquisition agreement is unclear is not the type of litigation that establishes a clear and direct link to the acquisition price, and therefore, its settlement is generally reflected in current earnings.

11.5 Impairment model

Goodwill is considered impaired when its carrying amount exceeds its implied fair value. An entity may first assess qualitative factors to determine whether it is necessary to perform the two-step goodwill impairment test. If determined to be necessary, the two-step impairment test should be used to identify a potential impairment and measure an impairment loss, if any. An impairment of goodwill can be recognised only if the carrying amount of a reporting unit exceeds its fair value under the first step of the two-step approach, with the exception of reporting units with zero or negative carrying amounts, for which a step two test should be performed if it is more likely than not that the goodwill is impaired. See BCG 11.5.3 for further information on the qualitative assessment.

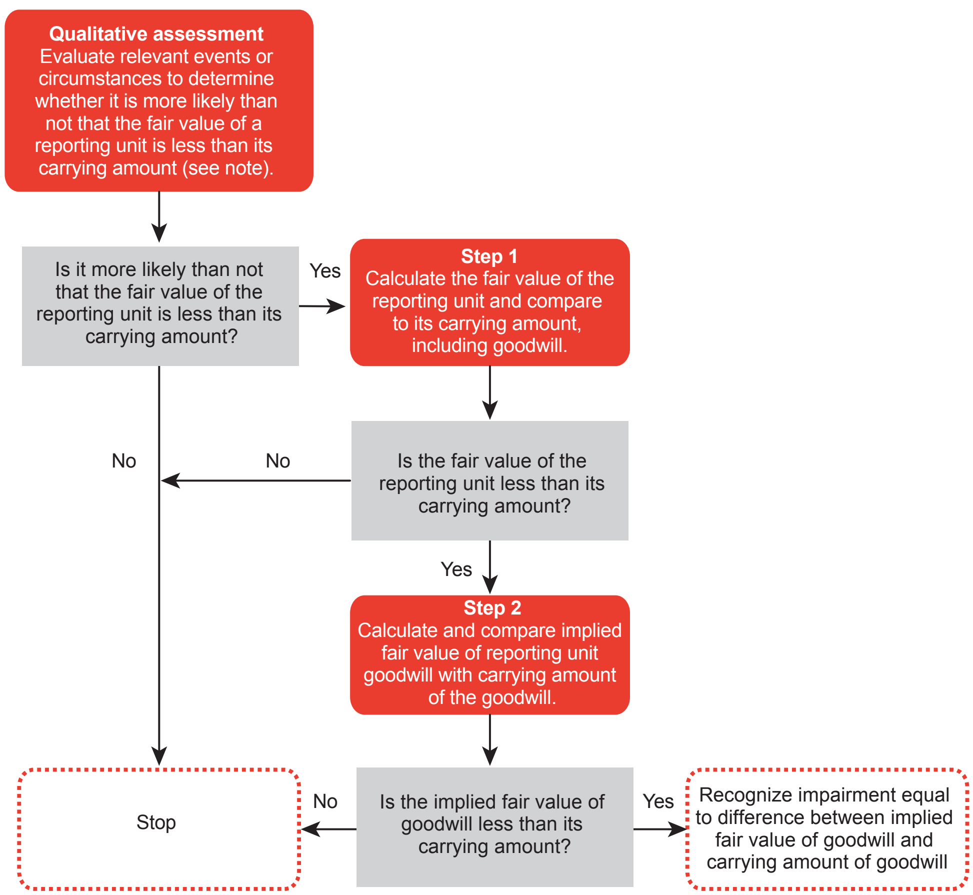
11.5.1 *The goodwill impairment test*

The goodwill impairment standard provides entities with the option to perform a qualitative assessment to determine whether the two-step impairment test is necessary. The two-step impairment test is required only if the entity concludes that it is more likely than not that a reporting unit's fair value is less than its carrying amount (that is, a likelihood of more than 50 percent). Otherwise, no further impairment testing is required. An entity can choose to perform the qualitative assessment on none, some, or all of its reporting units. Moreover, an entity can bypass the qualitative assessment for any reporting unit in any period and proceed directly to step one of the impairment test and then perform the qualitative assessment in any subsequent period.

Figure 11-3 illustrates a decision flow chart for the goodwill impairment test.

Figure 11-3
Goodwill impairment test decision flow chart

The following decision flow chart illustrates the application of the basic goodwill impairment test.



Note: An entity has the unconditional option to skip the qualitative assessment and proceed directly to performing step one, except in the circumstance where a reporting unit has a carrying amount that is zero or negative. An entity having a reporting unit with a carrying amount that is zero or negative would proceed directly to step two if it determines, as a result of performing its required qualitative assessment, that it is more likely than not that a goodwill impairment exists. To perform step two, an entity must calculate the fair value of a reporting unit.

11.5.1.1 The qualitative goodwill impairment assessment

The following section applies to reporting units with a positive carrying amount. See BCG 11.5.3 for guidance regarding impairment testing of reporting units with zero or negative carrying amounts.

The carrying amount of a reporting unit's goodwill should be tested for impairment at least on an annual basis and in between annual tests in certain circumstances. An entity is permitted to first assess qualitatively whether it is necessary to perform the two-step goodwill impairment test. The two-step impairment test is required only if the entity concludes that it is more likely than not that a reporting unit's fair value is less than its carrying amount. In evaluating whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount, an entity should consider the totality of all relevant events or circumstances that affect the fair value or carrying amount of a reporting unit. Examples of such events and circumstances include:

- **Macroeconomic conditions** such as a deterioration in general economic conditions, limitations on accessing capital, fluctuations in foreign exchange rates, or other developments in equity and credit markets

- **Industry and market considerations** such as a deterioration in the environment in which an entity operates, an increased competitive environment, a decline in market-dependent multiples or metrics (consider in both absolute terms and relative to peers), a change in the market for an entity's products or services, or a regulatory or political development

- **Cost factors** such as increases in raw materials, labor, or other costs that have a negative effect on earnings and cash flows

- **Overall financial performance** such as negative or declining cash flows or a decline in actual or planned revenue or earnings compared with actual and projected results of relevant prior periods

- **Other relevant entity-specific events** such as changes in management, key personnel, strategy, or customers; contemplation of bankruptcy; or litigation

- **Events affecting a reporting unit** such as a change in the composition or carrying amount of its net assets, a more likely than not expectation of selling or disposing all, or a portion, of a reporting unit, the testing for recoverability of a significant asset group within a reporting unit, or recognition of a goodwill impairment loss in the financial statements of a subsidiary that is a component of a reporting unit

- **Share price.** If applicable, a sustained decrease in share price—share price decreases should be considered not only in absolute terms but also relative to peers

These examples are not all-inclusive. An entity should consider other relevant events or circumstances specific to its reporting units when determining whether to perform step one of the impairment test. For example, the AICPA Accounting and Valuation Guide – *Testing Goodwill for Impairment* ("AICPA Goodwill Guide") provides additional examples of events that may require consideration such as (1) market reaction to a new product or service, (2) technological obsolescence, (3) a significant legal development, (4) contemplation of a bankruptcy proceeding or (5) an expectation of a change in the risk factors or risk environment influencing the assumptions used to calculate the fair value of a reporting unit, such as discount rates or market multiples.

During the assessment, an entity should consider each adverse factor as well as the existence of any positive and mitigating events and circumstances, including the difference between a reporting unit's fair value and carrying amount if determined in a recent fair value calculation ("cushion").

Entities should give more weight to those events and circumstances that impact most significantly a reporting unit's fair value or carrying amount. Some events and circumstances will affect most, if not all, reporting units. For example, many entities likely will determine that it is necessary to perform step one of the impairment test in an unfavorable economic environment. However, the relative importance of the various factors will be different for each reporting unit.

None of the individual examples summarised above are intended to represent standalone triggering events that would require an entity to perform step one of the goodwill impairment test. Similarly, the existence of positive and mitigating events and circumstances would not represent a rebuttable presumption that an entity does not need to perform step one of the goodwill impairment test.

If, after assessing the totality of events or circumstances such as those described above, an entity determines that it is more likely than not that the fair value of a reporting unit is less than its carrying amount, then the two-step goodwill impairment test is used to identify potential goodwill impairment and measure an impairment loss, if any. If the entity determines that it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, no further impairment testing is necessary. Example 11-14 illustrates the application of the qualitative goodwill impairment assessment by a company with two reporting units.

EXAMPLE 11-14

Qualitative assessment by a company with two reporting units

Company A has two reporting units: Reporting Unit X and Reporting Unit Y. The most recent annual step one impairment test, completed one year ago, resulted in a 40% cushion (i.e., fair value exceeded carrying amount by 40%) for Reporting Unit X and a 10% cushion for Reporting Unit Y. During the current year, macroeconomic trends have improved and the markets in which Reporting Units X and Y operate have remained stable. Company A has experienced increased access to capital at lower rates and market capitalisation has trended higher. Analysts reported a positive outlook for Company A. While there was limited deal activity in the industry, the deals that were completed had multiples consistent with the multiples used by Company A in the valuation of its reporting units in the prior year. Demand has grown for Reporting Unit X's products as evidenced by a better-than-expected increase in revenue, lower costs, and higher profit margins, resulting in Reporting Unit X's operating results exceeding budget. Demand for Reporting Unit Y's products, on the other hand, has been soft due to intense competition. As a result, Reporting Unit Y's revenue and profit margins were flat as compared to prior year, but below budget. Lastly, Company A had no change in management.

Analysis

Company A will need to broadly consider the positive, neutral, and adverse factors impacting the fair value of Reporting Unit X and Reporting Unit Y and will need to assess the weighting of each consideration in determining whether it will perform a qualitative assessment and, if a qualitative assessment is performed, whether the factors indicate it is more likely than not that the fair value of each reporting unit is less than its carrying value. These factors will likely include both quantitative and qualitative considerations.

In this fact pattern, Company A would likely perform a qualitative assessment for Reporting Unit X. The starting cushion of 40%, positive macroeconomic and market indicators, and the current year results exceeding budget indicate that the entity's management may be able to conclude, absent other significant negative information, that it is more likely than not that the fair value of Reporting Unit X exceeds its carrying value.

In contrast, Company A would likely proceed directly to step one for Reporting Unit Y. The lack of significant beginning cushion combined with the adverse impact of intense competition on revenue and profit margins makes it more difficult for Company A to conclude, solely using a qualitative assessment, that no further impairment testing is necessary. Small changes in the assumptions or inputs that could impact the valuation of Reporting Unit Y would likely not allow management to conclude, based solely on a qualitative assessment, that it is more likely than not that the fair value of Reporting Unit Y exceeds its carrying value.

11.5.1.2 Selecting reporting units for the qualitative assessment

An entity can choose to perform the qualitative assessment on none, some, or all of its reporting units. Moreover, an entity can bypass the qualitative assessment for any reporting unit in any period and proceed directly to step one of the impairment test, and then perform the qualitative assessment in any subsequent period. The selection of reporting units on which to perform the qualitative assessment is not an accounting policy decision that needs to be followed consistently every period. Therefore, an entity should tailor its use of the qualitative assessment based on specific facts and circumstances for each reporting unit.

Use of the qualitative assessment may be appropriate in many, but not all, situations. A qualitative assessment alone may not be sufficient to support a more likely than not assertion when certain adverse factors are present. In other cases, the qualitative assessment may not be cost effective compared to performing step one of the impairment test. If an initial review of the facts and circumstances suggests it will require an extensive qualitative assessment and there remains a strong possibility that step one may still need to be performed, an entity may conclude it will be more efficient to begin with a step one test. An entity that already has an efficient and robust process in place for determining the fair value of its reporting units may prefer to bypass the qualitative assessment and proceed directly to step one of the two-step goodwill impairment test rather than implement additional processes and internal controls for performing the qualitative assessment. Also, if a significant amount of time has elapsed since the last step one test, an entity may elect to perform a step one test as a means of refreshing its understanding of the extent of cushion between a reporting unit's fair value and carrying amount.

The qualitative assessment will be most appropriate when there is significant cushion based on a recent fair value measurement and no significant adverse changes have since occurred. Conversely, a qualitative assessment alone may not be effective or efficient if the cushion indicated by the most recent fair value measurement is not significant. This is the case, for example, when a reporting unit has recently been acquired or reorganised, or its goodwill recently impaired. The lack of cushion in these circumstances would cause the ability of this reporting unit to pass step one to be highly sensitive to adverse changes in both entity-specific factors such as actual and forecasted cash flows and non entity-specific factors such as discount rates and market multiples.

11.5.1.3 Considering the results of prior fair value measurements in the qualitative assessment

The amount of cushion, if any, between the fair value and the carrying amount of the reporting unit from a prior fair value measurement is a critical factor in the qualitative assessment. However, an entity should not look solely at the amount of cushion from a recent fair value measurement to determine whether to perform a qualitative assessment. An entity must first determine whether the assumptions and projections underlying the previous fair value measurement are still reasonable in the current period. For example, an entity's actual results for the current year combined with updated current forecasts may differ from the entity's prior year forecasts used in a discounted cash flow valuation model. The significance of the differences may indicate that the projections used for the last fair value calculation were too aggressive and that less weight should be given to the apparent cushion from the prior valuation. Conversely, more weight would likely be given to a prior cushion when actual results are consistent with or more favorable to the reporting unit's fair value than prior projections.

Question 11-3

How much cushion between a reporting unit's fair value and its carrying amount is required to allow an entity to start with a qualitative assessment of goodwill impairment rather than a step one impairment test?

PwC response

There are no bright lines. The test is qualitative and should consider all facts and circumstances impacting the comparison of a reporting unit's fair value to its carrying amount, including the length of time elapsed since the last fair value calculation and the impact of adverse qualitative factors. All else being equal, a reporting unit with a significant cushion is more likely to allow an entity to start with a qualitative assessment than a reporting unit with little to no cushion.

11.5.1.4 Periodically refreshing a reporting unit's fair value

Entities should consider periodically "refreshing" a reporting unit's fair value calculation. The more time that has elapsed since a recent fair value calculation, the more difficult it may be to support a conclusion based solely on a qualitative assessment. The frequency with which an entity refreshes its fair value calculation for a reporting unit will depend on a variety of factors, including how much cushion existed at the last fair value calculation, the reporting unit's financial performance, the current operating environment, the current market environment for similar entities, and any significant changes in the composition of the reporting unit. If an entity chooses not to refresh and determines that it will continue to apply the qualitative test, the entity may need to lessen the amount of weight it would place on the previous fair value calculation in its qualitative assessment.

Question 11-4

How many years can an entity use a previously-measured fair value of a reporting unit as a basis for assessing the extent of cushion between a reporting unit's fair value and its carrying amount?

PwC response

There are no bright lines. A determination of the appropriate length of time between quantitative measurements of the fair value of a reporting unit is a matter of judgment. Some entities may choose to establish policies requiring reporting unit fair values to be reassessed periodically. Even with such a policy, an entity may still need to determine a reporting unit's fair value more frequently than the policy requires if events and circumstances indicate a step one impairment test is appropriate.

11.5.1.5 An entity's assertion of its annual qualitative assessment

An entity should make a positive assertion about its conclusion reached and factors considered if it determines as part of its annual qualitative assessment that the two-step test is unnecessary. Therefore, while the level of documentation will vary based on facts and circumstances specific to each reporting unit, an entity should clearly document the conclusion reached and factors considered in an annual test.

Question 11-5

What processes would an entity be expected to have in place if it wishes to support its conclusion reached based on application of a qualitative assessment?

PwC response

An entity should make a positive assertion about its conclusion reached and the events and circumstances taken into consideration in performing a qualitative assessment. Therefore, in most cases, a robust process with supporting documentation will be needed to support an entity's conclusion that the two-step goodwill impairment testing is not necessary.

Generally, entities that use the qualitative assessment should have in place a comprehensive process to:

- Determine which factors are the key drivers of each reporting unit's fair value and monitor changes in those factors
- Identify the internal and external sources of information needed to monitor the relevant factors for each reporting unit; consider whether analyst and other external information is consistent with the entity's assessment of events and circumstances that could impact the reporting unit's fair value
- Consider the amount of "cushion" from the most recent fair value calculation and evaluate the financial performance of the reporting unit since that analysis
- Monitor changes in other market-based metrics that could impact significantly the fair value of the reporting unit, including items such as the long-term discount rate and market multiples for companies in the reporting unit's peer group
- Evaluate and weigh the impact of adverse and mitigating factors based on the extent those factors impact the comparison between fair value and carrying amount
- Consider if, and how frequently, a step one analysis should be performed for the purpose of "refreshing" the baseline valuation
- Affirmatively consider and document the qualitative assessment that includes consideration of the factors identified from the entity's process and the basis for its conclusion; generally, the greater the extent of analysis needed to assert that no further testing is necessary, the greater the extent of documentation that should be prepared

11.5.2 The two-step goodwill impairment test

If an entity bypasses the qualitative assessment or determines based on its qualitative assessment that further testing is required, the two-step goodwill impairment test should be followed. Step one of the goodwill impairment test entails identifying a potential impairment of goodwill, while step two entails measuring the amount of impairment, if any. The two steps of the goodwill impairment test are described below.

Step one: Compares the fair value of the reporting unit with the reporting unit's carrying amount (book value), including goodwill, to identify any potential impairment. The book value in step one is the reporting unit's carrying amount after all of the reporting unit's other assets (excluding goodwill) have been adjusted for impairment, if necessary, under other applicable GAAP. Note that this assumes the reporting unit is not a disposal group or part of a disposal group under ASC 360. See BCG 11.6.1 for further information.

- If the fair value of the reporting unit is greater than its carrying amount, the reporting unit's goodwill is considered not impaired, and step two is not performed.
- If the carrying amount of the reporting unit is greater than its fair value, the reporting unit's goodwill may be impaired, and step two must be completed to measure the amount of the goodwill impairment loss, if any, that may exist.

Step two: Compares the implied fair value of the reporting unit's goodwill with the carrying amount of the reporting unit's goodwill.

If the carrying amount of the reporting unit's goodwill is greater than the implied fair value of the reporting unit's goodwill, an impairment loss must be recognised for the excess (i.e., recorded goodwill must be written down to the implied fair value of the reporting unit's goodwill).

After a goodwill impairment loss for a reporting unit is measured and recognised, the adjusted carrying amount of the reporting unit's goodwill becomes the new accounting basis for that goodwill. A subsequent reversal of previously recognised goodwill impairment losses is prohibited once the measurement of that impairment loss is recognised [ASC 350-20-35-4 through 35-19].

Figure 11-4 provides a basic example of the goodwill impairment test.

Figure 11-4
Basic goodwill impairment test

The following illustrates the application of the basic two-step goodwill impairment test approach to two hypothetical Reporting Units A and B (in millions):

Step one:	Reporting Unit A	Reporting Unit B
Fair value of reporting unit	CU1,000	CU500
Carrying amount of reporting unit (including CU200 goodwill each for A and B)	600	600
Difference	CU400	CU(100)
	Passed	Failed

Step two:	Reporting Unit A	Reporting Unit B
Fair value of reporting unit	n/a	CU500
Fair value of reporting unit's identifiable assets and liabilities determined in accordance with ASC 805		(425)
Implied fair value of goodwill		75
Carrying amount of reporting unit's goodwill		200
Goodwill impairment loss		CU(125)

n/a—not applicable in this example, as Reporting Unit A passed step one.

11.5.3 *Qualitative assessment for reporting units with zero or negative carrying amounts*

Like all reporting units, reporting units with zero or negative carrying amounts should be tested for impairment at least annually and, in certain circumstances, between annual tests. For these reporting units, an entity is required to qualitatively assess whether it is more likely than not that a goodwill impairment exists. If it is more likely than not that a goodwill impairment exists the second step of the goodwill impairment test should be performed to measure the amount of impairment loss, if any.

In evaluating whether it is more likely than not that a goodwill impairment exists for these reporting units, an entity should, among other facts and circumstances, evaluate the same examples of qualitative factors as a reporting unit with a positive carrying amount as described in BCG 11.5.1.1. In addition, an entity with a zero or negative carrying amount reporting unit should consider whether there are significant differences between the carrying amounts and the estimated fair values of the reporting unit's assets and liabilities, including unrecognised intangible assets. If the fair value of recognise assets are estimated to exceed their carrying amounts or if the fair value of unrecognised assets (e.g., a trade-name intangible asset) are significant, this will reduce the implied fair value of goodwill in the step two test, and therefore, could impact the qualitative assessment.

11.5.4 *Application of step two of the impairment test for goodwill*

When an entity performs step two of the goodwill impairment test, it must determine the implied fair value of the reporting unit's goodwill. Because the fair value of goodwill can be measured only as a residual amount and cannot be determined directly, the implied fair value of a reporting unit's goodwill should be calculated in the same manner as the amount of goodwill that is recognised in a business combination would be determined pursuant to ASC 805. This process involves measuring the fair value of the reporting unit's assets and liabilities (both recognised and unrecognised) at the time of the impairment test, using the guidance in ASC 805. The difference between the reporting unit's fair value and the fair values assigned to the reporting unit's individual assets and liabilities (both recognised and unrecognised), is the implied fair value of the reporting unit's goodwill. It is important to note that this assignment process is performed only for the purpose of determining the implied fair value of the reporting unit's goodwill when testing goodwill for impairment and is not used to adjust the carrying amount of the entity's assets and liabilities (other than goodwill, when impaired) or to initially recognise previously unrecognised assets and liabilities [ASC 350-20-35-14 through 35-19]. BCG 7 discusses further the determination of the fair value of reporting units and certain assets and liabilities.

Question 11-6

If a company has concluded that a market participant would assume the pension obligations associated with the employees within a reporting unit if the reporting unit was sold, how should the pension obligation be measured when completing step two of the goodwill impairment test?

PwC response

When completing step two of the goodwill impairment test, a company is required to perform a hypothetical purchase price allocation as if the reporting unit was acquired on the test date. Therefore, the company should measure the projected benefit obligation and the fair value of the plan assets in accordance with ASC 715 as of the date of the test.

Question 11-7

In completing step two of the goodwill impairment test, would it be appropriate for a company to use current carrying amounts of the assets and liabilities on its balance sheet as a proxy for fair value when determining the implied fair value of goodwill?

PwC response

The implied fair value of a reporting unit's goodwill should be calculated in the same manner as the amount of goodwill that is recognised in a purchase price allocation in a business combination. This process involves measuring the fair value of the reporting unit's assets and liabilities (both recognised and unrecognised) at the time of the impairment test to perform a hypothetical purchase price allocation. The current carrying amounts of assets and liabilities may not approximate their fair values when completing step two of the goodwill impairment test. The difference between the reporting unit's fair value and the fair values assigned to the reporting unit's individual assets and liabilities (both recognised and unrecognised) is the implied fair value of the reporting unit's goodwill.

Example 11-15 illustrates an in-depth example of the goodwill impairment test.

EXAMPLE 11-15

Detailed example of the goodwill impairment test

Assume Company A is performing its annual impairment test for goodwill, and management determines the fair value of Reporting Unit X to be CU1,000. Reporting Unit X's carrying amount is $1,050. Because the carrying amount of the reporting unit exceeds its fair value, Company A has failed step one and will proceed to step two of the impairment test. All assets and liabilities have been tested for impairment under the applicable GAAP prior to testing goodwill for impairment. For simplicity, all tax effects have been ignored.

	Book value	Fair value
Working capital	CU80	CU80
Real estate	700	850
Notes receivable	100	100
Patent (finite-lived intangible)	50	40
Trade name (indefinite-lived intangible)	40	95
Notes payable	(200)	(185)
Net assets	770	980
Goodwill	280	
Total carrying amount of reporting unit X	1,050	
Fair value of reporting unit X		1,000
Implied fair value of goodwill		20
Carrying amount of goodwill		280
Goodwill impairment loss		CU(260)

Analysis

The implied fair value of goodwill is equal to the fair value of Reporting Unit X of CU1,000, less the recorded value of its net assets of CU980 measured in accordance with ASC 805. Based on the results of step two of the impairment analysis, a goodwill impairment charge of CU260 is recognised. Note that in this scenario, the amount of the goodwill impairment is greater than CU50, which is simply the difference between the total carrying amount of the reporting unit and its fair value (CU1,050 – CU1,000) due to differences between the book value and fair value of other net assets of CU210 (CU980 – CU770). If the fair value of the reporting unit had exceeded its carrying value, a detailed determination of the fair values of the individual assets and liabilities would not be necessary and no goodwill impairment would be recorded. Company A should also reassess the useful life of the patent because the decline in value may be the result of factors that also suggest the patent will have a shorter useful life.

11.5.4.1 Step two may not always result in an impairment loss

In some cases, a reporting unit that has failed step one of the goodwill impairment test may not actually have a goodwill impairment loss to recognise in step two because the implied fair value of goodwill exceeds its carrying amount. For example, a reporting unit may fail step one because the carrying amounts of the long-lived assets exceed their fair values, but an impairment on the long-lived assets is not recognised because their carrying amounts are recoverable on a **held and used** basis (i.e., through undiscounted cash flows). In these cases, the implied fair value of goodwill may still exceed its carrying amount, and no goodwill impairment loss would be necessary. This assumes that the reporting unit is not a disposal group or part of a disposal group as discussed in BCG 10.4.2.

However, instances when a reporting unit will fail step one of the goodwill impairment test and not result in a goodwill impairment loss are infrequent, and consideration should be given to whether all assets and liabilities have been appropriately considered for impairment prior to performing the goodwill impairment test.

11.5.4.2 Consistency between the fair values used to test indefinite-lived intangible assets for impairment and step two of the goodwill impairment test

Indefinite-lived intangible assets are tested for impairment based on their appropriate unit of accounting. If the unit of accounting of the indefinite-lived intangible assets is assigned to a single reporting unit, that unit of accounting and its associated fair value should be used for purposes of performing step two of the goodwill impairment test and measuring the goodwill impairment loss, if any [ASC 350-30-35-26(d)]. If the unit of accounting of the indefinite-lived intangible assets is assigned to multiple reporting units, judgment should be applied based on the facts and circumstances when determining the fair values to be utilised in performing step two of the goodwill impairment test and measuring the goodwill impairment loss, if any.

11.5.4.3 *Consistency of valuation methodologies between ASC 805 and step two of the goodwill impairment test*

The valuation methods used to determine the fair value of a reporting unit's individual assets and liabilities for purposes of step two of the goodwill impairment test should be consistent with the valuation methods that were applied in the determination of fair value as of the acquisition date. However, an entity is not precluded from using a different valuation method if there are specific facts and circumstances that support a conclusion that another valuation method is equally or more representative of fair value in the circumstances. This may be the case in instances where new markets develop, new information becomes available, information previously used is no longer available, or valuation techniques improve.

11.5.4.4 *Deferred income tax considerations when determining the fair value of a reporting unit and the implied fair value of goodwill of a reporting unit*

An acquiring entity must recognise a deferred tax asset or liability for the differences between the assigned values and income tax bases of the recognised assets acquired and liabilities assumed in a business combination [ASC 805-740-25-2]. An acquiring entity's tax bases in the assets acquired and liabilities assumed in a business combination are generally based on whether the combination was a taxable transaction (which results in new tax bases) or a nontaxable transaction (which results in carryover tax bases). Therefore, the amount of deferred income taxes recorded in a business combination and, in turn, the amount of goodwill recorded, can be significantly impacted by whether the combination was a nontaxable or taxable transaction. See BCG 5 for further information on determining whether the business combination was a nontaxable or taxable transaction.

When an entity tests goodwill for impairment, a question arises as to how the entity should consider recorded deferred tax balances that relate to differences between the book and tax bases of assets and liabilities assigned to reporting units. Specific considerations include how deferred taxes impact a reporting unit's fair value and carrying amount for applying step one of the goodwill impairment test and determining the implied fair value of goodwill in step two of the test.

ASC 350-20 provides guidance on how deferred income taxes should be considered in determining the fair value and carrying amount of a reporting unit. ASC 350-20-35-25 notes that the determination of the fair value of the reporting unit should include an assumption as to whether the reporting unit would be sold in a taxable or nontaxable transaction. Whether the reporting unit would be bought or sold in a taxable or nontaxable transaction is a matter of judgment that depends on the relevant facts and circumstances and must be evaluated carefully on a case-by-case basis. In making that determination, an entity should consider (1) whether the assumption is consistent with those that market participants would incorporate into their estimates of fair value, (2) the feasibility of the assumed structure, and (3) whether the assumed structure results in the highest economic value to the seller for the reporting unit, including consideration of related tax implications. In addition, in determining the feasibility of a nontaxable transaction, an entity should consider, among other relevant factors, (1) whether the reporting unit could be sold in a nontaxable transaction and (2) whether there are any income tax laws and regulations or other corporate governance requirements that could limit an entity's ability to treat a sale of the unit as a nontaxable transaction [ASC 350-20-35-25 through 35-27]. When evaluating whether a reporting unit would be sold in a taxable or nontaxable transaction, the AICPA Goodwill Guide states that it may be useful to consider the (1) structure of observed comparable transactions in the market, (2) type of buyer, and (3) tax status of a market participant.

Question 11-8

How should income taxes be considered when determining the fair value of a reporting unit in step one of a goodwill impairment test?

PwC response

An entity should determine whether the estimate of fair value of a reporting unit should be based on an assumption that the reporting unit would be sold in a nontaxable or taxable transaction. This assumption is a matter of judgment that depends on the relevant facts and circumstances [ASC 350-20-35-25]. The assumed structure of the transaction can affect the price a buyer is willing to pay for the reporting unit and the seller's tax cost on the transaction. For example, in a taxable transaction, the net assets of the entity are considered sold, and the buyer records a fair value tax basis in the net assets. The buyer may be willing to pay more to acquire a reporting unit in a taxable transaction if the transaction provides a step-up in the tax basis of the acquired net assets. In a nontaxable transaction, the stock of the company is sold and the buyer records a fair value tax basis in the acquired stock, but carryover (or predecessor) tax basis in the net assets. The buyer may be willing to pay more to acquire a reporting unit in a nontaxable transaction if the reporting unit has significant net operating loss or tax credit carryforwards that the buyer would be able to utilise.

The gross proceeds expected to be realised from a sale must be reduced by the seller's tax cost. The seller's tax cost should reflect, and can vary with, the structure of the transaction. For example, in a nontaxable sale, the seller's gain (or loss), and thus the seller's tax cost, is measured by reference to its tax basis in the stock of the reporting unit; in a taxable sale, the seller's taxable gain (or loss) is measured by reference to the tax basis in the net assets of the reporting unit. The effect of existing tax attributes of the seller would be considered in measuring the seller's tax cost.

The type of transaction that is consistent with market participant assumptions is feasible and that provides the highest value to the seller should be used in determining the fair value of a reporting unit.

ASC 350-20-35-7 requires that the carrying amount of the reporting unit for purposes of step one of the goodwill impairment test should include deferred tax assets and liabilities arising from assets and liabilities assigned to the reporting unit, regardless of whether the fair value of the reporting unit will be determined assuming the reporting unit would be bought or sold in a taxable or nontaxable transaction.

Finally, ASC 350-20-35-20 through 35-21 requires that the implied fair value of the reporting unit's goodwill in step two of the goodwill impairment test be determined using the same taxable or nontaxable assumption used in determining the fair value of the reporting unit. See BCG 5 for information on determining deferred taxes in a business combination.

Question 11-9

How should deferred income taxes be considered when performing step two of a goodwill impairment test?

PwC response

In step two of a goodwill impairment test, the implied fair value of goodwill is determined in the same manner as the amount of goodwill recognised in a business combination. Deferred income taxes included in step two should be calculated using the same assumption (i.e., taxable or nontaxable) that was used in determining the fair value of the reporting unit in step one. In a nontaxable transaction, the historical tax bases, net operating losses, and other tax attributes of the target usually carry over to the acquirer, and there is no step-up of the underlying tax bases of the acquired net assets. However, as identifiable net assets will be reflected at fair value for financial reporting purposes, the amount of deferred income taxes should be calculated based on the difference between such fair value and the historical tax bases. The amount of deferred taxes will likely be different than if the acquirer had simply carried forward actual deferred tax balances. Following the guidance in ASC 805, a deferred tax asset is included in step two if there is carryover tax basis in tax-deductible goodwill and it exceeds the implied fair value of book goodwill. Determining the amount of a deferred tax asset on goodwill requires an iterative calculation. See BCG 11.5.4.4 and BCG 5.7.2 for further information.

Generally, in a taxable transaction, the acquirer does not carry over the existing tax bases of the assets and liabilities within the target, nor does it carry over net operating losses and other tax attributes. Instead, the acquirer's tax basis balance sheet reflects the acquired assets and the assumed liabilities at their respective fair values for tax reporting purposes (pursuant to applicable guidance). In this case, as the tax-basis in the acquired assets and assumed liabilities would generally equal the book basis, there would not be any temporary differences that would result in deferred taxes.

Examples 11-16 and 11-17 demonstrate the effect of deferred income taxes when testing goodwill for impairment.

EXAMPLE 11-16

Excess of book goodwill over tax goodwill

Company A has a reporting unit that it is testing for impairment. A sale of the reporting unit would be feasible in both a taxable and nontaxable transaction. Assume the following:

- The carrying amount of net assets, excluding goodwill and deferred taxes, is CU1,300.

- The fair value of identifiable net assets, excluding goodwill and deferred taxes, is CU1,400.
- The tax basis of net assets is CU900 and Company A's tax basis in the shares of the reporting unit is CU1,125. There is no tax-deductible goodwill.
- The nondeductible book goodwill is CU500.
- The net deferred tax liabilities are CU160 (CU1,300 carrying amount of net assets, excluding goodwill and deferred taxes, less CU900 tax basis of net assets at a 40% tax rate).
- In a taxable transaction, the reporting unit could be sold for CU1,600.
- In a taxable transaction, at a 40% tax rate, current taxes payable resulting from the transaction would be CU280 (CU1,600 fair value less CU900 tax basis at 40 percent).
- In a nontaxable transaction, the reporting unit could be sold for CU1,500.
- In a nontaxable transaction, current taxes payable resulting from the transaction are assumed to be CU150 (CU1,500 fair value less Company A's tax basis in the shares of CU1,125 at 40 percent).

Analysis

Determination of taxable or nontaxable sale:

	Taxable	Nontaxable
Gross proceeds from sale (fair value)	CU1,600	CU1,500
Tax arising from transaction	(280)	(150)
Economic value from the reporting unit	CU1,320	CU1,350

The highest economic value could be realised in a nontaxable transaction. A nontaxable sale is assumed to be feasible for purposes of testing the reporting unit's goodwill for impairment.

Performance of step one of the goodwill impairment test:

	Nontaxable
Fair value of reporting unit	CU1,500
Net assets (excluding goodwill and deferred taxes)	1,300
Goodwill	500

	Nontaxable
Deferred taxes	(160)
Reporting unit carrying amount	1,640
Difference—Fails step one	CU(140)

For step one, the fair value of the reporting unit is compared to its carrying amount. Fair value is determined using the pretax proceeds that would be realised from a nontaxable sale and not the economic value that would be received after tax. Because the reporting unit's carrying amount exceeds its fair value, the reporting unit fails step one.

Performance of step two of the goodwill impairment test:

	Nontaxable
Fair value of reporting unit	CU1,500
Less: fair value of identifiable net assets	(1,400)
Plus: net deferred tax liability	200[1]
Implied fair value of goodwill	300
Book value of goodwill	500
Impairment loss	CU(200)

[1] Determined as the fair value of the identifiable net assets of CU1,400 less the tax basis of CU900 at a 40 percent tax rate.

For step two, the implied fair value of goodwill is determined by comparing the fair value of the reporting unit of CU1,500 to the fair value of the identifiable net assets and any deferred taxes following the guidance in ASC 805. The implied fair value of goodwill of CU300 is then compared to the book value of goodwill of CU500, resulting in an impairment loss of CU200.

To illustrate the determination of an impairment loss in a taxable sale, assume in the above example that the company determined that the highest economic value could be realised in a taxable transaction. In that case, the fair value of the reporting unit of CU1,600 is compared to the carrying amount of the reporting unit of CU1,640, which fails step one. The fair value of the identifiable net assets remains at CU1,400, and deferred taxes are assumed to be zero because the book and tax bases will typically be the same in a taxable transaction, thus implying a goodwill fair value of CU200. When compared to the recorded amount of goodwill of CU500, the resulting impairment charge would be CU300.

EXAMPLE 11-17

Excess of tax goodwill over book goodwill

Assume the same facts from Example 11-15, except that the reporting unit has tax-deductible goodwill of CU600 at the impairment testing date. If the highest economic value could be obtained through a nontaxable transaction, the fair value of the reporting unit of CU1,500 is compared to the carrying amount of the reporting unit of CU1,640, which fails step one.

Performance of step two of the goodwill impairment test:

	Nontaxable
Fair value of reporting unit	CU1,500
Less: fair value of identifiable net assets	(1,400)
Plus: net deferred tax liability on identifiable net assets	200[1]
Preliminary implied fair value of goodwill	300
Less: deferred tax asset for tax-deductible goodwill	(200)[2]
Implied fair value of goodwill	100
Book value of goodwill	500
Impairment loss	CU(400)

[1] Determined as the fair value of the identifiable net assets of CU1,400 less the tax-basis of CU900 at a 40% tax rate.

[2] Determined by applying the equation described in BCG 5.7.2 (Tax Rate of 40% / (1 – Tax Rate of 40%)) x Preliminary Temporary Difference (Tax deductible goodwill of CU600 less preliminary implied fair value of goodwill of CU300).

For step two, because there is tax-deductible goodwill in excess of book goodwill, the implied fair value of goodwill is determined in a two-step process. The implied fair value of goodwill, before deferred taxes for tax-deductible goodwill, is determined by comparing the fair value of the reporting unit of CU1,500 to the fair value of the identifiable net assets, net of any deferred taxes associated with the identifiable net assets following the guidance in ASC 805. This preliminary implied fair value of goodwill is then utilised in determining the deferred tax asset associated with the tax-deductible goodwill by applying the equation discussed in BCG 5.7.2, resulting in a deferred tax asset of CU200 and implied fair value of goodwill of CU100. The implied fair value of goodwill of CU100 is then compared to the book value of goodwill of CU500, resulting in an impairment loss of CU400.

See BCG 11.3.5 for further information on the assignment of **net operating loss** and tax credit carryforwards and see BCG 11.5.9.7 for further information on the allocation of a goodwill impairment loss to component-1 and component-2 goodwill.

11.5.5 Potential impact of unrecognised or appreciated asset values on step one test

Step one of the goodwill impairment test serves as a "screening process" for determining whether goodwill might be impaired. As a result, the recorded amount of a reporting unit's goodwill may sometimes be "shielded" from an impairment loss, even if its implied value has decreased. This shielding in step one can arise from the fact that the carrying amount of the reporting unit does not reflect the value of any of the reporting unit's unrecognised assets, such as internally developed intangible assets, or any appreciation in the fair value of the reporting unit's recognised assets, such as real estate. However, such unrecognised assets, or assets recorded at less than their fair value, will increase the goodwill impairment loss if the performance of step two becomes necessary.

An entity is required to perform step one of the goodwill impairment test before performing step two, even if the entity believes goodwill is impaired. If a reporting unit passes step one, the entity does not proceed to step two. Example 11-18 illustrates how unrecognised assets could shield an entity from a goodwill impairment charge.

EXAMPLE 11-18

Shielding of goodwill with internally developed intangible assets

Company A operates in the pharmaceutical industry and has various reporting units based on geographic and operational criteria. Reporting Unit X encompasses its European operations, including sales and significant research and development (R&D) efforts. Reporting Unit Y is predominantly represented by the large manufacturing facilities in the United States.

Goodwill assigned to the two reporting units arose from an acquisition several years ago. An acquired product line, including brand names and customer relationships, has since deteriorated and is no longer a high market performer. This might indicate that the acquired goodwill has also lost some of its value and its implied fair value may have declined compared to its carrying amount.

Analysis

In determining the fair values of the two reporting units for applying step one of the goodwill impairment test, management concluded that the fair values were in excess of the carrying amounts of the reporting units, including goodwill, for the following reasons:

- Reporting Unit X has some promising new products arising from its internal R&D efforts, which are expected to drive significant cash flows over the next few years. The anticipated cash flows from the new products cause the fair value of the reporting unit to increase significantly without a corresponding asset recorded for the internally developed technology.

- Reporting Unit Y owns substantial parcels of land that are used for its manufacturing facilities or kept as a reserve for future expansion. A significant increase in the value of land in the region has resulted in an increase in the fair value of the reporting unit, without any recognition of the increase in land values in the reporting unit's carrying amount.

Thus, due to the factors identified above, both reporting units passed step one of the goodwill impairment test and management should not perform step two, even though there were indications that the goodwill's implied fair value was less than its book value.

11.5.6 *When to test goodwill for impairment*

An entity is required to test the carrying amount of a reporting unit's goodwill for impairment on an annual basis [ASC 350-20-35-28]. An entity should also test goodwill for impairment between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of the reporting unit below its carrying amount [ASC 350-20-35-30].

If the carrying amount of a reporting unit is zero or negative, goodwill of the reporting unit should be tested for impairment on an annual or interim basis if an event occurs or circumstances exist that indicate that it is "more likely than not" that a goodwill impairment exists. ASC 350-20-35-3A defines "more likely than not" as "a likelihood of more than 50 percent."

11.5.6.1 *Triggering events for goodwill impairment testing*

If an event occurs or circumstances change between annual tests that could more likely than not reduce the fair value of a reporting unit below its carrying amount (triggering events), the goodwill of that reporting unit should be tested for impairment using the process described in BCG 11.5. The examples of qualitative factors outlined in BCG 11.5.1.1 are also examples of interim triggering events that should be considered in determining whether goodwill should be tested for impairment during interim periods. In addition to the triggering events, the goodwill of a reporting unit must also be tested for impairment after a portion of the reporting unit's goodwill is included in the carrying amount of a business to be disposed of [ASC 350-20-35-57]. See BCG 11.6 for further information.

Question 11-10

If none of the events and circumstances described in ASC 350-20-35-3C are present, can an entity conclude that it does not have a requirement to perform an interim impairment test for goodwill?

PwC response

The indicators listed in ASC 350-20-35-3C are examples, and do not comprise an exhaustive list. ASC 350-20-35-3F indicates that an entity "should consider other relevant events and circumstances that affect the fair value or carrying amount of a reporting unit."

The SEC staff provided the following additional examples of events that may indicate that an interim impairment test is necessary:

- Impairments of other assets or the establishment of valuation allowances on deferred tax assets
- Cash flow or operating losses at the reporting unit level (the greater the significance and duration of losses, the more likely it is that a triggering event has occurred)
- Negative current events or long-term outlooks for specific industries impacting the company as a whole or specific reporting units
- Not meeting analyst expectations or internal forecasts in consecutive periods, or downward adjustments to future forecasts
- Planned or announced plant closures, layoffs, or asset dispositions
- Market capitalisation of the company below its book value

Therefore, only after considering all available evidence, can a company conclude that it does not have a requirement to perform an interim impairment test for goodwill.

Question 11-11

Does the option to perform a qualitative impairment assessment change how an entity would determine whether it needs to perform an event-driven interim test?

PwC response

The option to perform a qualitative impairment assessment does not change when an entity should perform a goodwill impairment test. An interim test should be performed if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. Additionally, if the carrying amount of a reporting unit is zero or negative, goodwill of that reporting unit should be tested for impairment on an interim basis if an event occurs or circumstances exist that indicate that it is more likely than not that a goodwill impairment exists.

For entities with publicly traded equity or debt securities, although the impairment test for goodwill occurs at the reporting unit level, a significant decline in the market value of such securities may indicate the need for an interim impairment test. It is important to remember that the goodwill test is not based on an "other than temporary" decline. When a substantial decline occurs, an entity should consider whether it is "more likely than not" that the fair value of any of the entity's reporting units has declined below the reporting unit's carrying amount. In these situations, an entity should examine the underlying reasons for the decline, the significance of the decline, and the length of time the market price has been depressed to determine if a triggering event has occurred. A decline that is severe, even if it is recent, as a result of an event that is expected to continue to affect the company will likely trigger the need for a test. Further, a decline that is of an extended duration will also likely trigger the need for a test. In contrast, a relatively short-term decline in the market price of the company's stock may not be indicative of an actual decline in the company's fair value when one considers all available evidence. Interim impairment triggers can also be present at the reporting unit level even when a public company's market capitalisation is equal to or greater than its book value. All available evidence should be considered when determining a reporting unit's fair value.

Question 11-12

In lieu of performing its goodwill impairment test, can a company, whose market capitalisation is significantly below book value, write off its goodwill in its entirety?

PwC response

To recognise a goodwill impairment, the company will need to test each reporting unit to determine the amount of a goodwill impairment loss. If the fair value of a reporting unit is greater than the unit's carrying amount in step one or if the implied fair value of goodwill is greater than its recorded amount in step two, a company cannot record a goodwill impairment.

Question 11-13

If a company experiences a decline in market capitalisation that is consistent with declines experienced by others within its industry, is it reasonable for the company to assert that a triggering event has not occurred and that the decline is an indication of distressed transactions and not reflective of the underlying value of the company?

PwC response

As noted in ASC 820-10-35-15A, there are times when a distressed transaction may be put aside. However, a distressed market cannot be ignored. A decline in a company's market capitalisation, consistent with declines experienced by others within its industry, may be reflective of the underlying value of the company in a distressed market. Entities should distinguish between a distressed market, in which prices decline yet liquidity exists with sufficient volume, and a forced or distressed transaction. Transactions at depressed prices in a distressed market would not typically be distressed transactions.

Question 11-14

If a company has not experienced a decline in its cash flows and expects that it will continue to meet its projected cash flows in the future, can the company assert that a triggering event has not occurred even though the decline in its market capitalisation may be significant?

PwC response

While a company may not have experienced a decline in its cash flows and does not anticipate a future decline in projected cash flows, it is not appropriate to simply ignore market capitalisation when evaluating the need for an interim impairment test. The market capitalisation usually reflects the market's expectations of the future cash flows of the company. A company may need to reconsider its projected cash flows due to heightened uncertainty about the amount and/or timing of cash flows, particularly for industries in which customer purchases are discretionary. Even if there is no change in a company's cash flows, higher required rates of return demanded by investors in an economic downturn may decrease a company's discounted cash flows. This, in turn, will decrease fair value.

Question 11-15

If a company completed its annual goodwill impairment test during the fourth quarter and the company has not identified any significant changes in its business during the first quarter of the following year, is a continued depressed stock price or a further decline during the first quarter a triggering event for performing a goodwill impairment test?

PwC response

If a company's stock price remains at a depressed level or continues to decline during the first quarter, it is important to ensure all available evidence has been evaluated to determine if a triggering event has occurred. The market capitalisation generally reflects the market's expectations of the future cash flows of the company. When the market capitalisation drops, this may indicate that an event has occurred, or circumstances or perceptions have changed that would more likely than not reduce the fair value of a company's reporting unit below its carrying amount. For example, the decline in the stock price may be an indicator that the company's cash flow projections in future periods are too optimistic when considering the most recent macroeconomic forecasts.

A company should compare its actual results to date against budget and consider whether its projections appropriately reflect current expectations of the length and severity of recent economic conditions. Reviewing externally available information (e.g., analyst reports, industry publications, and information about peer companies) may provide further insight on the factors attributable to the decline and whether a reporting unit has had a triggering event. When evaluating external information, it is important to ensure it is comparable to the reporting unit under review and not solely to the consolidated company. Further, the amount by which the fair value of the reporting unit exceeded its carrying amount at the last goodwill impairment test date may also be a consideration in evaluating if it is more likely than not that the fair value of a reporting unit has dropped below its carrying amount.

Although annual goodwill impairment testing provides some assurance that goodwill impairment losses will be recognised in a timely manner, an entity's management should have appropriate processes and controls in place to monitor for interim triggering events. These processes and controls, however, may vary from entity to entity and from reporting unit to reporting unit, depending upon, among other things, the extent of differences that exist between a reporting unit's fair value and its carrying amount (i.e., cushion), the reporting unit's industry and relevant markets, the entity's experience, and the significance of goodwill recorded.

Similar to other impairment charges, financial statement users, auditors, and regulators may scrutinise the timing of goodwill impairment losses. Entities that recognise a goodwill impairment loss should be prepared to address questions about (1) the timing of the impairment charge, (2) the events and circumstances that caused the reporting unit's goodwill to become impaired, and (3) for public entities, the adequacy of the entity's "early warning" disclosures, including relevant risks and business developments leading up to the charge, in its public reporting for prior periods.

11.5.6.2 Annual goodwill impairment testing dates

An entity may perform the annual goodwill impairment test for each reporting unit at any time during the year, as long as the test is consistently performed at the same time every year for that reporting unit. In addition, an entity may test the goodwill of different reporting units at different times during the year.

In determining the timing of the annual impairment test, the entity may find it useful to consider the following factors, at a minimum:

- Availability of relevant information (e.g., prepared as part of the annual budgeting/forecasting cycle)
- Time and resource requirements to perform the test and the effect on timely reporting to the public
- Timing of the annual impairment test for indefinite-lived intangible assets assigned to the same reporting unit
- Effects of impairment losses on the entity's capital market communication (e.g., it might be difficult to explain an impairment loss in the first quarter, just after filing the annual report)
- Seasonal cycles in the reporting unit's business

Management may choose to test goodwill for impairment at a quarter-end date because of the more robust closing procedures that generally take place at quarter end. However, consideration should be given to the potential difficulty in completing the annual test prior to release of the quarterly results, especially if third-party valuations firms are engaged to assist management with its analysis. See BCG 11.5.6.4 for information on the accounting and disclosure considerations when an entity is unable to complete step two of the goodwill impairment test prior to issuing its financial statements.

A change in a reporting unit's annual goodwill impairment test date is considered to be a change in accounting principle (i.e., a change in the method of applying an accounting principle). In addition, an entity with publicly traded securities in the United States is required to obtain a preferability letter from its auditor when making such a change. When an entity changes its annual goodwill impairment testing date, the period between annual impairment tests should not exceed 12 months.

Example 11-19 illustrates a change in the timing of the annual impairment test.

EXAMPLE 11-19

A change in timing of the annual impairment test

Company A, a public registrant, changes its fiscal year-end for competitive and business reasons from 31 July to 31 December and will prepare and file financial statements for the five-month period from 1 August through 31 December. Historically, Company A has performed all of its annual impairment tests in its fourth quarter on 31 May, and intends to realign the annual impairment test date to a similar date in its new fourth quarter (i.e., 31 October).

Analysis

While each situation must be considered based on its own facts and circumstances, it is expected that a preferability letter will be issued based on the above fact pattern. This will allow the date of the impairment test to correspond with the new annual budgeting cycle and the performance of the test closer to the new year-end.

Company A will need to perform impairment tests as of 31 May and 31 October in the year of change because skipping the 31 May test will result in a period greater than 12 months between annual impairment tests.

An entity may complete an acquisition shortly before the date of its annual impairment test for goodwill for all of its reporting units and may intend to use that same date for impairment testing of goodwill arising from the current acquisition. The question arises as to whether the acquiring entity could omit the first year's annual impairment test for the recent acquisition, because the related valuation and determination of goodwill had just occurred; thus, impairment of goodwill shortly after the acquisition would be unlikely. However, omitting the impairment test for the goodwill in the recent acquisition at its usual annual testing date and performing it for the first time in the year after the acquisition would result in a period in excess of 12 months before the first goodwill impairment test.

As the first annual impairment test for the goodwill recorded in the current acquisition should be performed within 12 months of the date of close of the acquisition, the entity may wish to consider including the recent acquisition in its usual annual impairment test and, if so, performing step one of the impairment test. The entity should consider updating the acquisition valuation for any changes in the acquiree's business. If the recent acquisition constitutes its own reporting unit, the reporting unit may not be a good candidate for the qualitative impairment assessment as there would not likely be cushion on the acquisition date. Despite the fact that a fair value analysis was just completed upon acquisition, the lack of cushion could make it a challenge to conclude based solely on the qualitative assessment that no further impairment testing is necessary. As such, the qualitative assessment may not be appropriate to use in this circumstance.

Alternatively, the entity would be required to use a different date, which would be within 12 months of the date of close of the acquisition, for its annual impairment test for the recently acquired goodwill. However, for practical reasons, most companies assign the same annual goodwill impairment test date to all of their reporting units, including those reporting units that have been recently acquired.

Question 11-16

If a company performs step one of its annual goodwill impairment test at the beginning of the fourth quarter and passes step one, does the company need to further assess whether it may have a triggering event in the fourth quarter?

PwC response

While the company's reporting units passed step one at the beginning of the fourth quarter, this does not eliminate the company's need to continue to assess events and circumstances through the end of the reporting period which may indicate that it is more likely than not that a reporting unit's fair value has fallen below its carrying amount. For example, management may need to consider whether a significant decline in the company's stock price in the fourth quarter represents a triggering event.

Question 11-17

If a company performs its annual goodwill impairment test at the beginning of the fourth quarter and fails step one, does the company need to assess events occurring after the annual testing date when assessing its impairment loss for the fourth quarter?

PwC response

If a calendar year-end company performs its annual goodwill impairment test on October 1 and fails step one, and later in the fourth quarter, the company's stock price declines significantly, or other indicators of potential impairment arise, the company would need to give further consideration to the factors. Subsequent declines in a company's market capitalisation may be an affirmation of facts and circumstances that existed as of the annual impairment test date or may represent new events that should be considered as an interim triggering event.

11.5.6.3 Impairment of goodwill shortly after acquisition

An impairment of goodwill shortly after the acquisition is possible but rare.

ASC 805 requires that the value of equity securities issued as consideration in the acquisition of a business be measured on the date of the business combination. As a result, the acquisition date fair value of the consideration transferred may differ from the fair value of the consideration as of the date the acquisition was agreed to if an acquirer's share price has increased or decreased significantly prior to the closing of the acquisition. If there is a significant increase in the fair value of the acquirer's share price, then more goodwill would be recognised on the date of acquisition—this may be viewed as an overpayment. In connection with its deliberations of ASC 805, the FASB acknowledged that overpayments are possible, however, the Board believed that it would be unlikely that the amount would be known or measureable at the acquisition date and that overpayments are best addressed through subsequent impairment testing [FAS 141(R).B382]. Therefore, any impairment charge would need to follow the guidance in ASC 350-20, including assigning the goodwill to reporting units and evaluating if a triggering event has occurred based on changes in economic conditions relative to the business acquired that evidence impairment.

An acquirer's conclusion that goodwill is impaired within a short period of time after the acquisition should be supported by an analysis of the underlying events and circumstances. Such an analysis would need to consider a number of factors, including a review of the fair value determinations at the "agreed to and announced" date and acquisition date, any adjustments to provisional amounts recorded during the measurement period, the method for assigning goodwill to reporting units, and changes in economic conditions relative to the business acquired that evidence impairment. Given the subjective nature of these judgments and the infrequency of reporting a goodwill impairment loss immediately upon or shortly after the acquisition, a decision to impair goodwill shortly after an acquisition may attract considerable attention.

11.5.6.4 Estimate of an impairment loss if assessment is not completed before issuing financial statements

Because of the significant effort that may be required to determine the implied fair value of a reporting unit's goodwill in step two of the goodwill impairment test, there may be situations in which an entity is unable to complete this process before issuing its financial statements. When such a situation occurs and a goodwill impairment loss is probable and can be reasonably estimated, the best estimate of the loss should be recognised in the financial statements using the guidance in ASC 450-10 [ASC 350-20-35-18]. The fact that the amount of a goodwill impairment loss is an estimate and the reasons why it is an estimate must be disclosed in the financial statements. Upon completion of the measurement of the impairment loss, any adjustment made to the estimated loss should be recognised in the subsequent reporting period and the nature of the adjustment should be disclosed [ASC 350-20-35-19 and ASC 350-20-50-2(c)].

11.5.7 Interaction with impairment testing for other assets

Goodwill and other assets of a reporting unit that are held and used may be required to be tested for impairment at the same time, for instance, when certain events trigger interim impairment tests under ASC 350-20 and ASC 360-10. In such situations, other assets, or asset groups, should be tested for impairment under their respective standards (e.g., ASC 360-10, ASC 350-30, and ASC 323-10) and the other assets' or asset groups' carrying amounts should be adjusted for impairment before testing goodwill for impairment [ASC 350-20-35-31]. Note, however, the ordering for impairment testing will differ if goodwill is included as part of a disposal group that is classified as "held for sale" under ASC 360-10. See BCG 10.4.1.4 and BCG 10.4.2.1 for further information on impairment testing of other assets under the held for use and held for sale approaches.

A reporting unit may include assets, or asset groups, whose fair value are less than their carrying amounts but for which an impairment is not recognised. This would be the case if these assets' or asset groups' book values were determined to be recoverable under ASC 360-10 (i.e., the undiscounted cash flow test was sufficient to recover the carrying amount of the asset or asset group). In such a case, no adjustment to the carrying amounts would be permitted for the purpose of step one of the goodwill impairment test under ASC 350-20. However, if the reporting unit fails step one, such assets would be measured at fair value for purposes of measuring the implied fair value of goodwill in step two. It is important to note that the measurement of such assets is used only for the purpose of measuring the amount of the goodwill impairment and should not be used to adjust the carrying amount of such assets.

11.5.8 Determining the fair value of reporting units to which goodwill has been assigned

The fair value of a reporting unit refers to the price that would be received to sell the reporting unit as a whole in an orderly transaction between market participants at the measurement date. Quoted market prices in active markets are the best evidence of fair value and should be used as the basis for fair value measurement, if available. However, quoted market prices of an individual security may not be representative of the fair value of the reporting unit as a whole [ASC 350-20-35-22]. For example, a control premium (i.e., the premium an acquiring entity is willing to pay for a controlling interest versus the amount an investor would be willing to pay for a noncontrolling interest) may cause the fair value of a reporting unit to exceed its market capitalisation. However, an entity should not make adjustments to quoted market prices using broad assumptions. For example, it would not be appropriate to assume that a standard percentage for a control premium should be added to quoted market prices. Instead, a control premium should be based on a detailed analysis and should consider such things as industry, market, economic, and other factors that market participants typically take into account when determining the fair value of the entity.

Question 11-18

What is a reasonable control premium in determining the fair value of a reporting unit?

PwC response

A control premium can vary considerably depending on the nature of the business, industry and other market conditions. Accordingly, determining a reasonable control premium will be a matter of judgment. Generally, when assessing the reasonableness of a control premium, recent trends in a company's market capitalisation, comparable transactions within a company's industry, the number of potential acquirers, and the availability of financing should be considered. A well-reasoned and thoroughly documented assessment of the control premium value is necessary and the level of supporting evidence in making this assessment would be expected to increase as the control premium increases from past norms. Further, in a distressed market, consideration should be given as to whether prior market transactions used to evaluate control premiums would be indicative of future transactions. The use of arbitrary percentages or rules of thumb would not be appropriate.

A control premium is justified presumably due to synergies within the business that can be realised upon obtaining control. Therefore, one way to evaluate the reasonableness of a control premium is to perform a bottom up approach by identifying areas in which market participants could extract savings or synergies by obtaining control (e.g., eliminate duplicative costs and product diversification) and quantifying the discounted cash flows expected from the presumed synergies.

The SEC staff has, in some cases, issued comments to companies that assert their current market capitalisation does not reflect fair value because of a control premium. Such comments generally request management to provide support for their assertion.

Question 11-19

In distressed markets, is it expected that control premiums will rise?

PwC response

Some have asserted that control premiums should rise when there are broad market price decreases. Their theory is that the underlying fundamentals of a business may remain strong and, therefore, the business maintains its underlying fair value. Similarly, some companies have asserted that they would not be willing to sell at the pricing suggested by the market capitalisation, thus suggesting a significant control premium would exist in a fair value transaction. There are several factors that these views may not consider; therefore, a significant increase in control premiums in a time of distressed markets would generally not be expected.

First, in distressed markets, there tends to be a decrease in the number of acquirers willing and able to acquire entities for a variety of reasons, including lack of available capital, increased scrutiny by investors on significant purchases, or a desire to conserve cash. A reduced acquisition demand theoretically leads to a general decline in sales prices. Furthermore, as cash flows and discount rates are revisited in a distressed market, one may find that the fair value of a business has declined. This decrease in fair value would reduce the difference between the fair value of the business and its market capitalisation, resulting in a decrease in apparent control premiums.

Accordingly, increased control premiums in a distressed market should be carefully evaluated. A larger control premium must be adequately supported and consider the synergies inherent in a market participant's perspective of the fair value of a reporting unit. Only in those instances in which a reporting unit could command a higher price in the market can management consider applying a higher control premium. This assessment should be based on all facts and circumstances.

Question 11-20

Can multiple reporting units be combined for purposes of determining fair value?

PwC response

Generally, no. ASC 350-20-35-22 indicates that "the fair value of a reporting unit refers to the price that would be received to sell the unit as a whole in an orderly transaction between market participants at the measurement date." Measuring the fair value of multiple reporting units together and then allocating the aggregate fair value to the individual reporting units (top-down approach) would not be consistent with this guidance. Instead, the fair value of each reporting unit should generally be assessed individually. Any specifically identifiable synergies available to an individual reporting unit by working in combination with other reporting units (e.g., the benefits of lower costs arising from the combined purchasing power of multiple reporting units) may be included in the determination of the reporting unit's fair value if market participants would be expected to realise such synergies (bottom-up approach).

ASC 820 provides guidance on the application of various valuation techniques and establishes a fair value hierarchy that prioritises the inputs used in valuation techniques. If quoted market prices are not available, an estimate of fair value should be based on the best information available, including prices for similar assets and liabilities and the results of using other valuation techniques (including present value techniques). If a present value technique is used to measure fair value, estimates of future cash flows that are used in applying that technique should be consistent with the objective of measuring fair value. Those cash flow estimates should incorporate assumptions that market participants would use in their estimates of fair value. If a range is estimated for the amounts or timing of possible cash flows, the likelihood of possible outcomes should be considered.

Because quoted market prices for a reporting unit will probably not be available in most instances, a present value technique (i.e., an income approach), based on the guidance in ASC 820-10-55 might be the best available technique to measure the fair value of a reporting unit. ASC 820-10-55 discusses the use of (1) the discount rate adjustment technique (or best estimate approach) and (2) the expected cash flow approach. The discount rate adjustment technique (i.e., traditional approach) uses a single set of estimated cash flows that are discounted at a single interest rate commensurate with the risks involved. The expected cash flow approach uses explicit assumptions about the range of possible estimated cash flows and their respective probabilities (i.e., probability-weighted cash flows). The probability-weighted cash flows are then discounted using an appropriate discount rate commensurate with the risks involved. Also, the expected cash flow approach considers (either through adjustment to the expected cash flow or the discount rate) the price that market participants are able to receive for bearing the uncertainties in cash flows—referred to as "the adjustment for risk" or "cash risk premium"—if the amount is identifiable, measurable, and significant. ASC 820-10-55 neither prescribes the use of one specific present value technique nor limits the use of present value techniques to measure fair value.

An entity may also consider using a valuation technique based on multiples of earnings, revenues, or a similar performance measure, if that technique is consistent with the objective of measuring fair value (i.e., a market approach). Use of multiples of earnings or revenue in determining the fair value of a reporting unit may be appropriate, for example, when the fair value of an entity that has comparable operations and economic characteristics is observable and the relevant multiples of the comparable entity are known. Conversely, use of multiples would not be appropriate in situations in which the operations or activities of an entity for which the multiples are known are not of a comparable nature, scope, or size as the reporting unit for which fair value is being estimated [ASC 350-20-35-24].

ASC 820 emphasises that an entity's valuation technique for measuring fair value should maximise observable inputs (Level 1 inputs) and minimise unobservable inputs (Level 3 inputs). The entity's own data to develop Level 3 inputs should be adjusted if information is reasonably available that indicates that market participants would use different assumptions. To the extent measurements with significant Level 3 inputs are used, a description of the inputs and the information used to develop the inputs should be disclosed in the financial statements [ASC 820-10-50-5(c)].

See BCG 7 for further information on ASC 820 and its impact on determining the fair value of reporting units.

11.5.8.1 Considerations unique to determining the fair value of reporting units when using the income approach

It is often necessary to make adjustments to management's existing cash flow projections to ensure consistency with the valuation objective of determining the fair value of a reporting unit under ASC 350. Following are several considerations provided in the AICPA Goodwill Guide that may result in adjustments to cash flow projections:

- **Planned acquisition activity:** Generally cash flow projections used to determine the fair value of a reporting unit should not include prospective cash flows expected from a future acquisition as market participant cash flows typically would not include assumptions for acquisition activity.

- **Working capital:** The DCF method provides an indication of fair value that is consistent with normal levels of working capital. To the extent a reporting unit has an excess or deficit working capital position on the measurement date, that amount should be an adjustment to the fair value of the reporting unit. Cash is generally excluded from working capital in the DCF model.Net working capital is generally calculated on a debt-free basis by excluding the current portion of funded long-term debt because the cash flow model is typically prepared on a debt-free basis. When interest-bearing operating debt is determined to be part of working capital, the interest expense on the interest-bearing operating debt would be treated as part of the cash flows. It is generally appropriate to include deferred revenues as a component of working capital when revenue projections are developed on an accrual basis.

- **Nonoperating assets and liabilities:** To the extent nonoperating assets and liabilities are reflected in the carrying amount of a reporting unit, cash flow projections used to measure the reporting unit's fair value should incorporate cash flows expected to be generated by these assets and liabilities.

- **Legal form of reporting unit:** Reporting units may be held in nontaxable entities such as partnerships or limited liability companies. Generally, it is expected that market participants would be in the legal form of C corporations and thus subject to income taxes. Accordingly, cash flow projections are typically calculated on an after-tax basis to ensure consistency with market participant assumptions.

- **Depreciation and amortisation amounts:** While depreciation and amortisation are not cash flow items, tax depreciation and amortisation benefits result in cash tax savings and should be included in the cash flow projections used to determine a reporting unit's fair value.

- **Share-based compensation:** Non-cash expenses associated with share-based compensation should generally be included as a cash outflow when measuring the fair value of a reporting unit to the extent that these expenses are thought to be compensation in lieu of cash.

- **Income tax rate:** The appropriate tax rate would generally represent statutory rates adjusted for assumptions that are observable and applicable to market participants.

- **Related party transactions**: Intercompany transactions may require adjustment if the terms are not consistent with what market participants would expect to incur or receive.

See BCG 7 for further information about determining the fair value of a reporting unit using the income approach.

Question 11-21

If management uses a discounted cash flow approach to value a reporting unit and completes its annual budget process on 30 September, would it be reasonable for the company, which has a calendar year-end, to rely on this budget to complete its fourth quarter goodwill impairment test?

PwC response

Although the 30 September budget may be an appropriate starting point, during volatile economic times, cash flow estimates can change quickly. For impairment testing purposes, the company may need to revise its estimates if market events after 30 September impact the timing or amount of cash flows.

11.5.8.2 Considerations unique to determining the fair value of reporting units when using the market approach

When valuing a reporting unit using the market approach, stock trading prices or transaction prices generated by market transactions involving businesses comparable to the reporting unit are used. Two commonly used valuation techniques for measuring the fair value of a reporting unit are the guideline public company method and the guideline transaction method. The guideline public company method identifies the stock prices of public companies that are comparable to the reporting unit being tested. Performance metrics, such as price-to-revenues or price-to-EBITDA, are calculated for the comparable public companies and applied to the subject reporting unit's applicable performance metrics to estimate the reporting unit's fair value. The guideline transaction method identifies recent merger and acquisition transaction data for acquisitions of target companies that are similar to the subject reporting unit. Metrics such as multiples of the selling price to revenue, EBITDA or earnings measures are calculated for the guideline transactions and applied to the subject reporting unit's applicable revenue or earnings metric to estimate the reporting unit's fair value.

Under both the guideline public company method and the guideline transaction method, it is necessary to consider what makes a company "comparable" to the subject reporting unit from a valuation standpoint. While not an all-inclusive list, the AICPA Goodwill Guide lists operational characteristics that may be considered, such as whether the comparable company and the reporting unit (1) are in the same industry or sector, (2) are in similar lines of business, (3) have similar geographic reach (for example, domestic versus international versus multinational), (4) have similar customers and distribution channels, (5) have contractual or noncontractual sales, (6) have similar seasonality trends, (7) have similar business life cycles (e.g., short cycle characterised by ever-changing technology versus long cycle driven by changes in commodity pricing), (8) are in similar stage of business life cycle (e.g., start up, high growth, mature), or (9) have similar operating constraints (e.g., reliance or dependence on key customers or government regulations).

The AICPA Goodwill Guide also lists financial characteristics that may be considered, such as whether the comparable company and the subject reporting unit (1) are of similar size (e.g., revenues, assets, or market capitalisation, if subject is public), (2) have similar profitability (e.g., EBITDA, operating margin, contribution margin), (3) have similar anticipated future growth in revenues and profits, (4) have a similar asset-base (e.g., manufacturing versus service business), or (5) have a similar pattern of owning versus leasing real properties, machinery, and equipment (e.g., an entity that owns its manufacturing operations versus one that leases the building and machinery used for its operations).

Under both the guideline public company method and the guideline transaction method, it is often necessary to make adjustments to observed market multiples or transactions to make the comparable company data more consistent with the subject reporting unit. If guideline companies or transactions exhibit certain differences from the subject reporting unit but are otherwise deemed to be comparable to the reporting unit, the multiples or transactions associated with these companies should be adjusted to account for these differences. Such adjustments may relate to factors including profitability, anticipated growth, size, working capital, nonrecurring or nonoperating income or expenses, or differences in accounting policies. Once multiples or transactions have been adjusted, outliers that are not considered to be sufficiently comparable to the reporting unit should be eliminated from the data set. Generally, multiples that are in a narrow range are better indications of value than a data set with multiples that exhibit wide dispersion.

While the considerations applicable to the guideline public company method and guideline transaction method are similar, some additional considerations in applying the guideline transaction method include:

- **Availability of data**: Sufficient data about a specific transaction may not be available to determine whether the transaction provides a basis for measuring the reporting unit's fair value. For example, if information supporting the financial characteristics or the tax structure of the transaction is not available, it may be difficult to establish that the transaction would be comparable to a transaction in which the reporting unit is sold.

- **Relevant time period**: It is not appropriate to use guideline transactions that took place during periods in which economic conditions were not comparable to conditions at the goodwill impairment test date. Generally, the older the transaction, the less relevant the information.

When applying the market approach, it is important to determine whether the resulting enterprise value would be considered a controlling or noncontrolling interest. The guideline public company method has historically been regarded as indicating the enterprise or equity value on a noncontrolling basis. Because the subject reporting unit is valued on a controlling interest basis in step one of the goodwill impairment test, in some cases, it may be appropriate to apply a control premium to convert the reporting unit value determined using the guideline public company method to a controlling interest basis.

The guideline transaction method is typically regarded as indicating the enterprise or equity value on a controlling interest basis. Therefore, a premium for control would generally not be applied to the reporting unit value determined using the guideline transaction method.

Question 11-22

May management rely exclusively on comparable company pricing multiples when determining the fair value of a reporting unit?

PwC response

A common pitfall is the use of a market multiple of a public company that is not comparable to the reporting unit being tested. For example, a reporting unit may not be comparable to a public company that includes multiple reporting units. In these cases, relying solely on market comparables would not be appropriate and in determining fair value, management may need to place more reliance on another method, such as a discounted cash flow analysis.

11.5.8.3 Use of quoted market price of a reporting unit on a single date

ASC 820 requires an entity to begin its analysis in determining the fair value of a reporting unit with the quoted market price, if one is available, as of the measurement date (i.e., as of a single date). However, as discussed in the preceding section, when using quoted market prices to estimate the fair value of a reporting unit, an entity should consider all available evidence. Accordingly, a single day's quoted market price may not necessarily reflect a reporting unit's fair value. That might be the case if, for example, significant events occur which impact share price near the time goodwill is being tested for impairment. Determining whether to consider quoted market prices on more than a single date will depend on the facts and circumstances of each situation.

In a distressed market, it may be appropriate to consider recent trends in a company's trading price instead of just a single day's trading price in evaluating fair value. Frequently, averages over relatively short periods are used to determine representative market values. In some cases, prices may have moved dramatically over a short period of time or there may be a specific event that may have impacted market prices. Therefore, all relevant facts and circumstances must be evaluated. For example, an average may not be appropriate if a company's share price had a continued downward decline. On the other hand, an average may be a reasonable proxy for fair value when share prices experience significant volatility. However, stock prices after the impairment test date should not be considered unless those prices reflect the affirmation of events that existed as of the test date.

If a reporting unit's market capitalisation falls below its carrying amount, it may not be appropriate for an entity to assert that the reporting unit's market capitalisation is not representative of its fair value. Examples of evidence to support a fair value greater than market capitalisation may be (1) an analysis that indicates that a control premium should be added to the reporting unit's market capitalisation; or (2) as a result of an unusual event or circumstance, a temporary decline in quoted market prices occurs that indicates that the reporting unit's market capitalisation during that brief time would not represent the reporting unit's fair value.

11.5.8.4 Use of more than one valuation technique to estimate the fair value of a reporting unit

In instances where a quoted market price in an active market is not available or the current market price is believed to not be representative of fair value, the methodology used to determine fair value may be a single valuation technique or multiple valuation techniques (e.g., a present value technique and a market pricing multiple). If multiple valuation techniques are used, the entity should evaluate and weigh the results considering the reasonableness of the range indicated in determining the fair value. The results may indicate that a single point within the range or a weighting of values within the range is the most representative of fair value in the circumstances [ASC 820-10-35-24]. The methodology (including the use of more than one valuation technique) that an entity uses to determine the fair value of a reporting unit should be applied consistently. See BCG 11.5.8.5 for further information.

If a weighted approach with multiple valuation techniques is used to determine the fair value of reporting units, it is not necessary to use the same weighting for all reporting units. Each reporting unit should be valued individually using an approach that results in the best estimate of fair value of the reporting unit in the given circumstances—different approaches or weightings may be appropriate for determining the fair values of different reporting units.

11.5.8.5 Changing the valuation method used to estimate the fair value of a reporting unit

The valuation methodology used should be applied consistently from year to year, unless there are specific facts and circumstances that support a conclusion that another valuation methodology provides a better estimate of the reporting unit's fair value. ASC 820 permits an entity to change its methodology for determining the fair value of its reporting units if the change results in a measurement that is equally or more representative of fair value in the circumstances (e.g., a change in a particular method's weighting when multiple valuation techniques are used, or switching from a present value technique one year to a multiple of earnings or revenue technique in another year). A change in valuation technique might be warranted as new markets develop, new information becomes available, information previously used is no longer available, or valuation techniques improve [ASC 820-10-35-25]. A change in the methodology used to estimate fair value would be considered a change in accounting estimate. The disclosure requirements of ASC 250 are not required for revisions resulting from a change in a valuation technique or its application [ASC 820-10-35-26].

11.5.8.6 Reconciling the aggregate fair values of the reporting units to market capitalisation

Frequently, public companies have more than one reporting unit and, therefore, do not use the quoted market price of their stock to directly determine the fair value of reporting units. However, there is an expectation that the aggregation of reporting unit fair values can be reconciled to the company's market capitalisation. While not a requirement of ASC 350-10, the company's overall market capitalisation should reconcile, within a reasonable range, to the sum of the fair values of the individual reporting units.

Such reconciliation often includes both qualitative and quantitative assessments. As is the case in many areas requiring judgment, contemporaneous documentation of the assumptions and their applicability to the specific facts and circumstances is important.

When an entity performs a qualitative assessment for some reporting units but proceeds to step one for others, reconciling the overall market capitalisation to the aggregate fair value of reporting units can be challenging. There is no requirement to determine the fair value of reporting units that do not have goodwill or for which only a qualitative impairment test is performed. It may not be cost effective for some entities to determine the fair value of a reporting unit not subject to a step one test solely to allow for a reconciliation to the company's overall market capitalisation. However, a comparison of the aggregate fair values of reporting units for which a step one test is performed to the entity's market capitalisation still may be useful in order to establish that the aggregate fair value is not unreasonable relative to overall market capitalisation. For example, if an entity has five significant reporting units and performs step one for three of the five reporting units, the fair value determined for those three reporting units should not exceed the overall market capitalisation for the entity and in most cases should be less than the overall market capitalisation since the other two reporting units would be presumed to have value. In addition, the AICPA Goodwill Guide indicates that when performing an overall comparison to market capitalisation, entities could include the current year fair values for reporting units for which quantitative measurements were performed and estimate the fair value for the reporting units for which qualitative assessments were performed using a reasonable methodology.

Even though a reconciliation to market capitalisation may not be required, the underlying factors surrounding a decline in market capitalisation and whether those factors affect the fair value of the reporting unit being tested should be considered. SEC staff comments have historically focused on significant market declines and on the reconciliation of reporting unit fair values to a company's overall market capitalisation. In these comments, the SEC staff frequently asks how companies took into consideration the fact that their market capitalisation was below their book value when determining that goodwill had not been impaired.

Question 11-23

If management believes that the current trading price of its stock is not representative of fair value, can it assert that the market data is not relevant when determining the fair value of a reporting unit?

PwC response

A company's market capitalisation and other market data cannot be ignored when assessing the fair value of a company's reporting units. In a depressed economy, declines in market capitalisation could represent factors that should be considered in determining fair value, such as an overall re-pricing of the risk associated with the company. Determining the factors affecting market capitalisation and their impact on fair value requires the application of judgment.

Question 11-24

Is it acceptable if there is a significant difference between the aggregate fair values of a company's reporting units (derived using a cash flow analysis) and overall market capitalisation?

PwC response

When a significant difference exists between a company's market capitalisation and the aggregate fair values of a company's reporting units, the reasons for the difference should be understood. A company's cash flow models may not fully consider the risk associated with achieving those cash flows. Cash flow assumptions should be revisited and potential changes in the amount, timing and risks associated with those cash flows should be evaluated given the market environment. Cash flow analyses based on probability-weighted scenarios should likely include a wide range of potential outcomes. For example, outcomes in the past that were deemed to have little to no likelihood of occurrence may require greater weighting.

Question 11-25

What are common reconciling items between the aggregate fair values of a company's reporting units and its market capitalisation?

PwC response

A common reason for a difference between the aggregate fair values of the reporting units and the company's overall market capitalisation is that control premiums associated with a reporting unit are not reflected in the quoted market price of a single share of stock.

Other differences may be linked to external events or conditions, such as broad market reaction to circumstances associated with one or a few reporting companies. For example, the deteriorating financial condition of one company in a particular market sector could cause temporary market declines for other companies in the same sector. Unusual market activity, such as a spike in short selling activity, may also have a temporary impact on a company's market capitalisation but not reflect its underlying fair value. Short-term fluctuations in volatile markets may not necessarily reflect underlying fair values. It is therefore important to be able to explain the market fluctuations as part of the reconciliation of market capitalisation to the estimated fair values of reporting units. The AICPA Goodwill Guide indicates it is a best practice to identify and document the reasons for differences between the aggregate fair value of reporting units and the observable capitalisation. Factors identified included control synergies, data that may not be available to a market participant, tax consequences, entity specific versus market participant capital structures, excessive short positions against the stock, and controlling or large block interests.

11.5.9 *Special applications of the impairment test*

The following section discusses additional circumstances to consider when applying the impairment test.

11.5.9.1 *Impairment testing when a noncontrolling interest exists*

ASC 805 requires that the acquirer record all assets and liabilities of the acquiree at their fair values with limited exceptions and record goodwill associated with the entire business acquired. This means that in a partial business combination in which control is obtained, the acquiring entity will recognise and measure 100 percent of the assets and liabilities, including goodwill attributable to the noncontrolling interest, as if the entire entity had been acquired. Therefore, in terms of goodwill recognition and the amount of any subsequent impairment loss, no difference exists between acquiring a partial controlling interest in a business and the acquisition of an entire business accounted for in accordance with ASC 805.

When a noncontrolling interest exists, the fair value of a reporting unit and the implied fair value of goodwill should be determined in the same manner as it would be determined in a business combination accounted for in accordance with ASC 805 [ASC 350-20-35-57A]. If a company has a partially owned subsidiary, and only recorded goodwill related to the controlling interest in accordance with FAS 141, several methodologies may be appropriate when performing the goodwill impairment test after the adoption of ASC 805 and ASC 810-10.

One methodology would be to gross-up the carrying amount of the reporting unit to reflect recorded goodwill associated with the controlling interest and the notional amount of goodwill allocable to the noncontrolling interest (equalling the grossed-up goodwill and other net assets) based on the acquisition date ownership interests, and compare the reporting unit's adjusted carrying value to the fair value of the reporting unit determined in accordance with ASC 350. Under this methodology, any impairment loss resulting from step two of the test would only be measured and recorded for the portion of goodwill related to the parent's controlling interest. A second methodology would be to compare the carrying amount of the reporting unit, without adjustment, to its fair value—this may result in a cushion because the carrying amount of the reporting unit will only reflect a partial step-up of goodwill in the net assets of the subsidiary but the fair value will consider the full value of the subsidiary. Any impairment loss, based on step two of the goodwill impairment test, should be attributed entirely to the parent's controlling interest.

Further, any impairment loss measured in the second step of the goodwill impairment test must be attributed to the controlling and noncontrolling interests on a rational basis. In the case of a reporting unit containing an entity acquired before the adoption of ASC 805, which did not result in the recognition of goodwill attributable to the noncontrolling interest, the entire impairment loss would be attributed to the controlling interest.[1] If the reporting unit includes an entity for which goodwill was

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[1] Prior to the issuance of ASC 805, most entities did not record goodwill attributable to the noncontrolling interest in a partial business combination.

attributed to both the controlling interest and the noncontrolling interest, the goodwill impairment loss would be attributed to both.

Example 11-20 provides an example of a method for attributing a goodwill impairment loss to the controlling and noncontrolling interests.

EXAMPLE 11-20

Attribution of an impairment loss to the noncontrolling interest when the acquired entity is assigned to a new reporting unit

Company A acquires 80% of the ownership interests in Company B for CU800 million. Company A determines that the fair value of the noncontrolling interest is CU200 million. The aggregate value of the identifiable assets acquired and liabilities assumed, measured in accordance with ASC 805, is determined to be CU700 million. Company A's determination of goodwill related to the acquisition of Company B for purposes of attributing a goodwill impairment loss is as follows (in millions):

Fair value of the consideration transferred	CU800
Fair value of the noncontrolling interest	200
	1,000
Values of 100% of the identifiable net assets	(700)
Goodwill recognised	CU300
Goodwill attributable to the noncontrolling interest	CU60[1]
Goodwill attributable to the controlling interest	CU240[2]

[1] The goodwill attributable to the noncontrolling interest is the difference between the fair value of the noncontrolling interest and the noncontrolling interest's share of the recognised amount of the identifiable net assets (CU 60 = CU200 less 20% of CU700).

[2] The goodwill attributable to the controlling interest is the difference between the fair value of the consideration transferred measured in accordance with ASC 805 and the controlling interest's share of the recognised amount of the identifiable net assets (CU240 = CU800 less 80% of CU700).

For purposes of Company A's goodwill impairment testing, all of Company B's assets (including goodwill) and liabilities are assigned to a new reporting unit, Reporting Unit X.

Subsequent to the acquisition, another entity unexpectedly introduces a product that competes directly with Reporting Unit X's primary product. As a result, the fair value of Reporting Unit X falls to CU900 million and Company A tests Reporting Unit X's goodwill for impairment. For simplicity, assume that neither the carrying amount of Reporting Unit X nor the sum of the fair values of Reporting Unit X's identifiable net assets change between the acquisition date and the goodwill impairment testing date. Further, assume that Reporting Unit X's net assets other than goodwill do not require adjustment in accordance with other GAAP (e.g., ASC 360-10). For simplicity, all tax effects have been ignored.

Analysis

Company A's goodwill impairment test for Reporting Unit X is as follows (in millions):

Step one:

Fair value of reporting unit	CU900	
Carrying amount of reporting unit	(1,000)	
Excess carrying amount	CU(100)	Failed

Step two:

Fair value of reporting unit	CU900
Values of 100% of the identifiable net assets	(700)
Implied fair value of goodwill	200
Carrying amount of goodwill	300
Goodwill impairment loss	CU(100)
Goodwill impairment loss attributed to the noncontrolling interest	CU(20)[1]
Goodwill impairment loss attributed to the controlling interest	CU(80)[2]

[1] The goodwill impairment loss attributed to the noncontrolling interest is determined based on the total amount of the impairment loss of CU100 multiplied by the 20% ownership interest of the noncontrolling interest. The impairment loss would be the same if it was attributed based on the relative interest of the goodwill prior to impairment (CU60 attributable to the noncontrolling interest of CU300 of total goodwill). Note, however, that the full impairment loss of CU100 would be recorded in the statement of profit and loss.

[2] The goodwill impairment loss attributed to the controlling interest is determined based on the total amount of the impairment loss of CU100 multiplied by the 80% ownership interest of the controlling interest. The impairment loss would be the same if it was attributed based on the relative interest of the goodwill prior to impairment (CU240 attributable to the controlling interest of CU300 of total goodwill).

In Example 11-20, the goodwill impairment loss was attributed based on the relative ownership interests of the controlling and noncontrolling interests. The allocation would not have changed if it was determined using the relative interests in goodwill. However, as discussed in BCG 11.4.3, the fair value of the noncontrolling interest may not merely be an extrapolation of the consideration transferred for the controlling interest and, therefore, the fair value of the noncontrolling interest may have to be independently derived. In such cases, it is possible that the goodwill recorded in the acquisition may not be attributed to the controlling and noncontrolling interests based on their relative ownership interests. Example 11-21 demonstrates one approach to attributing the impairment loss to the controlling and noncontrolling interests in this case.

EXAMPLE 11-21

Attribution of goodwill to the controlling and noncontrolling interests when a premium is attributable to the controlling interest

Company A acquires 80% ownership interests in Company B for CU1,000. The value of the identifiable assets and liabilities measured in accordance with ASC 805 is determined to be CU700, and the fair value of the noncontrolling interest is determined to be CU200. Company A's determination of goodwill related to the acquisition of Company B is as follows:

Fair value of the consideration transferred	CU1,000
Fair value of the noncontrolling interest	200
	1,200
Fair values identifiable net assets	(700)
Goodwill recognised	CU500
Goodwill attributable to the noncontrolling interest	CU60[1]
Goodwill attributable to the controlling interest	CU440[2]

[1] The goodwill attributable to the noncontrolling interest is the difference between the fair value of the noncontrolling interest and the noncontrolling interest's share of the recognised amount of the identifiable net assets (CU60 = CU200 less 20% of CU700).

[2] The goodwill attributable to the controlling interest is the difference between the value of the consideration transferred measured in accordance with ASC 805 and the controlling interest's share of the recognised amount of the identifiable net assets (CU440 = CU1,000 less 80% of CU700).

Because Company A paid a premium to acquire a controlling interest in Company B, Company A's interest in goodwill is 88 percent (CU440 / CU500). This is higher than Company A's 80 percent ownership interest in Company B. Because the noncontrolling interest is always recorded at fair value, any control premium paid that does not also provide benefit to the noncontrolling interest is embedded in the controlling interest's share of goodwill.

For purposes of Company A's goodwill impairment testing, all of Company B's assets (including goodwill) and liabilities are assigned to a new reporting unit, Reporting Unit X.

Subsequent to the acquisition, another entity unexpectedly introduces a product that competes directly with Reporting Unit X's primary product. As a result, the fair value of Reporting Unit X falls to CU1,100 and Company A tests Reporting Unit X's goodwill for impairment. For simplicity, assume that neither the carrying amount of Reporting Unit X nor the sum of the fair values of Reporting Unit X's assets and liabilities change between the acquisition date and the goodwill impairment testing date. Further, assume that Reporting Unit X's net assets other than goodwill do not require adjustment in accordance with other GAAP (e.g., ASC 360-10). For simplicity, all tax effects have been ignored.

Analysis

Company A's goodwill impairment test for Reporting Unit X is as follows:

Step one:

Fair value of reporting unit	CU1,100	
Carrying amount of reporting unit	(1,200)	
Excess carrying amount	CU(100)	Failed

Step two:

Fair value of reporting unit	CU1,100
Fair values of identifiable net assets	(700)
Implied fair value of goodwill	400
Carrying amount of goodwill	500
Goodwill impairment loss	CU(100)
Goodwill impairment loss attributed to the noncontrolling interest	CU(12)[1]
Goodwill impairment loss attributed to the controlling interest	CU(88)[2]

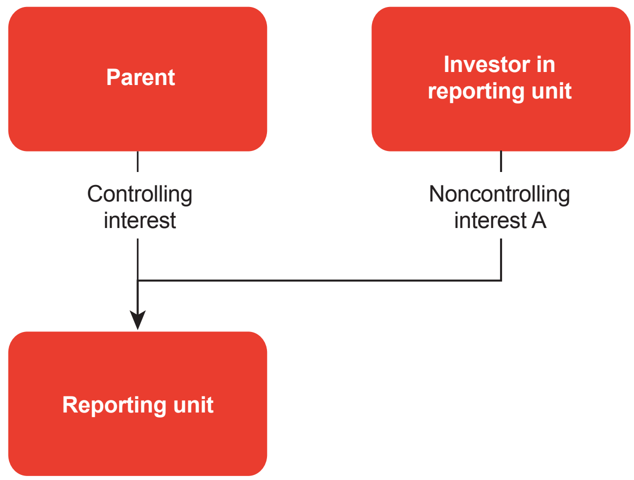
[1] The goodwill impairment loss attributed to the noncontrolling interest is determined based on the carrying amount of the goodwill attributable to the noncontrolling interest prior to impairment of CU60 relative to the total goodwill of CU500 (CU12 = (CU60 / CU500) x CU100). Note, however, that the full impairment loss of CU100 would be recorded in the statement of profit and loss.

[2] The goodwill impairment loss attributed to the controlling interest is determined based on the carrying amount of the goodwill attributable to the controlling interest prior to impairment of CU440 relative to the total goodwill of CU500 (CU88 = (CU440 / CU500) x CU100).

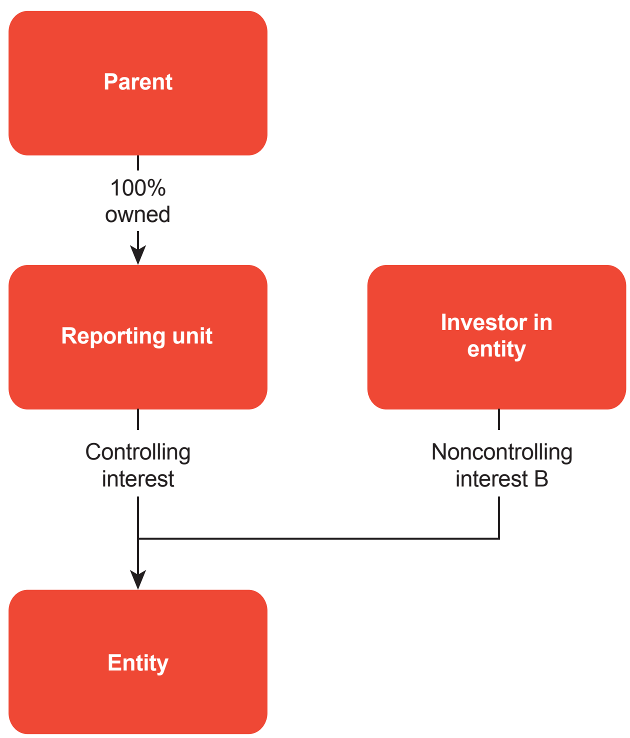
The attribution of any goodwill impairment loss to the controlling interest and the noncontrolling interest will not change unless there is a change in the relative ownership interests. If there is a change in ownership interests, any subsequent goodwill impairment charge is attributed to the controlling and noncontrolling interests on a rational basis.

11.5.9.2 Fair value of a noncontrolling interest may differ depending on whether a noncontrolling interest exists above the reporting unit or within the reporting unit

The fair values of controlling and noncontrolling interests may differ on a per share basis. An understanding of whether and to what extent the noncontrolling interest benefits from synergies, rights, and preferences that benefit the reporting unit as a whole is needed when determining the fair value of the noncontrolling interest. A noncontrolling interest may exist above the reporting unit while in other cases it may exist within the reporting unit. For example, the reporting unit could be partially owned by its parent. See noncontrolling interest A in the following diagram.



In another example, the reporting unit might be wholly owned but it may consolidate an entity that is partially owned by the reporting unit. See noncontrolling interest B in the following diagram.



The fair value of a reporting unit refers to the price that would be received for selling the unit as a whole. When a noncontrolling interest exists above the reporting unit (similar to Noncontrolling Interest A in the example above), the fair value of the controlling interest and the noncontrolling interest would likely be the same on a per-share value basis as both would likely participate in the exchange transaction for the sale of the reporting unit at the same per share price absent any rights or restrictions to the contrary. Conversely, when a noncontrolling interest exists within a reporting unit (similar to Noncontrolling Interest B in the example above), the sale of the reporting unit as a whole could leave the noncontrolling interest outstanding. If the noncontrolling interest is not expected to participate in the sale of a reporting unit, there may be a difference in the per-share fair value of the controlling and noncontrolling interests.

11.5.9.3 Impairment testing when a noncontrolling interest exists and the reporting unit contains goodwill from multiple acquisitions

When a noncontrolling interest exists, a number of complex scenarios may arise when goodwill is tested for impairment. For example, a reporting unit that includes a partially owned subsidiary could have operations and goodwill from another acquisition assigned to it, or the net assets and goodwill of a partially owned subsidiary might be assigned to more than one reporting unit. When goodwill in a reporting unit was generated from multiple acquisitions, including a partial acquisition, the tracking of acquisition-related goodwill may be necessary to appropriately attribute goodwill impairment charges between the controlling and noncontrolling interests.

The exposure draft on business combinations released by the Boards in 2005 proposed to amend ASC 350-20 to provide guidance on how to determine and attribute subsequent impairment losses to the controlling and noncontrolling interests. While the final standard did not include an amendment to provide guidance for allocating a goodwill impairment loss, we believe the exposure draft guidance may provide one acceptable alternative for attributing any such loss. The allocation approach provided was:

If the partially owned subsidiary is part of a reporting unit, the portion of the impairment loss allocated to that subsidiary would be determined by multiplying the goodwill impairment loss by the portion of the carrying amount of the goodwill assigned to that partially owned subsidiary over the carrying amount of the goodwill assigned to the reporting unit as a whole.

The amount of the impairment loss allocated to the partially owned subsidiary would then be attributed to the controlling and noncontrolling interests pro rata based on the relative carrying amounts of goodwill attributed to those interests.

Example 11-22 provides an example of this allocation approach.

EXAMPLE 11-22

Attribution of impairment loss to the noncontrolling interest when the reporting unit contains multiple acquisitions

Reporting Unit X includes a partially owned Subsidiary Z acquired previously in a business combination. The annual goodwill impairment test for Reporting Unit X resulted in an impairment loss of CU200 million. At the time of the acquisition of Subsidiary Z, the carrying amount of goodwill in Reporting Unit X was CU500 million, of which CU300 million is allocated to partially owned Subsidiary Z, and of that CU75 million is attributable to the noncontrolling interest.

Analysis

The impairment loss of CU200 million is attributed to the controlling interest and noncontrolling interest based on the pro rata carrying amounts of goodwill as follows (in millions):

Step one: Allocate the impairment loss to the wholly and partially owned subsidiaries

Wholly owned subsidiaries of Reporting Unit X (controlling interest):

CU200 x (CU200 / CU500) = CU80

Partially owned Subsidiary Z of Reporting Unit X (controlling and noncontrolling interests):

CU200 x (CU300 / CU500) = CU120

Step two: Attribute the impairment loss attributable to the partially owned subsidiary to the controlling and noncontrolling interests

Controlling interest of Subsidiary Z:

CU120 x (CU225 / CU300) = CU90

Noncontrolling interest of Subsidiary Z:

CU120 x (CU75 / CU300) = CU30

Step three: Sum the controlling and noncontrolling interests' allocations

Impairment loss attributed to the controlling interest of Reporting Unit X:

CU80 + CU90 = CU170

Impairment loss attributed to the noncontrolling interest of Reporting Unit X:
Equals noncontrolling interest of Subsidiary Z = CU30

The attribution of an impairment loss to the noncontrolling interest effectively results in an allocation of goodwill to entities below the reporting unit level. As described in the preceding example, an acquired partially owned subsidiary may be combined in a reporting unit with other acquired entities for which goodwill has been recorded. In this case, the goodwill impairment loss is allocated between the partially and wholly owned subsidiaries. Such allocations could represent additional operational challenges to management when other organisational changes are made that result in changes to reporting units.

11.5.9.4 Impairment testing of goodwill for separate subsidiary financial statements

When a subsidiary of an entity issues separate financial statements that are prepared in accordance with U.S. GAAP, all goodwill that is recognised in those financial statements must be tested for impairment as though the subsidiary were a standalone entity [ASC 350-20-35-48]. This includes goodwill arising from the parent's acquisition of the subsidiary, which may have been required to be recognised under push-down accounting, any acquisitions by the subsidiary, and any acquisitions by the parent that have been transferred to, and included in, the subsidiary's financial statements.

A subsidiary should test its recognised goodwill for impairment based on subsidiary-specific reporting units. The reporting units of the subsidiary must be determined from the perspective of the subsidiary's operating segments and an analysis of the components of those operating segments. We would expect the CODM and segment managers at the subsidiary level to review different information than the CODM at the consolidated level. Accordingly, the determination of operating segments, pursuant to ASC 280-10, could differ.

11.5.9.5 Impact of impairment at a subsidiary level on impairment testing at the parent level

Any goodwill impairment loss that is recognised at the subsidiary level would not necessarily be recognised in the parent company's **consolidated financial statements**. Instead, the consolidated entity's reporting unit(s) that includes a subsidiary's reporting unit(s) with impaired goodwill should be tested for impairment if it is more likely than not that the event or circumstance that gave rise to the goodwill impairment loss at the subsidiary level would reduce the fair value(s) of the consolidated entity's reporting unit(s) below the carrying amount of the reporting unit(s). In other words, an impairment loss at the subsidiary level may represent a triggering event for an interim impairment test at the consolidated level. The consolidated entity should recognise a goodwill impairment loss only when goodwill is impaired from the perspective of the consolidated entity's reporting unit(s).

Even when a subsidiary is a single reporting unit from the perspective of the consolidated entity, the subsidiary may have two or more of its own reporting units for purposes of testing its goodwill for impairment. If such a subsidiary recognised a goodwill impairment loss within one of its two reporting units, the impairment loss may be shielded at the consolidated level due to the consideration of the subsidiary as a whole as a single reporting unit by the consolidated entity. In another example, the subsidiary may consist of a single reporting unit, consistent with the consolidated entity; however, the balance of goodwill in the consolidated entity's reporting unit may not mirror the goodwill recorded by the subsidiary. Such instances could arise because the consolidated entity's reporting unit may also include goodwill assigned from other acquisitions or the goodwill may be reduced due to the assignment of goodwill to other reporting units due to synergies from the acquisition.

Example 11-23 demonstrates the necessary consideration of the impact of a subsidiary impairment loss at the consolidated level.

EXAMPLE 11-23

Considering a subsidiary impairment loss at the consolidated level

Subsidiary A is issuing standalone financial statements. Subsidiary A has goodwill of CU300 million. At Parent X, Subsidiary A and Subsidiary B combine to form one reporting unit, which includes goodwill of CU300 million (all Subsidiary A goodwill). Based on the completion of step one of the annual goodwill impairment test at Parent X, no goodwill impairment is indicated.

As a result of completion of the goodwill impairment tests at Subsidiary A, a goodwill impairment loss of CU100 million is determined.

Analysis

In this situation, Subsidiary A would record a goodwill impairment charge of CU100 million in its standalone financial statements. No goodwill impairment charge would be recorded in Parent X's consolidated financial statements because, at the Parent X level, there was no impairment of goodwill indicated by step one of the annual goodwill impairment test.

11.5.9.6 Equity-method investment goodwill not subject to the ASC 350-20 impairment test

Although equity-method investments are accounted for under ASC 323-10 rather than ASC 805, the difference between the acquisition cost of an equity-method investment and the amount of the investor's underlying equity in the net assets of the investee should be accounted for as if the investee were a consolidated subsidiary [ASC 323-10-35-13]. Therefore, a portion of the difference may be attributable to goodwill (equity-method goodwill), which is neither amortised nor separately reported outside the equity-method investment. The total carrying amount of the equity-method investment should be reviewed for impairment [ASC 350-20-35-59]. The impairment standard for an equity-method investment is "a loss in value of an investment which is other than a temporary decline" [ASC 323-10-35-32]. When a determination is made that an other-than-temporary decline exists, the equity-method investment should be written down to its fair value, which then establishes a new cost basis.

An equity-method investor should not separately test an investee's underlying asset(s), including goodwill, for impairment [ASC 323-10-35-32A]. However, the investor generally should record its share of any impairment recognised by the investee and consider the effect, if any, of the impairment on its basis difference in the assets giving rise to the investee's impairment [ASC 323-10-35-32A]. In the case of goodwill, the investee will be testing its own goodwill under the provisions of ASC 350-20 because it controls the underlying businesses that gave rise to the goodwill. An investor, on the other hand, does not control the businesses or underlying assets of an equity-method investee that gave rise to the goodwill of the investee. Therefore, an equity-method investor should recognise its proportionate share of a goodwill impairment loss recorded by an investee because the investee's goodwill would not be subject to direct impairment testing by the investor in its reporting unit structure. After an investor records its share of any impairment of the investee, the remaining investment should be tested for an other-than-temporary decline.

Under ASC 350-20 an entity may include equity-method investments within the overall net assets of a reporting unit for the purposes of performing a goodwill impairment test on the reporting unit as a whole, provided that the equity-method investment is appropriately assigned to the reporting unit. See BCG 11.3.5 for further information. In such cases, when the criteria in ASC 350-20-35-39 are met, the equity-method investment should be treated the same as any other asset within the reporting unit and, therefore, should be included in both the carrying amount and the fair value of the reporting unit when performing the goodwill impairment test. The equity-method investment would be tested for impairment under ASC 323-10 prior to performing the reporting unit's goodwill impairment test. Any adjusted carrying amount should be recorded as the new carrying value of the investment and included in the carrying amount of the reporting unit.

11.5.9.7 Allocation of impairment to goodwill components for tax purposes

When a company records an impairment of its goodwill, any **deferred tax liability** or **deferred tax asset** related to goodwill may also be affected by such a charge. The determination of whether a corresponding tax benefit should be recorded is based on whether the goodwill is tax deductible.

As more fully discussed in BCG 5, an acquirer should recognise and measure deferred tax assets and liabilities arising from the assets acquired and liabilities assumed in a business combination in accordance with ASC 740-10 [ASC 805-740-25-2]. Some business combination transactions, particularly **taxable business combinations**, can result in goodwill that is deductible for tax purposes (also referred to as "tax-deductible goodwill"). The amount assigned to goodwill for book and tax purposes could differ due to different valuation and allocation rules and differences in determining the amount of consideration transferred (e.g., different treatment of costs incurred for the transaction). ASC 805 prohibits recognition of a deferred tax liability related to goodwill (or the portion thereof) for which amortisation is not deductible for tax purposes. In situations in which goodwill is not deductible for tax purposes, a goodwill impairment would have no corresponding tax effect.

In those transactions in which goodwill is deductible for tax purposes, the reported amount of goodwill and the tax basis of goodwill are each separated into two components as of the acquisition date for purposes of the deferred tax calculations. The first component (component-1) equals the lesser of (1) goodwill for financial reporting or (2) tax-deductible goodwill. The second component (component-2) equals the remainder of each, that is, (1) the remainder, if any, of goodwill for financial reporting in excess of tax-deductible goodwill or (2) the remainder, if any, of tax-deductible goodwill in excess of goodwill for financial reporting.

Any difference that arises between the book and tax bases of component-1 goodwill in future years (e.g., amortisation for tax purposes or impairment for book purposes) is a temporary difference for which a deferred tax liability or asset is recognised, based on the requirements of ASC 740-10. If component-2 is an excess of tax-deductible goodwill over the amount of goodwill for financial reporting, the tax benefit for that excess is a temporary difference for which a deferred tax asset is recognised based on the requirements of ASC 740-10 at the acquisition date. However, if component-2 is an excess of goodwill for financial reporting over the tax-deductible amount of goodwill, no deferred taxes are recognised at the acquisition date or in future years [ASC 805-740-25-9].

We believe a reasonable methodology to allocate a goodwill impairment loss between the components would be to allocate the loss proportionally to the carrying amount of component-1 and component-2 goodwill. Subsequent to the acquisition, tax-deductible goodwill will have been amortised and will create a book/tax basis difference for component-1 goodwill, giving rise to a deferred tax liability (assuming no previous goodwill impairment for book purposes). In addition, amortisation of any component-2 excess tax-deductible goodwill for which a deferred tax asset was established at the acquisition date will have reduced the deferred tax asset. An impairment of book goodwill will reduce the deferred tax liability of component-1 goodwill and may create a deferred tax asset (after considering any valuation allowance), depending on the amount of the impairment charge. If component-2 is excess book goodwill (i.e., goodwill without a corresponding tax basis) an impairment charge would not affect deferred tax balances.

Example 11-24 demonstrates the tax effect of a goodwill impairment loss.

EXAMPLE 11-24

Deferred tax effect of a goodwill impairment loss

Company A performs its annual goodwill impairment tests and concludes that the goodwill for Reporting Unit X suffered an impairment loss of CU400 million. The assets and liabilities in the reporting unit had been acquired four years ago in an asset acquisition accounted for as a business combination (i.e., a taxable transaction) and the related tax goodwill is deductible over 15 years. Assume an applicable tax rate of 40 percent (in millions):

Analysis

	Component-1 goodwill	Component-2 goodwill	Book basis	Tax basis	Deferred taxes
Balance at acquisition date	CU900	CU300	CU1,200	CU900	CU—
Tax amortisation	—	—	—	(240)	(96)
Balance before impairment test	900	300	1,200	660	(96)
Impairment loss	(300)	(100)	(400)	—	120
Ending balance	CU600	CU200	CU800	CU660	CU24

The goodwill impairment loss of CU400 million is allocated proportionately to component-1 and component-2 goodwill based on their relative carrying amounts. Deferred taxes represent the temporary difference between component-1 goodwill and its tax basis multiplied by the applicable tax rate. The deferred tax asset of CU24 million ((CU600 – CU660) x 40%) would be subject to a valuation allowance if its recovery is not "more likely than not." No tax benefit is recorded for the component-2 goodwill impairment because there is no current or future tax benefit associated with the component-2 goodwill since financial reporting goodwill exceeds tax deductible goodwill. In connection with recording the goodwill impairment loss of CU400 million, Company A would record a deferred tax benefit of CU120 million.

If a deferred tax asset was recorded on the acquisition date for excess of tax-deductible goodwill over the amount of goodwill for financial reporting purposes (i.e., component-2 goodwill), subsequent impairment charges may (1) increase an existing or create a new deferred tax asset, or (2) decrease or eliminate a deferred tax liability that was created subsequent to the acquisition through the amortisation of tax-deductible goodwill.

Example 11-25 illustrates the tax effect of a goodwill impairment loss when there is excess of tax-deductible goodwill over the amount of goodwill for financial reporting purposes at acquisition.

EXAMPLE 11-25

Deferred tax effect of a goodwill impairment loss: excess of tax-deductible goodwill over the amount of goodwill for financial reporting purposes at acquisition

Company A acquires a business in a nontaxable transaction and accounts for the acquisition under ASC 805. At the acquisition date, Company A has goodwill for financial reporting purposes of CU400 and tax-deductible goodwill of CU900 (carried over from a prior acquisition) and, therefore, there is no component-2 goodwill for financial reporting purposes. A deferred tax asset (DTA) for the excess tax-deductible goodwill of CU200 is recorded at the acquisition date. The DTA (using a 40% tax rate) and resulting financial reporting goodwill was computed by applying the iterative calculation described in TX 10.7.2. The tax goodwill is deductible ratably over 10 years. In year 4, Company A performs its annual goodwill impairment tests and concludes that the goodwill for reporting unit X suffered an impairment loss of CU200.

Analysis

When a DTA is recorded on the acquisition date for excess tax-deductible goodwill, subsequent impairment charges will cause a re-measurement of deferred taxes.

In this example, activity for years 1–4 is presented below (in millions):

Year	Financial reporting (book basis) goodwill	Tax basis goodwill	Annual tax amortisation	Deferred taxes
At acquisition	CU400	CU900	CU —	CU200
Year 1	400	810	90	164
2	400	720	90	128
3	400	630	90	92
4	400	540	90	56
Book impairment loss	(200)	—	—	80
Post-impairment carrying amount (Year 4)	CU200	CU540	CU —	CU136

In general, when tax-deductible goodwill exceeds goodwill for financial reporting purposes, the decrease in tax basis from tax amortisation first reduces the DTA recorded on the acquisition date before creating a deferred tax liability (DTL). The goodwill impairment loss reduces the carrying amount of book goodwill. There is no component-2 book goodwill, so there is no need to allocate the impairment between components. In this example, the book basis impairment loss reduces the carrying amount of goodwill for financial reporting purposes and results in an increase in the existing DTA. The resulting post-impairment DTA of CU136 ((CU540 – CU200) x 40%) would require a valuation allowance if its realisation is not "more likely than not."

In contrast, an impairment loss in later years may reduce an existing DTL. For example, assume reporting unit X suffered a CU200 impairment loss in year 8.

Year	Financial reporting (book basis) goodwill	Tax basis goodwill	Annual tax amortisation	Deferred taxes
At acquisition	CU400	CU900	CU —	CU200
Year 1	400	810	90	164
2	400	720	90	128
...				
7	400	270	90	(52)
8	400	180	90	(88)
Book impairment loss	(200)	—	—	80
Post-impairment carrying amount (year 8)	CU200	CU180	CU —	CU(8)

In this case, the CU200 million book basis impairment loss reduces the carrying amount of goodwill for financial reporting purposes, and reduces the existing DTL from CU88 to CU8.

11.5.9.8 *Different aggregation of goodwill for ASC 740-10 and ASC 350-20*

The determination of tax goodwill must be performed on a jurisdictional basis and not on a reporting unit basis or some higher level of aggregation. However, when assigning goodwill for financial reporting purposes, ASC 350-20 requires that goodwill be assigned at the reporting unit level. Reporting units, therefore, may include various tax jurisdictions and legal entities, or only portions of a company's operations contained in certain tax jurisdictions or legal entities. Consequently, at the reporting unit level, the tax goodwill associated with the reporting unit may be different than the goodwill assigned under ASC 350-20. In the case of goodwill impairments or other changes in goodwill (e.g., dispositions), the entity will need to evaluate the goodwill for financial reporting purposes and the tax basis of goodwill attributable to reporting units for purposes of determining the tax effects of such changes on the reporting units under ASC 740-10.

11.6 Disposal considerations

When a reporting unit is to be disposed of in its entirety, the entity must include in the reporting unit's carrying amount the goodwill of that reporting unit in determining the gain or loss on disposal. When some, but not all, of a reporting unit is to be disposed of, the accounting for that reporting unit's goodwill will depend on whether the net assets that are to be disposed of constitute a business. If the net assets that are to be disposed of do not constitute a business, no goodwill should be allocated to those net assets. If, on the other hand, the net assets that are to be disposed of do constitute a business, the entity should allocate a portion of the reporting unit's goodwill to that business in determining the gain or loss on the disposal of the business. The amount of goodwill that is allocated to the business should be based on the relative fair values of (1) that business and (2) the portion of the reporting unit that will be retained [ASC 350-20-35-51 through 35-53]. The broad definition of a business in ASC 805 results in many disposals of such groups qualifying as sales of businesses.

If, however, the business that is to be disposed of was never integrated into the reporting unit after its acquisition and thus the rest of the reporting unit never realised the benefits of the acquired goodwill, the relative fair value allocation approach is not used. This situation might occur when the acquired business is operated as a standalone entity or when the business is to be disposed of shortly after it is acquired. In that case, goodwill associated with the nonintegrated business would not be included in a relative fair value calculation. Instead, the original goodwill amount associated with that business should be included when determining the gain or loss on disposal. However, these situations occur infrequently because some amount of integration generally occurs after an acquisition. The determination of whether the business to be disposed of has never been integrated largely depends on the specific facts and circumstances and requires significant judgment. The following factors are helpful when determining whether some level of integration has occurred:

- Level of management interaction between the acquired business and its parent
- Length of time between the acquisition date and the subsequent disposal
- Level of shared customers, shared customer lists, customer referrals, etc. amongst the acquired business and the parent
- Extent of any corporate level services provided to the acquired business by the parent
- Joint marketing efforts between the acquired business and the parent or other businesses owned by the parent
- Use of common brands and trademarks
- Expected integration plans and synergies underlying the original acquisition
- Legal ownership structure
- Geographic proximity (potentially indicating shared services and market operations)

When only a portion of a reporting unit's goodwill is allocated to a business that is to be disposed of, the goodwill remaining in the portion of the reporting unit that is to be retained should be tested for impairment [ASC 350-20-35-57]. See BCG 11.4.4 for further information.

11.6.1 Impairment testing in connection with the disposal of a business

The disposal timeline can usually be divided into three discrete accounting events that require consideration: (1) a current expectation of an impending disposal, (2) classification of the disposal group as held-for-sale under ASC 360-10, and (3) the actual disposal. See BCG 10 for further information on classification of the disposal group as held-for-sale under ASC 360-10. These three events may occur in the same accounting period and, therefore, require no separate accounting consideration. Usually, however, the events transpire over two or more accounting periods. Therefore, because each event may result in an impairment test or other consequences for the carrying amount of goodwill, the accounting associated with a disposition may involve more than simply recording a gain or loss upon sale.

In cases in which management is planning to sell a business before the end of the estimated useful lives of the underlying long-lived assets, if the entity determines the business does not yet meet the held-for-sale criteria, management would still need to consider whether to revise the remaining estimated useful lives of the assets. See BCG 10.4 for further information.

When there is a planned sale of a business, a company should consider the relevant guidance in determining the carrying amount of the business for purposes of evaluating the business and/or the underlying assets for impairment. For example, the following discussion focuses on the sale of an asset group (either all, or a portion of a reporting unit) that constitutes a business for which goodwill is included in the disposal group.

11.6.1.1 Expectation of a disposal

An entity should test all of a reporting unit's goodwill for impairment if (1) the entity has a "more likely than not" expectation that the reporting unit or a significant portion of the reporting unit will be sold or otherwise disposed of [ASC 350-20-35-3C] and (2) based on that expectation, it is "more likely than not" that the fair value of the reporting unit is below its carrying amount. Any impairment charge resulting from this impairment test would be recognised as part of an impairment loss.

11.6.1.2 Assets held for sale

A disposal group that is classified as held for sale should be measured at the lower of its carrying amount or **fair value less cost to sell** each reporting period [ASC 360-10-35-43]. The carrying amount of any assets that are not covered by ASC 360-10, including goodwill, that are included in a disposal group classified as held for sale should be adjusted in accordance with other applicable U.S. GAAP prior to measuring the fair value less cost to sell of the disposal group.

11.6.1.3 Disposal of the business

A gain or loss that results from the disposal of a business should be recognised at the date of sale. In most cases, such a gain or loss may not be significant when impairment losses have been recognised at the time the disposal group meets the held-for-sale criteria (or upon the expectation to sell) and is subsequently adjusted to its fair value less cost to sell prior to the disposition. At the time of sale, assets, including any goodwill, and liabilities included in the carrying amount of the disposal group will be factored into the determination of gain or loss on the disposal of a business.

Example 11-26 demonstrates the goodwill accounting considerations when disposing of a business that is a portion of a reporting unit.

EXAMPLE 11-26

Disposal of a business that is a portion of a reporting unit

Company A is a calendar year-end diversified manufacturing company that has an electronics reporting unit. The electronics reporting unit includes two geographically based businesses, one in the United States and the other in Europe, both of which were originally acquired in purchase transactions. Although its U.S. electronics business is profitable and expected to remain stable, Company A's electronics business in Europe has only managed to break even, and is in decline due to high levels of competition. Company A's annual goodwill impairment testing in November 20X7 indicated that the CU1,100 carrying amount of the electronics reporting unit's goodwill was not impaired because the unit's fair value of CU5,500 exceeded the unit's carrying amount of CU5,100. For simplicity, all tax effects have been ignored, and assume that there is no change in other net assets throughout the example and it has been assumed that there are no direct costs to sell the European electronics business.

Analysis

"More likely than not" expectation that European electronics business will be sold

In May 20X8, the European electronics business loses one of its significant customers. Based on this event, while Company A's management has not yet committed to a plan to sell the European electronics business, it determines that it is more likely than not that it will sell the European electronics business within the next year and that the fair value of the electronics reporting unit may no longer exceed the unit's carrying amount. Therefore, Company A tests the entire electronics reporting unit's goodwill for impairment during May 20X8. Prior to testing the electronics reporting unit's goodwill for impairment, Company A determines that the carrying amounts of the unit's other assets do not require adjustment under other applicable GAAP (e.g., ASC 350 and ASC 360-10) including testing the European electronics business under the held-and-used model. The electronics reporting unit fails step one of the goodwill impairment test because the fair value of the reporting unit has declined, and step two results in a CU100 goodwill impairment loss. After the entity recognises the goodwill impairment loss, the carrying amount of the electronics reporting unit is as follows:

	Carrying Amount
Goodwill	CU1,000
Other net assets:	
U.S. electronics business	2,300
European electronics business	1,700
Total	CU5,000

European electronics business is held for sale

In September 20X8, Company A's management commits to a plan to sell the European electronics business. That plan meets all of ASC 360-10's criteria for the European electronics business to be (1) classified as held for sale (i.e., a disposal group), and (2) reported as a discontinued operation pursuant to ASC 205-20. At this point, Company A would assign the electronics reporting unit's goodwill to the U.S. and European electronics businesses based on the relative fair values of those businesses. Company A determines this goodwill allocation as follows:

	U.S.	Europe	Total
Fair values	CU3,000	CU2,000	CU5,000
Relative fair value	60%	40%	100%
Goodwill	CU600	CU400	CU1,000

Company A would measure the European electronics business at the lower of its carrying amount or fair value less cost to sell pursuant to ASC 360-10. In doing so, however, Company A would first adjust the carrying amount of the goodwill that was assigned to the European electronics business by applying ASC 350-20's goodwill impairment test. After Company A assigns goodwill to the European electronics business, the business' (a reporting unit) carrying amount of CU2,100 (goodwill of CU400 and other net assets of CU1,700) exceeds the business' fair value of CU2,000. The European electronics business fails step one of the goodwill impairment test.

Step two:	Total
Fair value of European's electronics business	CU2,000
Fair value of European's net assets, excluding goodwill	(1,700)
Implied fair value of goodwill	300
Allocated goodwill	400
Impairment loss	CU(100)

In its third quarter financial statements, Company A would recognise the loss of CU100. There would be no further loss recognised for classifying the European electronics business as held for sale because the carrying amount would be equal to the disposal group's fair value less cost to sell.

Company A would also need to test the goodwill of CU600 that was assigned to the U.S. electronics business (i.e., the portion of the electronics reporting unit that is to be retained) for impairment. That goodwill would not be impaired because the U.S. electronics business' fair value of CU3,000 exceeds its carrying amount of CU2,900 (goodwill of CU600 and other net assets of CU2,300).

European electronics business is sold

In December 20X8, Company A sells the European electronics business for CU1,800. The sales price is below Company A's previous estimates of the European electronics business' fair value because the business lost another major customer in November 20X8. In its fourth quarter financial statements, Company A would recognise an additional CU200 loss (sales proceeds of CU1,800 minus a carrying amount of CU2,000) on the disposal of discontinued operations. The total loss on the disposal of the discontinued business would be CU300 (CU100 recognised in the third quarter plus CU200 in the fourth quarter) representing accumulated losses, since it was determined that the discontinued operation met the held-for-sale criteria. The goodwill impairment loss of CU100 recognised in May of 20X8 on the electronics reporting unit would not be included in the loss on disposal of the discontinued business.

Company A does not believe that the additional loss is an indicator of the value of the goodwill assigned to the U.S. electronics business and, therefore, it does not represent a triggering event for an interim impairment test of the goodwill included in the U.S. electronics business. However, if Company A had an annual impairment test date of 31 December, it would still have to perform the impairment test for the remaining U.S. electronics business at that time.

11.6.2 Allocation of goodwill in a spin-off

When a reporting unit or a portion of a reporting unit that constitutes a business is to be spun off to shareholders, goodwill associated with the disposal group should be allocated to and included in the distributed carrying value at the distribution date. In determining the goodwill to be allocated to the spin-off transaction, the parent would usually follow the relative fair value approach discussed above (assuming the parent is spinning off a portion of the reporting unit), and the goodwill allocated to the spin-off entity would be removed from the parent's balance sheet at the time of the spin-off. Until the time of the spin-off, the disposal group should be tested for impairment on a held and used basis. In addition to any impairment losses required to be recognised while the asset is classified as held and used, an impairment loss, if any, shall be recognised when the asset is disposed of if the carrying amount of the asset (disposal group) exceeds its fair value [ASC 360-10-40-4].

Goodwill recorded in the spin-off entity's financial statements is not necessarily the same amount as what the parent would eliminate from its balance sheet at the time of the spin-off (i.e., the accounting may not be symmetrical because the method of allocating goodwill to be removed from the parent's balance sheet may differ from the method used to measure the value of goodwill received by the spin-off entity). While the parent's accounting is based on the relative fair value of the reporting unit, the standalone or carve-out statements prepared for the spin-off entity follow a historical goodwill concept and reflect the acquisition-specific goodwill of any previously acquired entities that will be part of the spin-off. Such goodwill includes any goodwill residing at the parent level that had not previously been pushed down to any subsidiaries that are included in the spin-off entity. Furthermore, any prior impairments of goodwill at the parent level may not necessarily be reflected in the carve-out financial statements. Goodwill recorded at the spin-off entity level would be allocated to the spin-off entity's reporting units and may be separately tested for impairment for all prior periods, similar to subsidiary goodwill impairment testing as discussed in BCG 11.5.9.4. In such a case, impairment testing at the spin-off entity level may produce goodwill impairment charges that have not been required to be recorded at the parent level.

11.6.3 Allocation of goodwill for a nonmonetary exchange transaction

The SEC indicated in an announcement made by one of their staff members at an EITF meeting that if an SEC registrant engages in a transaction that involves the exchange of a business for any nonmonetary asset(s) (including an equity-method investment), such transactions must be accounted for at fair alue, unless fair value is not determinable within reasonable limits. We believe that when a portion of a reporting unit that constitutes a business is to be disposed of in a nonmonetary exchange transaction that will be accounted for at fair value, a portion of the reporting unit's goodwill should be allocated to the business in the same manner as discussed above for a disposal by sale.

Question 11-26

Should goodwill be allocated to a disposal group that is a business and part of a reporting unit in determining a gain or loss upon disposal when the disposal group is contributed to a joint venture?

PwC response

ASC 350-20-35-57 states, "when a portion of a reporting unit that constitutes a business is to be disposed of, goodwill associated with that business shall be included in the carrying amount of the business in determining the gain or loss on disposal." The contribution of a business to a joint venture is analogous to other disposals (e.g., a sale or spin-off). Further, the FASB clarified in ASU 2010-02 that the guidance in ASC 810-10 should be followed when a subsidiary that is a business is transferred to an equity-method investee or a joint venture. Therefore, a gain or loss would be realised based on the difference between the fair value of the equity investment in the joint venture received and the carrying amount of the business contributed, which includes an allocation of goodwill.

Following allocation of goodwill to the disposed business, ASC 350-20-35-57 requires that any goodwill that remains in the reporting unit be tested for impairment.

11.7 Presentation and disclosures

ASC 350-20-45 and ASC 350-20-50 describe disclosure requirements for goodwill. Article 5-02(16) of Regulation S-X requires that the amount of accumulated amortisation of intangible assets (including goodwill) be set forth separately in the balance sheet or in a note thereto. It should be noted that if accumulated amortisation of intangible assets (including goodwill) relates to assets held for sale at the balance sheet date, it would need to be presented as a separate line item in the statement of financial position [ASC 360-10-45-14].

See BCG 13.2.8 for further information on disclosure requirements relating to goodwill and recognised or potential impairments.

11.8 Private company accounting alternative

On January 16, 2014, the FASB and the PCC issued ASU 2014-02, *Accounting for Goodwill* (the "goodwill alternative"). For private companies, the goodwill alternative represents a fundamental overhaul of the existing accounting model for goodwill. Application of the goodwill alternative is optional, and a private company can continue to follow the existing goodwill accounting guidance. An eligible company that elects the goodwill alternative will be able to apply a simplified impairment test but also will be required to amortise goodwill.

Only private companies are eligible to elect the goodwill alternative. Companies considering adoption should carefully review the definition of a public business entity, as defined in ASU 2013-12, *Definition of a Public Business Entity*. A company that meets the definition of a public business entity is not eligible to apply any of the PCC's accounting alternatives in its financial statements. Additionally, not-for-profit entities and employee benefit plans are not eligible to adopt PCC accounting alternatives.

ASU 2013-12 defines a public business entity as a business entity meeting any one of the following criteria:

- It is required by the SEC to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers) with the SEC (including other entities whose financial statements or financial information are required to be or are included in the filing).

- It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC.

- It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer.

- It has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market.

- It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including footnotes) and make them publicly available on a periodic basis (for example, interim or annual periods). An entity must meet both of these conditions to meet this criterion.

An eligible private company is required to make an accounting policy election if it intends to adopt the goodwill alternative. The alternative is effective for annual periods beginning after December 15, 2014 and interim periods within annual periods beginning after December 15, 2015. Early adoption is permitted for any annual or interim period for which a company's financial statements have not yet been made available for issuance.[2]

The PCC is addressing accounting alternatives in other areas as well. A private company will generally be able to choose which of the accounting alternatives it will adopt and will not be required to adopt all of the accounting alternatives being offered just because it adopts one or more of them. However, if the goodwill alternative is adopted, a private company must apply all provisions of ASU 2014-02 prospectively to all of its existing and future goodwill. Therefore, if a company elects to adopt the goodwill alternative for impairment testing, it must apply the standard's amortisation guidance.[3]

Question 11-27

What factors should a private company consider before deciding whether it will adopt the goodwill alternative?

PwC response

A company should carefully consider whether it currently meets the definition of a public business entity and whether it expects to meet that definition in the future. If a company that is private today later meets the definition of a public business entity (for example, due to a public offering of the company's securities), it will no longer be eligible to apply the goodwill alternative and will be required to retrospectively adjust its historical financial statements to apply the requirements of the existing goodwill accounting guidance.

In addition to determining whether it is eligible to adopt the goodwill alternative, a company should also assess the impact a transition to the goodwill alternative will have on its key financial metrics, particularly those affecting its debt covenant

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[2] Under the guidance in ASC 855, *Subsequent Events* (ASC 855), financial statements are available to be issued when they are complete in a form and format that complies with GAAP and all approvals necessary for issuance have been obtained.

[3] A private company that elects to adopt the goodwill alternative will be required to amortise the portion of the difference between the cost of an investment accounted for on the equity method and the amount of underlying equity in net assets of the equity method investee that is recognised as goodwill. Additionally, a private company should consider what impact, if any, the amortisation of goodwill will have on its accounting for deferred tax assets and liabilities.

compliance. While a company's EBITDA will not likely be impacted by adoption of the goodwill alternative, other key measures of performance such as net income, operating income, net assets and retained earnings will be affected.

Key differences between the goodwill alternative and the existing goodwill impairment guidance are summarised in Figure 11-5.

Figure 11-5

Key differences between the goodwill alternative and the existing goodwill guidance

	Goodwill alternative	**Existing goodwill guidance**
Amortisation	Requires goodwill to be amortised on a straight-line basis over a period of ten years, or less in certain circumstances	Does not allow goodwill to be amortised
Level of testing for impairment assessment	Either entity-wide or reporting unit (policy election upon adoption of the accounting alternative)	Reporting unit
Frequency of impairment assessment	Upon occurrence of a triggering event	At least annually, and between annual tests whenever a triggering event occurs
Measurement of impairment	Single step test, which compares the fair value of the entity (or reporting unit) to its carrying amount	Two-step test: In the first step, the fair value of each reporting unit is compared to its carrying amount. If the fair value of the reporting unit is less than its carrying amount, a second step is used to measure any impairment. This second step requires the preparation of a hypothetical purchase price allocation to determine the implied fair value of goodwill. The impairment, if any, is the amount by which the carrying amount of the reporting unit's goodwill exceeds its implied fair value

	Goodwill alternative	Existing goodwill guidance
Allocation of impairment	Impairment charge allocated to separate amortisable units of goodwill using either a pro rata allocation based on relative carrying amounts of goodwill or another reasonable and rational basis	Impairment charge allocated at the reporting unit level
Disposal of business that constitutes a portion of an entity (or reporting unit)	Goodwill allocated to disposed business using a reasonable and rational approach	Goodwill allocated based on the relative fair value of the business disposed of to the portion of the reporting unit being retained

The remainder of this section addresses the provisions of the goodwill alternative.

11.8.1 Amortisation of goodwill

A company should amortise goodwill on a straight-line basis over ten years, or less than ten years if the company demonstrates that another useful life is more appropriate [ASC 350-20-35-63]. The amortisation guidance applies to existing goodwill, whether it resulted from a business combination or application of fresh-start reporting, at the adoption date as well as any new goodwill arising subsequent to adoption.

Upon adoption, a company should assign a useful life to its existing **amortisable units of goodwill** as of the beginning of the period of adoption and begin amortising the goodwill on a straight-line basis from the beginning of the period. Assigning a remaining useful life of ten years to all existing goodwill on the adoption date, unless a shorter useful life is more appropriate, is intended to simplify the accounting. In no circumstances is a company permitted to assign a useful life in excess of ten years to its goodwill. Example 11-27 illustrates how a company should transition to the goodwill alternative.

Example 11-27

Transition to goodwill alternative

Company A, which is eligible to apply the PCC's accounting alternatives, elects to early adopt the goodwill alternative in its year ended December 31, 2013 financial statements. On January 1, 2013, the beginning of the year of adoption, Company A has goodwill of CU100. Company A concludes that it will assign a useful life of ten years to this goodwill balance, without further analysis of the life, as a practical expedient.

Analysis

Assuming there are no impairments or disposals during 2013, Company A should record CU10 of goodwill amortisation expense in operating expenses for the year-ended December 31, 2013.

11.8.1.1 *Amortisation after initial adoption*

A company should assign a useful life to new goodwill arising after initial adoption on an acquisition-by-acquisition basis, thus creating separate amortisable units of goodwill. A useful life of ten years can be assigned to a new amortisable unit of goodwill as a practical expedient. As with existing goodwill on the adoption date, a company has the option to assign a shorter useful life to a new amortisable unit of goodwill if it demonstrates that the goodwill has a shorter useful life. The determination of the useful life of goodwill should be made separately for each amortisable unit of goodwill.

A company may revise the remaining useful life of each of its amortisable units of goodwill upon the occurrence of an event or change in circumstance that could indicate a different remaining useful life is more appropriate. The cumulative amortisation period of any single amortisable unit of goodwill cannot exceed ten years. Therefore, if an individual amortisable unit of goodwill is initially assigned a useful life of ten years, it may be appropriate in certain circumstances to subsequently shorten the life, but in no circumstances should the useful life be extended beyond a total life of ten years. If the estimated remaining useful life of an amortisable unit of goodwill is adjusted, the change would be treated as a change in accounting estimate, and thus applied on a prospective basis from the date the useful life is adjusted [ASC 350-20-35-64].

11.8.2 *Impairment model*

The goodwill alternative simplifies many aspects of the goodwill impairment model for private companies by changing the level at which the impairment assessment is performed, when the test is performed, and how an impairment charge is calculated. The goodwill alternative does not change the order in which goodwill is assessed for impairment. The order of impairment testing is described in BCG 10.4.1.4 and BCG 10.4.2.1.

11.8.2.1 *Level to test goodwill for impairment*

Goodwill may be assessed for impairment at the entity-wide level or at the reporting unit level. The level at which to test goodwill for impairment is a policy election that is required to be made on the date the goodwill alternative is adopted. If a company elects to assess goodwill for impairment at the reporting unit level, it will continue to follow the existing goodwill model to determine its reporting units, assign assets and liabilities to its reporting units, and allocate goodwill to its reporting units. See BCG 11.2, 11.3 and 11.4 for more information about these topics. If a company elects to assess goodwill for impairment at the entity-wide level, a determination of the company's reporting units is not necessary.

11.8.2.2 Frequency of impairment testing

The impairment assessment is a trigger-based assessment, whereby a company is only required to test goodwill for impairment if an event occurs or circumstances change that indicate that the fair value of the entity may be below its carrying amount or the fair value of a reporting unit may be below its carrying amount depending on the level at which the test is performed based on the accounting policy adopted [ASC 350-20-35-66]. A company is no longer required to assess goodwill for impairment on an annual basis.

The goodwill alternative does not change the examples of events and circumstances, identified in BCG 11.5.1.1, that indicate that the fair value of the entity (or reporting unit) may be below its carrying amount. However, those examples are not meant to be all-inclusive. As part of its analysis of potential triggering events, a company should consider other factors that could impact the fair value of the entity (or reporting unit), the extent to which each of the identified adverse events or circumstances impact the entity's (or reporting unit's) fair value, the presence of any positive or mitigating factors that impact fair value, and, if applicable, the results of any recent fair value calculations [ASC 350-20-35-68].

11.8.2.3 The goodwill impairment test

Upon the occurrence of a triggering event, a company is permitted to first assess qualitative factors to determine whether it is more likely than not that the fair value of the entity (or the reporting unit) is less than its carrying amount, including goodwill. The qualitative assessment, commonly referred to as "step zero," applied in the goodwill alternative is the same as the qualitative assessment under the existing goodwill impairment guidance. See BCG 11.5.1.1 for a discussion of how to apply the qualitative impairment test. An entity is also permitted to bypass the qualitative assessment and proceed directly to the quantitative test. If a company elects to bypass the qualitative assessment, or, after performing the qualitative assessment concludes that it is more likely than not that the fair value of the entity (or reporting unit) is less than its carrying amount, it should proceed to a quantitative impairment test.

Similar to step one under the existing goodwill impairment guidance, a company should compare the fair value of the entity (or reporting unit) to its carrying amount, which includes goodwill. If the fair value exceeds the carrying value, no impairment loss exists. If the fair value is less than the carrying amount, a goodwill impairment loss is measured and recorded.

Consistent with the existing goodwill impairment guidance, when determining the fair value of the entity (or reporting unit), a company will need to determine whether the entity (or reporting unit) would be bought or sold in a taxable or nontaxable transaction. However, when performing the single step impairment test, a company should include its deferred income taxes in the carrying amount of the entity (or reporting unit), regardless of how the fair value of the entity (or reporting unit) is determined (i.e., whether the entity (reporting unit) would be bought or sold in a taxable or nontaxable transaction) [ASC 350-20-35-76].

11.8.2.4 *Measurement of an impairment loss*

A goodwill impairment loss is measured as the amount by which the carrying amount of the entity (or reporting unit) exceeds its fair value. However, the impairment loss cannot exceed the entity's (or reporting unit's) carrying amount of goodwill [ASC 350-20-35-73]. A hypothetical application of the acquisition method to calculate implied goodwill (step two) is not required.

Question 11-28

A company elects to continue to assess goodwill for impairment at the reporting unit level and measures an impairment loss in one reporting unit that exceeds the carrying amount of that reporting unit's goodwill. Should the company allocate the excess amount to the goodwill in its other reporting units?

PwC response

No. For a company that assesses for impairment at the reporting unit level, the measurement of any impairment loss is limited to the carrying amount of goodwill in that reporting unit. Therefore, if the calculated impairment loss for any single reporting unit is greater than the carrying amount of the reporting unit's goodwill, the company should not allocate the remaining difference to its other reporting units. Separately, the company should assess its long-lived assets for impairment before assessing goodwill for impairment.

Example 11-28 demonstrates measurement of an impairment loss under the goodwill alternative.

Example 11-28

Measurement of an impairment loss

Company A has elected to assess its goodwill for impairment at the entity-wide level. During 20x4, Company A experiences a decline in its consolidated earnings and operating cash flows, and on June 30, 20x4, concludes that it is more likely than not that the fair value of the entity has fallen below its carrying amount. Before assessing its goodwill for impairment, Company A assessed its long-lived assets and determined there were no impairments. On June 30, the carrying amount of Company A's consolidated net assets is CU950, which includes goodwill of CU200.

Analysis

Company A is required to assess its goodwill for impairment on June 30, 20x4, the date it has determined that the fair value of the entity may be below its carrying amount. On that date, Company A should determine the fair value of the consolidated entity using the same measurement principles described in ASC 350-20-35-22 through 35-27 (i.e., the existing guidance for determining the fair value of a reporting unit). Company A concludes that its fair value is CU800. Therefore, Company A's carrying amount exceeds its fair value by CU150. Company A should recognise a goodwill impairment loss of CU150, thus reducing the carrying amount of its goodwill to CU50.

Alternatively, if the carrying amount of Company A's goodwill was CU100 on June 30, 20x4, the impairment loss would be limited to CU100 because the total impairment loss cannot exceed the carrying amount of goodwill.

Question 11-29

How should a company with a negative carrying amount at the entity (or reporting unit) level measure a goodwill impairment loss?

PwC response

The goodwill alternative does not specifically address how a company should test goodwill for impairment when the goodwill resides within a reporting unit with a negative carrying amount or when the goodwill is being tested for impairment at the entity-wide level and the entity has a negative carrying amount. For areas not addressed in the goodwill alternative, an entity should continue to follow the applicable requirements of the existing goodwill accounting and reporting model [ASC 350-20-05-6]. Therefore, it would appear that in these circumstances, the guidance in ASC 350-20-35-8A should be followed. See BCG 11.5.3 for more discussion of the impairment test for entities (or reporting units) with zero or negative carrying amounts.

11.8.2.5 Allocation of an impairment loss

A company should allocate the goodwill impairment loss to individual amortisable units of goodwill of the entity if it tests for goodwill impairment at the entity-wide level, or to amortisable units of goodwill within the impaired reporting unit if it tests for goodwill impairment at the reporting unit level. Therefore, the level at which a company assesses its goodwill for impairment will determine how a goodwill impairment charge is allocated to the separate amortisable units of goodwill. A company is permitted to allocate the impairment loss on a pro rata basis using the relative carrying amounts of its separate amortisable units of goodwill. While a company may allocate the impairment loss using another reasonable and rational basis, entities generally should use the pro rata allocation method unless there is clear evidence supporting a specific identification of the impairment loss to one or more amortisable units of goodwill.

After the goodwill impairment charge is allocated to individual amortisable units of goodwill, the adjusted carrying amounts of the individual units should be amortised over their respective remaining useful lives [ASC 350-20-35-78]. Example 11-29 demonstrates allocation of a goodwill impairment loss to amortisable units of goodwill.

Example 11-29

Allocating an impairment loss to amortisable units of goodwill on a pro rata basis

Company A assesses goodwill for impairment at the entity-wide level. Upon a triggering event in 20x5, Company A performs the goodwill impairment test and determines that it has a goodwill impairment loss of CU100 that it needs to allocate to its three amortisable units of goodwill.

	Goodwill origin	Goodwill carrying amount before impairment loss	Remaining useful life at impairment test date
Unit 1	Existing goodwill on adoption date	CU300	5 years
Unit 2	20x3 acquisition	CU150	8 years
Unit 3	20x4 acquisition	CU50	9 years

Company A determines that the impairment loss will be allocated to its three amortisable units of goodwill on a pro rata basis using their relative carrying amounts.

Analysis

Since it is using a pro rata allocation, Company A should allocate 60% of the impairment loss, or CU60, to Unit 1, 30% of the impairment loss, or CU30, to Unit 2, and 10% of the impairment loss, or CU10 to Unit 3.[4] The allocation of the impairment loss impacts the amount of amortisation expense that will be recognised in each future period.

11.8.3 Disposal considerations

When a company disposes of a business that is part of an entity (or reporting unit), the goodwill associated with that business should be included in the carrying amount of the business in determining the gain or loss on disposal [ASC 350-20-40-9].

The amount of goodwill to allocate to a disposed business should be determined using a reasonable and rational approach. A relative fair value approach would generally be considered a reasonable and rational approach. Other approaches may be considered reasonable and rational, depending on a company's specific facts and circumstances.

Under the existing guidance, the amount of goodwill to allocate to the business to be disposed of is determined based on the relative fair values of (1) the business being sold and (2) the portion of the reporting unit that will be retained unless the business to be disposed of was never integrated into the reporting unit (see BCG 11.6). In most cases it is difficult to establish that the benefits of the acquired goodwill were never realised by the rest of the reporting unit. Therefore, the relative fair value approach generally will be the most appropriate method of allocating goodwill to a disposed business for companies adopting the goodwill alternative.

[4] The total carrying amount of goodwill is CU500. Unit 1's goodwill represents 60% [CU300 / CU500] of the total, Unit 2's goodwill represents 30% [CU150 / CU500] of the total, and Unit 3's goodwill represents 10% [CU50 / CU500] of the total.

11.8.4 Presentation and disclosure

ASC 350-20-45 and ASC 350-20-50 describe the presentation and disclosure requirements under the goodwill alternative, which are generally consistent with the disclosures required under the existing goodwill model. Key differences include the removal of the requirement for a company to disclose a tabular reconciliation of the beginning balance, ending balance, and activity in the goodwill balance from period to period and the addition of requirement to disclose the weighted-average amortisation period of goodwill.

Excerpts from ASC 350-20-45-5 through 45-7:

Excerpt from ASC 350-20-45-5 through 45-7

The aggregate amount of goodwill net of accumulated amortisation and impairment shall be presented as a separate line item in the statement of financial position.

The amortisation and aggregate amount of impairment of goodwill shall be presented in income statement line items within continuing operations (or similar caption) unless the amortisation or a goodwill impairment loss is associated with a discontinued operation.

The amortisation and impairment of goodwill associated with a discontinued operation shall be included (on a net-of-tax basis) within the results of discontinued operations.

Excerpts from ASC 350-20-50-4 through 50-7:

Excerpt from ASC 350-20-50-4 through 50-7

The following information shall be disclosed in the notes to financial statements for any additions to **goodwill** in each period for which a statement of financial position is presented:

a. The amount assigned to goodwill in total and by major business combination or by reorganisation event resulting in fresh-start reporting

b. The weighted-average amortisation period in total and the amortisation period by major business combination or by reorganisation event resulting in fresh-start reporting.

The following information shall be disclosed in the financial statements or the notes to the financial statements for each period for which a statement of financial position is presented:

a. The gross carrying amounts of goodwill, accumulated amortisation, and accumulated impairment loss

b. The aggregate amortisation expense for the period

c. Goodwill included in a disposal group classified as held for sale in accordance with paragraph 360-10-45-9 and goodwill derecognised during the period without having previously been reported in a disposal group classified as held for sale.

For each goodwill impairment loss recognised, the following information shall be disclosed in the notes to the financial statements that include the period in which the impairment loss is recognised:

a. A description of the facts and circumstances leading to the impairment

b. The amount of the impairment loss and the method of determining the fair value of the entity or the reporting unit (whether based on prices of comparable businesses, a present value or other valuation technique, or a combination of those methods)

c. The caption in the income statement in which the impairment loss is included

d. The method of allocating the impairment loss to the individual amortisable units of goodwill.

The quantitative disclosures about significant unobservable inputs used in fair value measurements categorized within Level 3 of the fair value hierarchy required by paragraph 820-10-50-2(bbb) are not required for fair value measurements related to the financial accounting and reporting for goodwill after its initial recognition in a business combination.

Chapter 12: Postacquisition accounting issues—IFRS

12.1 Chapter overview

This chapter addresses certain issues arising in postacquisition accounting for the acquired assets, assumed liabilities, and contingent liabilities of the **acquired business**. There are few explicit changes in postacquisition accounting under IFRS 3; those limited changes are highlighted in this chapter. The chapter also addresses some of the challenging issues in applying the postacquisition accounting guidance to assets typically acquired in a **business combination**, such as **intangible assets** and **goodwill**. Also covered is the subsequent accounting for the assets and liabilities of the **acquirer** that may arise in a business combination from seller-granted indemnities, and **contingent consideration** classified as a liability.

IFRS permits or requires the use of **fair value** for the subsequent measurement of investment properties, biological assets, property, plant and equipment, and a limited category of intangible assets. This chapter does not address subsequent measurement for these assets or other tangible fixed assets. There are few specific accounting issues that arise if these types of assets are acquired in a business combination.

Current IASB projects may result in amendments to existing guidance. These possible amendments may impact the guidance in this chapter. Specifically the IASB issued IFRS 9, *Financial Instruments*, in November 2009. The effective date of IFRS 9 has been left open pending the finalisation of the impairment and classification and measurement requirements. Contingent consideration financial assets and liabilities will be measured at fair value through profit or loss under IFRS 9. The IASB also has a project to consider revisions to IAS 37, which may impact, among other things, the subsequent accounting of contingent liabilities assumed in a business combination. See BCG 12.3.2 for information on contingent consideration and BCG 2.5.13 for information on contingent liabilities in a business combination.

The key takeaways from this chapter are:

- **All of the identifiable intangible assets acquired in a business combination must be identified and recognised.** An intangible asset that meets the contractual-legal criterion or the separability criterion is presumed to be reliably measurable and is recognised. IFRS 3[1] also impacts certain aspects of the related postacquisition accounting.

- **Seller-granted indemnities are recognised as assets and measured on the same basis as the related indemnified items.** An indemnification asset may be recognised if the seller contractually indemnifies the acquirer for a particular uncertainty, such as litigation outcomes or an uncertain tax position. The recognition and measurement of the indemnification asset is matched to the recognition and measurement of the indemnified item, subject to any limitations on the indemnity and the creditworthiness of the seller. Any remeasurement of the indemnified item is matched by changes in the indemnification asset, subject to any limitations on the indemnity and the creditworthiness of the seller. This treatment will minimise potential income statement volatility.

[1] IFRS 3 refers to the current version of the standard unless otherwise stated.

- **Certain types of contingent consideration are remeasured to fair value at each reporting date.** Contingent consideration is classified as an asset, liability, or equity and is measured at fair value on the **acquisition date**. Contingent consideration classified as an asset or liability is remeasured to fair value each reporting period. Changes are included in profit or loss. Profit or loss is potentially volatile as a result of certain types of contingent consideration. Measuring contingent consideration at fair value may require complex valuation techniques.

- **Reacquired rights are recognised at fair value subject to certain limitations.** A reacquired right recognised in a business combination is based on the cash flows of the remaining contractual period for which the right was granted, excluding renewal periods. The useful life is limited to the remaining contractual period.

- **The impairment testing of goodwill and the allocation of any impairment charges can be complex.** Goodwill needs to be specifically identified and tracked. Goodwill that originated prior to IFRS 3 (2008), or is recognised under the proportionate share method policy choice for noncontrolling interest, may add further complexity. The choice of measurement, and how goodwill is allocated to **cash-generating units** (CGUs) or groups of CGUs, has a significant impact on goodwill impairment testing.

12.2 Overview of impairment testing under IAS 36

This section presents an overview of **impairment** testing under IAS 36. See BCG 12.4.4 and BCG 12.5 for information on specific issues relevant to testing intangible assets and goodwill. See BCG 12.6 for further information on the requirements of impairment testing.

An asset may not be carried in the balance sheet at more than its **recoverable amount**. The carrying amount is reduced to the recoverable amount if an asset's **carrying amount** is in excess of its recoverable amount. Carrying amount is the amount at which the asset is recognised after deducting accumulated depreciation or amortisation and accumulated impairment losses.

Assets should be tested for impairment at the lowest level possible, which may be the individual asset level [IAS 36.22]. Few assets generate cash inflows largely independent of the cash inflows generated by other assets or groups of assets. Therefore, most assets are tested within a CGU. A CGU is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets [IAS 36.6].

Assets that do not yet generate cash flows, such as intangible assets not yet in use, are tested separately for impairment.

Certain assets, such as **goodwill** and **corporate assets**, provide benefits to more than one CGU and are tested with groups of CGUs. The goodwill is added to the carrying value of the group of CGUs for purposes of impairment testing. Goodwill is tested at the lowest level monitored by management. In no case can the group of CGUs that the goodwill is associated with be larger than an operating segment as defined in IFRS 8, *Operating Segments*. Corporate assets may provide benefits to the entire entity and should be grouped with the CGUs comprising the entity for purposes of impairment testing.

An asset's (or CGU's or group of CGUs') recoverable amount is the greater of **fair value less costs of disposal** (FVLCOD) or **value in use** (VIU). FVLCOD is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market-participants at the measurement date, less the costs of disposal. VIU is the present value of the future cash flows expected to be derived from the asset or CGU in its current condition. VIU is a discounted cash flow approach with a number of elements and assumptions prescribed by the standard. FVLCOD is also often based on a discounted cash flow approach, but uses assumptions that a **market-participant** might use to value the asset or CGU.

The recoverable amount is compared to the carrying amount, and any impairment loss is recorded first against goodwill then pro rata against the carrying value of assets within the scope of IAS 36. Impairments of assets, other than goodwill, can be reversed when certain criteria are met. See BCG 12.6.9 for further information. Impairments of goodwill are never reversed.

Assets or CGU(s) are tested for impairment when there are indicators present, or at least annually in the cases of goodwill, indefinite-lived intangible assets, and intangible assets not yet ready for use.

12.3 Accounting issues for the acquirer

While primarily related to acquisition accounting, IFRS 3 also addresses the postacquisition accounting for certain assets and liabilities of the acquirer. Postacquisition accounting guidance includes seller-granted indemnities and contingent consideration classified as a liability or an asset.

12.3.1 Indemnification assets

Indemnification assets are an exception to the recognition and fair value measurement principles. They are recognised and measured differently from contingent assets. Indemnification assets (sometimes referred to as "seller indemnifications") may be recognised if the seller contractually indemnifies, in whole or in part, the acquirer for a particular uncertainty. Contractual indemnities are common for litigation contingencies and uncertain tax positions.

The recognition and measurement of an indemnification asset is based on the related indemnified item. The acquirer should recognise an indemnification asset at the same time that it recognises the indemnified item. The indemnification asset is measured on the same basis as the indemnified item, subject to collectibility or any contractual limitations. The acquirer should recognise an indemnification asset at its fair value on the acquisition date if the indemnification relates to an asset or a liability that is recognised at the acquisition date and measured at its fair value. A separate valuation allowance for credit risk is not necessary if an indemnification asset is measured at fair value. The fair value measurement will reflect any uncertainties in future cash flows [IFRS 3.27].

Seller indemnifications may relate to indemnified items that are not recorded at the date of acquisition. For example, a contingent liability might not be recognised at the acquisition date because it cannot be reliably measured. The contingent liability is recognised when it subsequently becomes reliably measureable. An indemnification asset is recorded at the same time and on the same basis (subject to contractual limitations on the indemnified amount and management's assessment of collectability) as the contingent liability, regardless of whether the recognition is within the measurement period.

Indemnification assets continue to be measured on the same basis as the related indemnified item, giving effect to the collectability and contractual terms. Final measurement occurs when the indemnified item is collected, sold, or cancelled, or when the entity otherwise loses the right to it in the postacquisition period [IFRS 3.57].

An indemnification asset might relate to any asset, liability, or contingent liability of the acquired business. The indemnified item might be an employee benefit obligation measured under IAS 19, a provision under IAS 37, or an uncertain tax position. The entity should measure the indemnification asset on the same basis as the related indemnified item, subject to any restrictions in the contractual terms. Restrictions include ceilings on the amount payable and adjustments for the creditworthiness of the seller.

The indemnified item might be a contingent liability. The contingent liability would be remeasured only if an outflow of resources embodying economic benefits to settle the liability is probable within the meaning of IAS 37 (i.e., more likely than not to occur) and was accounted for under that standard. The difference between the previously recorded amount and the best estimate of the future outflow would be recorded as an increase in the liability and the indemnification asset if the full amount of the contingency was subject to the indemnity and the outflow of resources became probable. The contingent liability also might be derecognised without payment. Derecognition of the contingency without payment would occur if the entity was released from the obligation. Both the indemnification asset and the liability would be derecognised then.

12.3.2 Contingent consideration

Contingent consideration is recognised and measured at its fair value as of the acquisition date [IFRS 3.39]. An acquirer's right to receive contingent consideration (i.e., contingently returnable consideration) should be classified as an asset [IFRS 3.40]. An acquirer's obligation to pay contingent consideration that meets the definition of a financial instrument should be classified as a financial liability or equity based on the definitions in IAS 32 [IFRS 3.40]. A financial liability is (1) a contractual obligation to deliver cash or other financial assets, or exchange financial assets or liabilities under conditions that are potentially unfavourable; or (2) a contract that will or may be settled in the entity's own equity instruments and is a:

- Nonderivative for which an entity is or may be obliged to deliver a variable number of its own equity shares

- Derivative that will or may be settled other than by exchange of a fixed amount of cash or another financial asset for a fixed number of its own equity instruments [IAS 32.11]

An equity instrument is a contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities [IAS 32.11].

The accounting for contingent consideration in the postacquisition period is determined by the classification of the contingent consideration. Contingent consideration that is classified as an asset or liability (financial or non-financial) should be remeasured to fair value at each reporting date, and changes in fair value should be included in profit or loss in accordance with IAS 39 or IFRS 9. Contingent consideration that is classified as an equity instrument is not remeasured.

Contingent consideration receivable from the seller seldom occurs in practice. A contingent arrangement that is variable will likely be categorised as an available-for-sale debt asset. The contingent amount is not readily determinable and therefore cannot be classified as a loan or receivable. Interest is calculated using the effective interest method and recognised in profit and loss for available-for-sale debt instruments [IAS 39.55]. The estimate of the future cash flows is revised if there is a change in the expected level of consideration to be received [IAS 39.AG8]. The entity recalculates the carrying amount of the available-for-sale debt instrument by discounting the revised estimated cash flows using the original effective interest rate. The resulting adjustment to the carrying amount of the available-for-sale debt asset is recognised immediately in the income statement as a gain or loss. Other fair value movements on available-for-sale debt instruments (for example, those caused by changes in market interest rates) are recognised in other comprehensive income in accordance with IAS 39.55(b). Any gains or losses that have been recorded in other comprehensive income for contingent consideration receivable would be recycled to the income statement when the contingent consideration is collected or derecognised.

See BCG 2.6.4.2 for further information on contingent consideration.

12.4 Intangible assets

An acquirer must recognise all of the identifiable intangible assets acquired in a business combination. An intangible asset is identifiable if it meets the **contractual-legal criterion** (i.e., arises from contractual or other legal rights) or the **separability criterion** (i.e., capable of being separated from the entity and sold, transferred, licensed, rented, or exchanged) [IAS 38.12]. The recognition of intangible assets in a business combination gives rise to a number of postacquisition accounting issues. This section addresses the grouping of intangible assets that have similar attributes and lives; selection of useful lives, including the assessment of an **indefinite useful life**; amortisation methods; and specific issues relating to impairment testing.

12.4.1 Grouping intangible assets

Groups of similar or related assets are often acquired in a business combination. Some intangible assets are recognised only in conjunction with other assets. This is the case when the similar or related assets could only be disposed of in a group. Complementary assets can be grouped if the assets have similar useful lives. An example might be the group of trade names and trademarks collectively described as a brand [IAS 38.37].

A group of complementary assets might include tangible and intangible assets. This would be appropriate when the assets cannot be separated because the individual fair values cannot be reliably measured. Examples are a license to operate a nuclear power plant and the physical fixed assets of the plant, or a brand name for spring water and the source of the spring water.

Assets that are dissimilar or have different useful lives cannot be grouped or recognised as a single asset. An example might be a group of in-process research and development assets. The individual assets arise from the research activities of the acquired business. These assets are inherently unique and may have very different useful lives when brought into use. For example, one research project may be abandoned soon after the date of the business combination and then impaired. A different project may be the subject of further development for a number of years and then become a marketed product. Amortisation would begin when the project was completed and placed in service.

Customer-related intangible assets present similar challenges. A number of different assets might arise from the customers of the acquired business. These might include a customer list, order backlog, and customer relationships. The assets might have different useful lives, because the customer relationship might be amortised over the customer churn period, whereas the order backlog would be amortised only over the fulfillment period.

12.4.2 Intangible assets—useful lives

Intangible assets that have a determinable useful life are amortised over that useful life using an appropriate method. Useful life is defined as:

- The period over which an asset is expected to be available for use by an entity, or
- The number of production or similar units expected to be produced from the asset by an entity [IAS 38.8]

Useful lives are usually determined by reference to time periods, except for those assets, such as mineral resources, that are clearly consumed through use. Economic and legal factors may influence the useful life of an intangible asset. Economic factors determine the period over which future economic benefits will be received by the entity. Legal factors may restrict the period over which the entity controls access to those benefits. The useful life is generally the shorter of the legal period and the period in which the entity expects to benefit from the asset [IAS 38.94-95].

12.4.2.1 Renewal periods

Some legal rights remain in force indefinitely, can be continually renewed by the acquirer (e.g., trademarks that secure brand names), or can be renewed by the entity without substantial cost. Any one of these circumstances may support a useful life beyond the legal or contractual period.

The useful life of an intangible asset (other than reacquired rights, further described in BCG 12.4.2.2) arising from contractual or legal rights can extend beyond the period of the contractual or legal rights only if appropriate evidence is available to support renewal by the entity. Examples of the evidence necessary to extend the useful life of an asset are:

- Evidence, possibly based on experience, that the contractual or legal rights will be renewed. This includes evidence that if the consent of a third party is required, then such consent will be forthcoming.
- Evidence that any conditions necessary to obtain renewal will be satisfied. This would include evidence that no conditions that have to be complied with in respect of renewal have been or will be breached (e.g., evidence that a train operating company has met operational targets that are a condition of renewal of its operating license).
- Evidence that the cost of renewal to the entity is not significant when compared with the future economic benefits expected from the renewal [IAS 38.96].

A significant renewal cost represents, in substance, the cost of acquiring a new intangible asset at the renewal date. The carrying amount of the intangible asset should be fully amortised by the renewal date, and the renewal cost is then capitalised as a new intangible asset.

12.4.2.2 Reacquired rights

IFRS 3 gives specific guidance for the accounting for **reacquired rights**. An entity may reacquire a right in a business combination that it had previously granted to the **acquiree** to use the acquirer's intangible assets. Such rights are recognised as intangible assets and measured at fair value based on the term of the related contract. This measurement excludes the effects of expected contractual renewals. After initial recognition, the assets are amortised over the remaining period of the contract in which the right was granted. The amortisation period also excludes any renewals and extensions [IFRS 3.55; IAS 38.94]. A reacquired right may be perpetual if there are no contractual renewals and the remaining contractual life is not limited. Such a reacquired right may have an indefinite useful life. See BCG 2.5.6.1 for further information.

12.4.2.3 Indefinite useful lives

Indefinite-lived intangible assets are not amortised. They are tested annually for impairment and whenever indicators of impairment are present [IAS 38.107,108]. Indefinite-lived intangible assets are tested with the CGU or group of CGUs that derive benefit from the intangible asset. *Indefinite* is not the same as an *infinite useful life*. It indicates that there is no foreseeable limit on the ability to derive benefits from the asset [IAS 38.91].

Indefinite-lived intangible assets are rare under IFRS. Support for an indefinite life for an intangible asset generally requires a business, industry, or product to have a track record of stability and financial achievement, as well as barriers to market entry. Established brands or leading brands in a mature industry may have an indefinite useful life. Finite lives may be appropriate for other brands and publishing titles that are relatively new, dependent on an individual's reputation, or that operate in more volatile sectors.

12.4.2.4 Acquired in-process research and development

Another intangible asset commonly acquired in a business combination is in-process research and development (IPR&D). IPR&D is used to describe research and development projects, not products or processes already in service or being sold. It is not amortised as it is not yet ready for use. It is tested annually for impairment or when there are indicators of impairment. IPR&D assets are tested separately for impairment as they do not yet produce cash flows. They are usually tested using a FVLCOD approach, similar to the valuation method used for initial recognition.

12.4.2.5 Intangible assets that the acquirer does not intend to use

An entity may acquire intangible assets that it does not intend to use. The entity may continue to receive indirect benefits from the asset if it prevents the asset from being used by others. The fair value of these intangible assets should be recognised at the acquisition date based upon market-participant assumptions. See BCG 4.5 for further information.

The acquirer's intentions or subsequent use of the asset will affect the asset's useful life after the acquisition date. The useful life should reflect the acquiring entity's consumption of the asset's expected benefits. This is the time period over which the asset is expected to contribute directly or indirectly to the acquiring entity's future cash flows. These defensive intangible assets are rarely expensed immediately at the date of acquisition, or rarely have an indefinite useful life.

These intangible assets will need to be reviewed and tested for impairment when appropriate under IAS 36 in the postcombination period.

12.4.3 Amortisation

The method of amortisation for all intangible assets with a finite life should reflect the pattern in which the economic benefits are expected to be consumed by the entity [IAS 38.97]. Amortisation charges should be recognised as an expense, unless they are included in the carrying amount of another asset as permitted, or required, by another standard. For example, amortisation may be included in inventory or work-in-progress as part of an allocation of overhead, in accordance with IAS 2 [IAS 38.99].

Amortisation applies to all long-lived tangible or intangible assets that have a **finite useful life**, whether held at historical cost or revalued. The amortisation method should reflect the pattern in which future economic benefits of the intangible asset are expected to be consumed. This could be straight line, diminishing returns, or a units-of-production method.

12.4.4 Specific issues in impairment testing of intangible assets

A number of issues arise in impairment testing related to intangible assets. Intangible assets that are in service seldom give rise to independent cash flows. They are used in conjunction with other assets of the entity to generate cash flows. Common examples are licenses to provide mobile phone services, brands, technology, software, and drugs in patent. These intangible assets cannot be tested separately for impairment under IAS 36. They must be tested as part of a CGU, a group of CGUs, or as corporate assets. Assets must be tested at the lowest level of largely independent cash flows. The individual CGUs should be tested first if indicators of impairment exist. Any resulting impairment loss should be recognised before testing for impairment of intangible assets and goodwill that relate to that group of CGUs. The nature of the intangible asset, and the rights or know-how it conveys to the entity, is crucial to understanding how it contributes to the generation of cash flows. An intangible asset that gives an entity a right to operate a service or sell a product in a particular country would contribute to the ability to generate cash flows in that country. The intangible asset would be grouped with the CGU or group of CGUs from that country for the purposes of impairment testing. See BCG 12.6 for further information on impairment testing.

Example 12-1 provides an example of the grouping of intangible assets with a CGU or group of CGUs.

EXAMPLE 12-1

Impairment testing—intangible assets

An entity that provides mobile telephone services in a number of countries under a single strong global brand is acquired. The acquirer recognises the license to provide services in each country and recognises a group of trademarks and trade names that it groups as the brand. The brand is assigned an indefinite useful life. The licenses have fixed terms with significant costs to renew or a requirement to renew at an auction, and have all been assigned finite useful lives.

Analysis

The license in each country should be grouped with the CGU or CGUs in each country for the purpose of impairment testing. The individual CGUs should be tested first for impairment if there are indicators of impairment. The brand would need to be included in the group of CGUs comprising all of the countries that benefit from the brand. This group of CGUs might be the entire entity. The existence of the brand, an indefinite-lived intangible asset, imposes a requirement for annual impairment testing for the groups of CGUs that benefit from it.

The recognition of indefinite-lived intangible assets in a business combination is almost always accompanied by the recognition of goodwill. The existence of goodwill can complicate impairment testing and the allocation of the impairment loss. Annual testing of indefinite-lived intangible assets and goodwill is required. An entity should consider whether there are indicators of impairment in any individual CGUs that will require separate impairment testing before performing the annual testing. Any impairment loss at the individual CGUs should be recognised in the income statement and as a reduction in the carrying amount of the related group of CGUs. An impairment loss has occurred if the recoverable amount of the group of assets comprising the brand, the allocated goodwill, and the associated CGUs is below the carrying amount (after reflecting all individual CGU impairments). The goodwill is written off first in accordance with the hierarchy for allocating impairment losses. The impairment loss is allocated to tangible and intangible assets of the brand and to the other assets within the scope of IAS 36 after goodwill is written off. See BCG 12.6.8 for further information.

Example 12-2 provides an example of applying the hierarchy of allocating impairment losses.

EXAMPLE 12-2

Allocation of an impairment loss to goodwill and brands

An entity is performing the annual impairment test for goodwill and two brands with indefinite useful lives and the group of CGUs that are associated with the brands and the goodwill. The carrying amount of the CGUs (after reflecting any individual CGU impairments), including the brands and goodwill, is higher than the recoverable amount. The recorded amount of goodwill is CU12 million, the carrying amount of Brand X is CU5 million, and the carrying amount of Brand Y is CU6 million. The amount of the impairment loss is CU10 million. Management believes that the impairment loss is largely the result of the poor performance of Brand X and wants to allocate the impairment loss first to Brand X and then to other assets.

Analysis

The impairment loss must be allocated first to goodwill. Recorded goodwill exceeds the total amount of the impairment loss, so none of the loss is allocated to the brands or to the other assets of the CGUs.

12.5 Goodwill

Goodwill must be tested annually for impairment [IAS 36.10(b)]. Goodwill must be allocated to one or more CGUs for the purpose of impairment testing because it does not generate independent cash inflows. Goodwill is commonly allocated to groups of CGUs for the purpose of impairment testing.

Goodwill is allocated to the CGUs that are expected to benefit from the synergies of the combination, both existing and acquired CGUs. The group of CGUs to which goodwill is allocated shall represent the lowest level at which the goodwill will be monitored and managed. The group of CGUs cannot be larger than an operating segment as defined in IFRS 8 [IAS 36.80]. It is possible that goodwill recognised in a less-than-100-percent acquisition will be allocated to a CGU or group of CGUs in which the **noncontrolling interest** does not have an interest. This will have an impact on the impairment testing of goodwill and the allocation of any impairment loss to the controlling and noncontrolling interests. See BCG 12.5.2 for further information.

Goodwill is the residual in a business combination after all of the identifiable assets, liabilities, and contingent liabilities of the acquiree have been recognised. Goodwill may include:

- The fair value of expected synergies from the combination
- Assets that are not capable of recognition (e.g., skilled workforce, noncontractual customer relationships)
- Assets and liabilities that are not measured at fair value, such as deferred tax and employee benefits

Identification of the constituent parts of goodwill (a qualitative discussion is a required disclosure of IFRS 3) may assist in allocating the goodwill to the CGUs or groups of CGUs that are expected to benefit from the synergies, or to which the unrecognised assets have been deployed.

The allocated goodwill forms part of the CGU's carrying amount. Potential impairment of the CGU is measured by comparing its carrying value, including any allocated goodwill, to its recoverable amount. The goodwill forms part of the total carrying amount of the group of CGUs for impairment testing purposes when goodwill is allocated to a group of CGUs rather than an individual CGU.

The fair values of identifiable net assets recognised in a business combination may be based on the provisional fair values available at the time of the acquisition. The fair value of these assets and liabilities and the resulting amount of any goodwill must be finalised no later than 12 months from the acquisition date. Goodwill, as the residual, is not finally determined until the fair value exercise is complete. A change to goodwill arising from the completion of the fair value exercise is not an impairment.

Goodwill acquired in a business combination during the period may not have been allocated to a CGU or group of CGUs at the reporting date. The reasons why a portion has not been allocated, and the amount of unallocated goodwill, should be disclosed [IAS 36.133]. Goodwill must be allocated to CGUs by the end of the year following the year of the business combination. Entities should not avoid an impairment charge as a result of goodwill not being allocated. Entities should allocate the goodwill, even if provisionally, and perform impairment testing if indications of impairment exist.

12.5.1 Goodwill and the valuation choice for noncontrolling interests

A **parent** company that has done only 100 percent acquisitions does not need to apply the gross-up method or the allocation method described in this section because the parent does not have noncontrolling interest in its **consolidated financial statements**. A parent company that has acquired goodwill and has any noncontrolling interest needs to consider carefully the calculation and allocation of any impairment loss. The allocation methodology in IAS 36, Appendix C, paragraphs 5–9, must be applied if an entity has acquired goodwill and there are noncontrolling interests in the CGU or groups of CGUs that goodwill has been allocated. The application of the gross-up method interacts with the allocation of any impairment loss.

IFRS 3 (2004) required an entity to record noncontrolling interest as the proportionate share of the recognised amount of the acquiree's identifiable net assets at the acquisition date (proportionate share method). IFRS 3 (2008) allows an entity the choice of measuring the noncontrolling interest at fair value (fair value method) or the proportionate share method. The discussion that follows applies to any situation where the proportionate share method was applied in a business combination of less than 100%, whether it was required under IFRS 3 (2004), or a choice under IFRS 3 (2008). A number of factors will impact the impairment testing of goodwill, potentially increasing or decreasing the complexity of the process. The factors that will impact how goodwill is tested for impairment include:

- The existence of any noncontrolling interests
- One or more business combinations of less than 100 percent using the **proportionate share method** for measurement of noncontrolling interest
- One or more business combinations of less than 100 percent using the **fair value method** for measurement of the noncontrolling interest
- How the entity groups CGUs for the testing of goodwill

The accounting choice of proportionate share method or fair value method can be elected on a transaction-by-transaction basis and does not require an entity to make an accounting policy choice [IFRS 3.19]. An entity that chooses the fair value method recognises goodwill relating to both the controlling and the noncontrolling interests. The valuation method chosen will have ongoing consequences for the impairment testing of goodwill and the associated recordkeeping. An acquisitive group with one or more noncontrolling interests will face significant challenges. The challenges increase if the entity tests goodwill with groups of CGUs that include controlling and noncontrolling interests. See BCG 6.2 for further information on the measurement of noncontrolling interest.

The requirement to gross-up goodwill for impairment testing applies when an entity has used the proportionate share method. This creates an ongoing requirement to track goodwill by transaction to determine whether the goodwill was recognised under the proportionate share or fair value method. The gross-up requirement is driven by the origin of the goodwill, not by whether there is a noncontrolling interest in the CGU or groups of CGUs to which the goodwill has been allocated.

Goodwill that is recorded under the fair value method is subject to the ordinary impairment testing requirements of IAS 36. Any impairment loss is allocated to the controlling and noncontrolling interests as described in BCG 12.5.2. The allocation method will be impacted by the grouping of CGUs.

Goodwill that is recorded under the proportionate share method must be grossed up for impairment testing [IAS 36.C4]. The recorded goodwill and the notional amount of goodwill allocable to the noncontrolling interest (equalling the grossed-up goodwill) are included in the carrying amount of the CGU or group of CGUs being tested and compared to the recoverable amount. Any impairment loss calculated on the gross-up method is then segregated into the amount relating to recorded goodwill and notional goodwill. The amount that relates to the notional goodwill is not recognised as a loss as the related "asset" has never been recognised. The amount that relates to recorded goodwill is recognised as an impairment loss in the income statement and subject to the allocation method described in BCG 12.5.2. The allocation method may be impacted by the grouping of CGUs. Partially owned CGUs may be grouped with wholly owned CGUs for impairment testing purposes.

12.5.2 Allocating goodwill impairment losses to controlling and noncontrolling interests

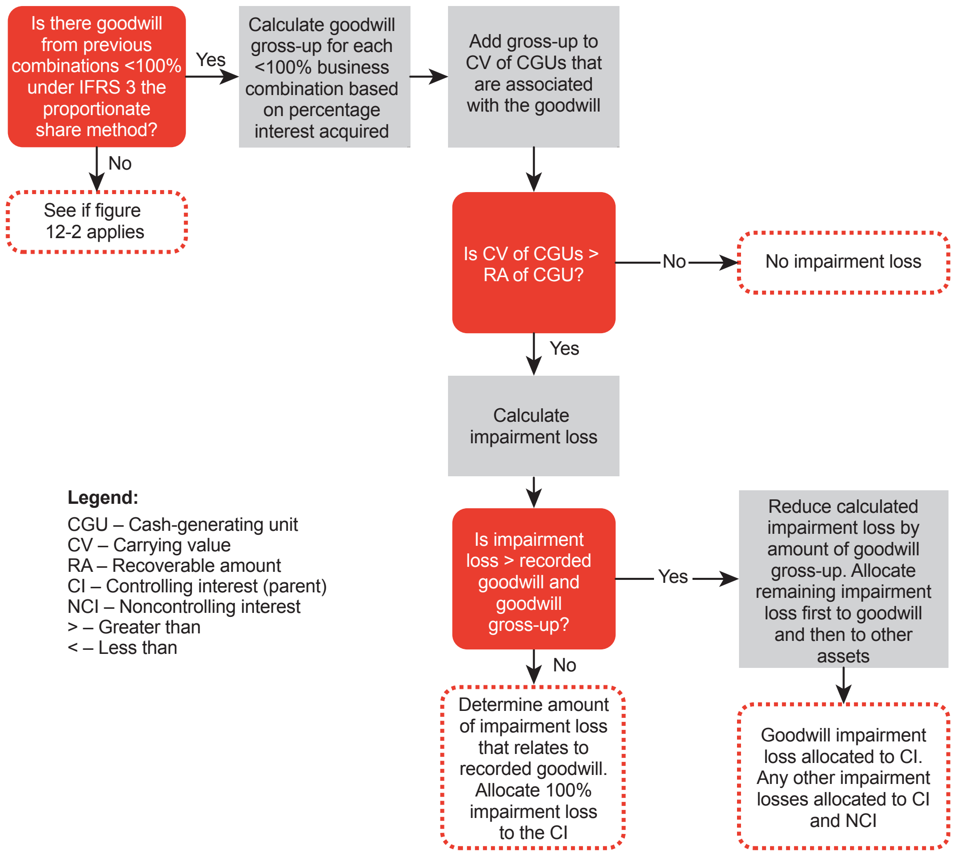
The allocation of impairment losses can be complex under both the proportionate share method and the fair value method. Some potentially significant complications to the allocation of impairment losses are created by the fair value method for measuring the noncontrolling interest, combined with the guidance in IAS 36. IAS 36 allows the grouping of CGUs for purposes of impairment testing.

The choice of measuring the noncontrolling interest using the proportionate share method or the fair value method will need to be tracked to determine whether the gross-up method is required. Goodwill must continue to be specifically identified and tracked where CGUs are grouped for the purpose of goodwill impairment testing. The goodwill allocated to such a grouping of CGUs may combine goodwill from 100 percent business combinations and goodwill from business combinations where only the controlling shareholder's proportion of goodwill was recognised. It may be necessary to allocate impairment losses between the controlling and noncontrolling interests.

Figure 12-1 illustrates the process for determining whether goodwill needs to be grossed up for impairment testing, the calculation of impairment losses for goodwill, and the allocation of losses between the controlling and noncontrolling interests if the proportionate share method is chosen.

Figure 12-1

Impairment testing and allocation of impairment losses using the proportionate share method



Example 12-3 provides an example that illustrates the impact of grouping wholly owned CGUs with CGUs containing a noncontrolling interest when testing goodwill for impairment if the proportionate share method is chosen.

EXAMPLE 12-3

Allocation of an impairment loss to controlling and noncontrolling interests if the proportionate share method is chosen

An entity has recorded goodwill of CU400 in an 80% acquisition and applied the proportionate share method to the valuation of the noncontrolling interest. The goodwill is allocated to a group of CGUs for impairment testing, including some wholly owned CGUs of the entity. There is no other goodwill. The group of CGUs is tested for impairment annually. The carrying amount of the CGUs and recorded goodwill is CU1,400. The recoverable amount of the CGUs is CU1,100.

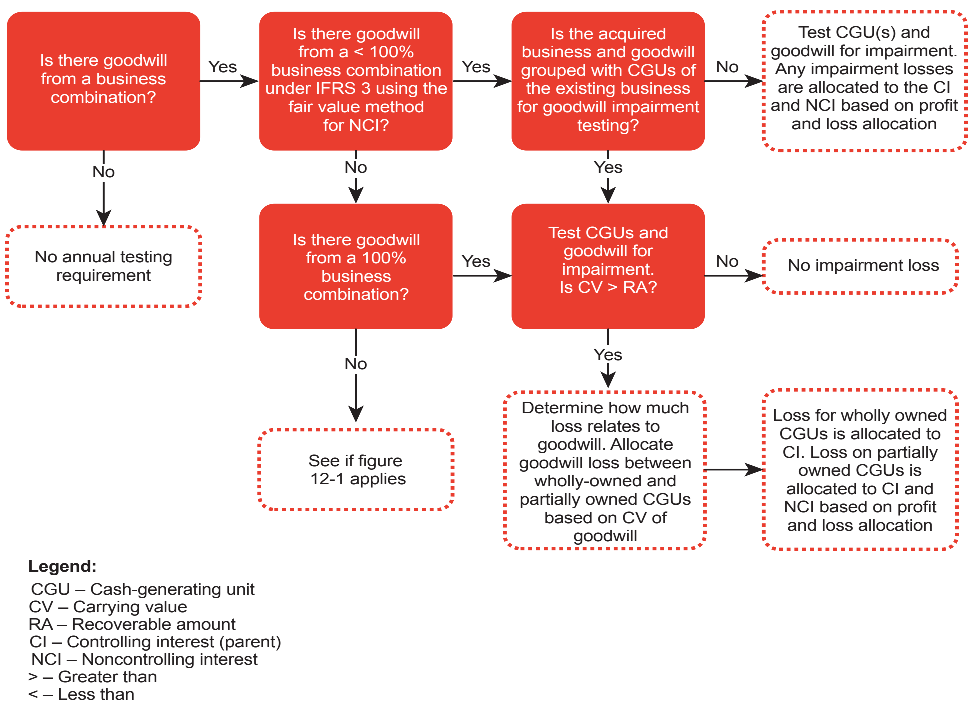
Analysis

The goodwill gross-up, or notional goodwill, is CU100 (CU400 / 80% – CU400) and this amount is added to the carrying value of the group of CGUs. The carrying value for the purposes of testing goodwill is CU1,500 (CU1,400 + CU100). The recoverable amount is less than the adjusted carrying value, and an impairment loss of CU400 is calculated (CU1,100 – CU1,500). The impairment loss is less than the total of recorded goodwill plus notional goodwill of CU500. It must be allocated between the recorded and the unrecorded (notional) elements of goodwill. The impairment loss of CU400 is allocated CU320 (CU400 x CU400 / CU500) to the recorded portion of goodwill, and CU80 to the unrecorded (notional) portion of goodwill. CU320 of the impairment loss is recorded as an expense and a reduction of recorded goodwill. It is allocated in total to the controlling interest. CU80 of the impairment loss relates to the noncontrolling interest, but is effectively ignored because it relates to unrecorded notional goodwill.

Figure 12-2 illustrates the process for the calculation of impairment losses for goodwill and the allocation of losses between the controlling and noncontrolling interests if the fair value method is chosen.

Figure 12-2

Impairment testing and allocation of impairment losses using the fair value method



A group of CGUs that goodwill has been allocated to may include wholly owned CGUs and CGUs with a noncontrolling interest. An entity that has acquired goodwill from a less than 100 percent acquisition using the proportionate share method first calculates the gross-up of goodwill. Any impairment loss is then calculated. The impairment loss is applied first to the goodwill in accordance with the hierarchy for allocating impairment losses.

An entity that has applied only the fair value method of measuring noncontrolling interests does not need to calculate the goodwill gross-up. Some of the goodwill may be allocated to a group of CGUs that include both wholly owned CGUs and CGUs that have noncontrolling interests. This goodwill is tested for impairment as part of the carrying value of the group of CGUs. Any impairment loss is allocated between the wholly owned and partially owned CGUs based on the relative carrying amounts of goodwill. Any impairment loss on the portion allocated to the wholly owned CGUs is allocated to the **controlling interest**. Any impairment loss on the portion allocated to the CGUs with a noncontrolling interest is allocated between the controlling and noncontrolling interests in the same way that profit and loss is allocated as specified in IAS 36.C6.

An entity that has applied both the proportionate share method and the fair value method to measure noncontrolling interest will face challenges in calculating and recording any goodwill impairment when it incorporates a newly acquired business into a group of existing CGUs with goodwill.

Example 12-4 provides an example that illustrates the allocation of an impairment loss for testing goodwill when there are wholly owned CGUs grouped with CGUs with a noncontrolling interest.

EXAMPLE 12-4

Allocation of an impairment loss to controlling and noncontrolling interests with preexisting goodwill

An entity has previously recorded goodwill of CU800, all arising from 100% acquisitions that occurred under IFRS 3 (2004). It subsequently records goodwill of CU500 in an 80% acquisition and applies the fair value method to the valuation of the noncontrolling interest. The acquired business is a single CGU, but is grouped with a number of wholly owned CGUs for impairment testing. The CU800 of previously recorded goodwill is also allocated to that group of CGUs. There is no other noncontrolling interest. Profit or loss of the acquired business is allocated on the basis of the common shareholding. The group of CGUs is tested for impairment annually. The annual testing indicated that the carrying value of the CGUs and the goodwill that is tested with them is less than the recoverable amount by CU500, resulting in an impairment loss.

Analysis

Goodwill gross-up is not required. All existing goodwill arose in 100 percent acquisitions and a partial acquisition using the fair value method to value the noncontrolling interest. The impairment loss is first allocated between the wholly owned portion of the group of CGUs and the portion with controlling and noncontrolling interests by the relative carrying amounts of goodwill. A goodwill impairment loss of CU307 (CU500 x CU800/CU1,300) is allocated to the wholly owned portion of the group of CGUs. All of this loss is allocated to the controlling interest. A goodwill impairment of CU193 (CU500 x CU500/ CU1,300) is allocated to the CGU that includes the controlling and noncontrolling interests. This is further allocated between the controlling and noncontrolling interests on the same basis as profit and loss. Therefore, the amount of impairment loss attributed to the controlling interest is CU154 (CU193 x 80%), and the amount allocated to the noncontrolling interest is CU39 (CU193 x 20%). The total impairment loss allocated to the controlling interest is CU461 (CU307 + CU154).

12.5.3 Disposals and group reorganisations with goodwill

Goodwill that has been allocated to a CGU or group of CGUs is included in the carrying amount of the operation when calculating the profit or loss on disposal.

The goodwill attributable to the disposed operation and the part of the CGU that is retained is based on relative fair values. This method is applied unless the entity can demonstrate that some other method better reflects the goodwill attributable to the operation being disposed of [IAS 36.86]. The relative fair value method is the method commonly used in practice. It is very difficult to demonstrate that another method better represents how goodwill might be attributed.

An entity might reorganise its business and change the composition of one or more CGUs to which goodwill has been allocated. The goodwill attributable to operations that are moved between CGUs is calculated using the relative fair values of the CGUs transferred and remaining in the CGU. This method is applied unless the entity can demonstrate that another allocation method better reflects the goodwill attributable to the transferred operations [IAS 36.87].

12.6 Impairment of assets

An asset is impaired when its carrying amount exceeds its recoverable amount. IAS 36 sets out the requirements for impairment testing for all assets not specifically covered by other standards. An asset's recoverable amount is the higher of its VIU and its FVLCOD. If the asset's carrying amount exceeds its recoverable amount, the asset is impaired, and it is written down to its recoverable amount through recognition of an impairment loss.

Certain assets are tested for impairment at least every year: goodwill, indefinite-lived intangible assets, and assets not subject to depreciation or amortisation, because they are not yet ready for use.

12.6.1 Scope of IAS 36

All assets are within the scope of IAS 36 unless specifically excluded [IAS 36.2]. The assets scoped out are:

- Inventories
- Assets arising from construction contracts
- Deferred tax assets

- Assets arising from employee benefits
- Assets carried at fair value under International Accounting Standard 40, *Investment Property* (IAS 40), and International Accounting Standard 41, *Agriculture* (IAS 41)
- Financial assets within the scope of IAS 39
- Assets within the scope of IFRS 4
- Assets **held-for-sale** within the scope of IFRS 5

Investments in subsidiaries, joint ventures, and associates are within the scope of IAS 36 [IAS 36.4].

12.6.2 Indicators of impairment

An entity must determine at each reporting date whether there is any indication that an asset is impaired [IAS 36.9]. The asset's recoverable amount must be determined and compared with its carrying amount to assess the amount of any impairment if an indicator of impairment exists. This requirement extends to goodwill, indefinite-lived intangible assets, and assets not yet subject to depreciation or amortisation.

Indicators of impairment may arise from the external environment in which the entity operates, or from within the entity's own operating environment. IAS 36 lists examples of impairment indicators, as follows.

External indicators:

- Significant decline in the asset's market value
- Adverse changes in technology, the market, the economic or legal environment
- Increases in market interest rates
- Carrying amount of the entity's net assets exceeds its market capitalisation

Internal indicators:

- Evidence of obsolescence
- Plans to discontinue use of the asset or to dispose of it
- Change from indefinite to determinable useful life for an intangible asset
- Evidence that the asset is performing below expectations [IAS 36.12]

Downturns caused by general economic conditions or specific company circumstances often present indicators of impairment. Although not an exhaustive list, examples of these types of indicators include:

- Actual results significantly lower than budgeted
- Cash flows significantly lower than forecasted
- Material decreases in mid-term or long-term growth rates
- Significant or prolonged decrease in the entity's stock price
- Announced change in business model, restructuring, or discontinued operations
- Increase in the entity's cost of capital
- Change of market interest rates or other market rates of return
- Fluctuations in foreign exchange rates or commodity prices that impact the entity's cash flows
- Deferral of investment projects

Management should not limit the assessment of indicators to those noted above. It is necessary to consider and evaluate any adverse change in circumstances as a potential indicator of impairment.

12.6.3 Determination of cash-generating units

The existence of independent cash flows and the identity of an entity's CGUs is usually a matter of fact rather than judgment. The independence of cash inflows will often be evident. Management can gain valuable insights from additional information that is readily available [IAS 36.69, IE1]. IAS 36 focuses on cash inflows, not net cash flows. Shared support assets and infrastructure do not undermine the independence of cash inflows. Such assets are tested with the groups of CGUs they support, or as corporate assets by reference to the totality of cash flows of the entity.

The existence of an active market for the output of an asset or group of assets is evidence that cash inflows are independent. Such an asset or group of assets will be a CGU, even if the output is consumed internally [IAS 36.70]. Examples of outputs from assets for which an active market exists include oil, gold, and electricity.

The identification of CGUs should be consistent from period to period [IAS 36.72]. An asset that was previously part of a CGU, but is no longer utilised, should be excluded from the CGU and assessed separately for impairment.

Examples 12-5 to 12-7 provide examples that illustrate the identification of CGUs.

EXAMPLE 12-5

Identification of CGUs within entities that operate at different locations

An entity operates at many different locations, such as hotels, transport entities, and retail operations. Management is considering how to identify and group CGUs for impairment testing.

Analysis

Hotels: Individual hotels usually generate income/cash inflows that are independent of others. Management monitors their performance on an individual basis. Each hotel should be considered to be an individual CGU, even if sales and marketing and finance functions are centralised.

Transport entities: Entities involved in the transport business commonly provide services on a number of routes. The assets deployed to each route and that route's cash inflows can usually be separately identified. Each route can be identified as a CGU even though the entity may market its services on a regional basis.

Loss-making routes will be an indicator of impairment, except if a regulatory requirement dictates that these routes be serviced alongside the entity's more profitable routes.

Retail Operations: Each individual store is generally a CGU because it generates independent cash inflows.

Management may monitor goodwill on a regional basis by aggregating stores, hotels, or transport routes by region or by some other criteria that relate to how the entity is managed. Goodwill is reviewed at the higher level.

EXAMPLE 12-6

Identification of CGUs if an entity operates at different locations, but with centralised functions

Entity A runs a fast food restaurant chain. Each restaurant is supplied by Entity A's central purchasing and distribution system. There are five restaurants in London (but in different neighbourhoods), and another 50 in other cities and towns in the United Kingdom. All of the restaurants are managed in the same way. Pricing, marketing, advertising, and personnel policy (except for the local recruitment of waiters and kitchen staff) is decided centrally by Entity A. Seven of the restaurants were purchased five years ago, and goodwill was recognised.

Analysis

In determining the CGU in this situation, several factors should be considered, including whether:

- Performance is monitored on an individual restaurant basis, or at regional or other levels—for example, considering the lowest level at which meaningful profitability statements are produced.
- Product offering and investment decisions are made at individual, regional, or other grouping levels.
- Individual outlets generate business for other parts of the network.
- Units are managed on a combined basis, share systems, centralised purchasing, and distribution functions.
- Product pricing is determined locally or on a regional or national basis.

All the restaurants are in different neighbourhoods and probably have different customer bases. Each restaurant generates cash inflows that are largely independent from the cash flows of the other restaurants, and therefore it is likely that each restaurant is a CGU in this situation. The goodwill arising on the acquisition of the seven restaurants would have been allocated to the group of CGUs that incorporated the seven restaurants or other CGUs that benefit from the business combination. Each restaurant (CGU) should be tested for impairment when there is an indicator. If an impairment occurs, it should be recognised. Secondly, the group of restaurants and goodwill should be tested for impairment.

EXAMPLE 12-7

Identification of CGUs in an entity that has vertically integrated operations

The reporting entity has two plants. Plant A produces raw material that is sold to Plant B of the same entity. The raw material is sold by Plant A to Plant B at a price that transfers all the margins to Plant B. Plant A sells 100 percent of its production to Plant B. All of the production of Plant B is sold to external customers. The issue is to determine the CGUs for Plant A and Plant B when (1) Plant A could sell its production in an active market instead of to Plant B, and (2) there is no active market for the production of Plant A.

Analysis:

There is an active market for Plant A's production in situation (1). It is likely that Plant A is a separate CGU. Plant B would also be a separate CGU because it sells all of its output externally. Plant B generates cash inflows that are largely independent of the cash flows from the other assets of the reporting entity. The internal transfer prices for the production sold by Plant A to Plant B should be adjusted to arm's length prices in the financial forecasts and budgets used for determining value in use for both Plant A and Plant B.

There is no active market for the output of Plant A in the second situation (2). The cash inflows of Plant A depend on the demand for the product sold by Plant B. Plant A does not generate cash flows that are largely independent of the cash flows of assets operated by Plant B. The use of internal transfer prices demonstrates the two plants are managed together. The two plants should be treated as one CGU.

12.6.4 Grouping cash-generating units

Goodwill does not generate cash flows independent of other assets or groups of assets. It often benefits or contributes to the cash flows of more than one CGU. Goodwill that contributes to the cash flows of more than one CGU should not be arbitrarily allocated to the individual CGUs but should be allocated to the group of CGUs that is benefited for the purposes of impairment testing. The group of CGUs that goodwill is allocated to should be the lowest level at which management monitors goodwill for impairment and cannot exceed an operating segment as defined in IFRS 8 [IAS 36.80]. Goodwill is allocated to the CGU or group of CGUs that will benefit from the business combination, including the existing business of the acquirer. See BCG 12.5 for further information on the elements of goodwill which may assist in allocating goodwill to a group of CGUs.

CGUs can be grouped for the purposes of testing goodwill for impairment when they benefit from the business combination that gave rise to the goodwill, subject to the ceiling of an operating segment.

12.6.5 Allocating assets and liabilities to cash-generating units

The recoverable amount of a CGU is the higher of VIU and FVLCOD for the CGU. The manner in which the carrying value of the CGU is determined should be consistent with the manner in which the recoverable amount is determined. Thus, different assets and liabilities may be included in the carrying amount for comparison between a VIU and a FVLCOD calculation.

The carrying amount of the CGU is established by identifying the assets and liabilities of the individual CGU plus any assets, such as goodwill or corporate assets, that can be allocated to it on a nonarbitrary basis. The carrying amount of a CGU consists of:

- Assets that are directly and specifically attributable to the CGU (e.g., machinery or a factory building)

- An allocation of assets that are indirectly attributable on a reasonable and consistent basis, including corporate assets (e.g., delivery trucks based on the relevant number of trips made to each location, supported from a central depot) and goodwill (if an acquired business is a single CGU, or goodwill can be allocated on a nonarbitrary basis)

- Recognised liabilities to the extent that the recoverable amount of the CGU cannot be determined without consideration of those liabilities

Cash flows prepared for a VIU calculation would exclude working capital cash flows; therefore, the carrying amount of the CGU should also exclude working capital. VIU is a pretax approach, and the carrying amount should exclude tax assets and liabilities, whereas FVLCOD is often calculated on a post-tax basis; thus, tax cash flows and tax assets and liabilities are included. Liabilities that relate to financing the operations of a CGU are also excluded when determining the recoverable amount for VIU and FVLCOD.

Many entities do not allocate goodwill or corporate assets to individual CGUs because often there is no basis to do so at this lowest level other than on an arbitrary one. Instead, CGUs are most often grouped. Goodwill and corporate assets are allocated to groups of CGUs. Some corporate assets, such as the head office building and a global brand, would typically be tested at the level of the whole entity.

12.6.6 Determining recoverable amount—fair value less costs of disposal

Fair value should be measured in accordance with IFRS 13 [IFRS 13.9]. The expected costs of disposal should be deducted to calculate FVLCOD [IAS 36.28]. Costs of disposal are only the direct incremental costs of the disposal [IAS 36.28, BCZ 35].

IFRS 13 states that a quoted price in an active market provides the most reliable evidence of fair value [IFRS 13.77]. However, few assets (or businesses) tested for impairment under IAS 36 are traded in an active market and therefore a valuation technique often will be used to measure fair value.

There are a number of valuation methodologies that are used to assess the value of a business or an asset under FVLCOD. More than one methodology is normally used to ensure that the valuations are cross-checked and considered in light of appropriate market evidence. The replacement cost method is not appropriate for the purpose of impairment testing, as it does not reflect the economic benefits recoverable from use or disposal [IAS 36 para BCZ 29].

For some assets, particularly land and buildings, fair value measured by using the market approach may be most appropriate, as there is usually market data on sales or rentals. For many assets and businesses, however, fair value measured by an income approach will be appropriate. See BCG 7.2 .4 for information on valuation techniques used to measure fair value.

12.6.7 Determining recoverable amount—value in use

An asset or CGU's VIU is the present value of the future cash flows expected to be derived from the use of an asset or CGU and from its disposal. VIU is calculated by applying an appropriate pretax discount rate to the asset or CGU's estimated future pretax cash flows [IAS 36.31]. The VIU calculation is not a fair value calculation and VIU is not a proxy for fair value. VIU is a prescribed form of cash flow model described in IAS 36 for the purposes of comparability in the testing of goodwill.

12.6.7.1 Cash flows for value in use

Cash flow projections for a VIU calculation should be based on reasonable assumptions that represent management's best estimate of the range of economic conditions that will exist over the remaining useful life of the asset [IAS 36.33(a)]. Management must assess the reasonableness of the assumptions used as the basis for the current cash flow projections, and give greater weight to assumptions supported by external market data. Management should consider the extent to which its previous forecasts have proved reliable and the reasons for variances in assessing assumptions [IAS 36.34].

Two approaches for constructing a cash flow projection for value in use include:

- The *traditional* approach, consisting of a single set of estimated cash flows and a single discount rate [IAS 36.A4]. Uncertainties are reflected through the risk premium included in the discount rate.

- The *expected cash flow* approach, consisting of all expectations about possible cash flows instead of the most likely cash flow [IAS 36.A7]. Uncertainties are reflected through probability-weighted cash flows.

Theoretically, these two approaches should provide the same result. However, determining the risk premium to include in the discount rate under the traditional approach can be challenging. Therefore, management should consider probability-weighting different scenarios to estimate the expected cash flows.

The cash flow projections must be based on the most recent financial budgets that have been approved by management. The projections, using specific assumptions, should cover a maximum period of five years, unless a longer period can be justified [IAS 36.33(b)]. The cash flows associated with assets under construction include expenditures necessary to get the asset ready for use [IAS 36.42].

Cash flow projections beyond five years are estimated by extrapolating the projections for the first five years using a steady or declining growth rate for subsequent years, unless an increasing rate can be justified. The growth rate should not exceed the long-term average growth rate for the products, industries, or countries in which the entity operates, or for the market in which the asset is used, unless justifiable [IAS 36.33(c)].

Cash flow projections exclude expenditures related to (and benefits of) any restructuring plan for which management has not created a constructive obligation. The projections also exclude any future capital expenditure that will improve or enhance the asset's or CGU's performance [IAS 36.44, 45]. The asset or CGU is assessed for impairment in its current condition, not as a modified asset or CGU that the entity might own in the future.

The cash flows include any costs payable at the end of the asset's life (for example, decommissioning costs) and any amounts receivable on disposal [IAS 36.39(c)]. The carrying amount of the asset or CGU should also include any liabilities if the recoverable amount of the CGU or asset cannot be determined without consideration of the liability [IAS 36.76].

The cash flows should exclude any financing cash flows and any tax cash flows [IAS 36.50]. They should also exclude any cash flows to the lessor regarding assets of the CGU held under a finance lease. Central overhead costs should be considered based on how the related assets are tested. For example, if the head office is tested as a corporate asset, the related costs are included in the cash flows for that CGU or group of CGUs that include the corporate asset.

12.6.7.2 *Selection of a discount rate*

The discount rate used is the pretax rate that reflects the specific risks of the asset or CGU. Different CGUs will often warrant different discount rates. The discount rate should not be adjusted for risks that have already been considered in projecting future cash flows [IAS 36.56].

Management might consider the entity's **weighted average cost of capital** or its incremental borrowing rate when determining an appropriate discount rate [IAS 36.A17]. Consideration should also be given to country risk, currency risk, and cash flow risk. Different rates should be used for different future periods with different risks where appropriate [IAS 36.A21].

The discount rate does not simply result from the application of a formula but requires the exercise of judgment. If the cash flows do not incorporate a sufficient level of risk and uncertainty (for example, through probability weighting of cash flow scenarios), the discount rate should be adjusted to include an additional risk premium. However, management should attempt to adjust the cash flows prior to making adjustments to the discount rate, as it is generally more difficult to estimate and support the amount by which the discount rate should be adjusted.

12.6.8 *Recognising an impairment loss*

An impairment loss should be recognised if the carrying amount of an asset, CGU, or group of CGUs is greater than the recoverable amount. The carrying amount should be reduced to the recoverable amount [IAS 36.59–60]. The corresponding charge is recognised in the income statement, unless there are assets accounted for under the revaluation model. An impairment charge is recognised against a revaluation surplus to the extent that it reverses a previous revaluation uplift for that asset [IAS 36.60].

The future depreciation or amortisation of any impaired assets is adjusted to reflect the revised carrying amount [IAS 36.63]. The asset's remaining useful economic life should also be reviewed.

An impairment loss arising in a CGU or a group of CGUs is allocated to reduce the carrying amounts of the individual nonmonetary assets on the following basis [IAS 36.104]:

- First, to goodwill allocated to the CGU or group of CGUs
- Second, to the other nonmonetary assets in proportion to their carrying amounts, subject to the limits set out below

The other nonmonetary assets are likely to include property, plant and equipment, and intangible assets.

The carrying amount of each asset within the CGU is reduced to the higher of [IAS 36.105]:

- Its FVLCOD (if determinable)

- Its VIU (if determinable)
- Zero

Any unallocated impairment is reallocated to the nonmonetary assets, subject to the same limits. This could result in an iterative process, continuing until the impairment charge is fully allocated or until each of the CGU's nonmonetary assets have been reduced to the higher of each asset's FVLCOD, VIU, and zero. The recognition of an impairment loss shall not result in the recognition of a liability, unless it meets the definition of a liability under another IFRS Standard [IAS 36.108].

See BCG 12.5.1 for information on the allocation of impairment to goodwill and how this interacts with the valuation choice for the noncontrolling interest under IFRS 3.

12.6.9 Reversing an impairment loss

Impaired assets, other than goodwill, are assessed in subsequent years for indications that the impairment may have reversed. The indicators are generally the converse of those used to identify impairment [IAS 36.111]. A reversal is recognised when it arises from a change in the estimates used to calculate the recoverable amount [IAS 36.114].

The asset's recoverable amount is recalculated, and its carrying amount increased to the revised recoverable amount, subject to the following limits:

- Goodwill impairment is never reversed [IAS 36.124].
- The increased carrying amount due to the impairment reversal is limited to the amount that would have been recognised had the original impairment not occurred, after allowing for depreciation or amortisation in the intervening period [IAS 36.117].

The same principles apply to the reversal of an impairment of a CGU. The allocation of the reversal is made to assets, other than goodwill, on a pro rata basis [IAS 36.122]. When reversing impairment losses previously applied to assets within a CGU, the carrying amount of each asset cannot be increased above the lower of:

- Its recoverable amount.
- Its carrying amount if no impairment loss had been recognised after allowing for depreciation and amortisation in the intervening period. The determination of this amount also requires detailed recordkeeping [IAS 36.123].

Chapter 13: Other business combination considerations

13.1 Chapter overview

This chapter covers additional considerations applicable to companies subject to the SEC's accounting and reporting rules and regulations, companies engaged in acquisitions of entities in the insurance industry, and internal controls related to the accounting and reporting for a business combination. Specifically, the following topics are covered:

- Public companies – Companies subject to SEC rules and regulations have additional accounting and disclosure requirements to consider, including the application of pushdown accounting.

- Companies in the insurance industry – The application of acquisition accounting to business combinations in the insurance industry may be complex due to limited insurance-specific guidance in the Standards.

- Internal control implications – Companies engaged in business combinations will likely need to design and implement internal controls over their related accounting and reporting processes.

13.2 Disclosure, reporting, and pushdown accounting considerations for companies filing under United States Securities and Exchange Commission rules

This section provides a brief overview of certain SEC disclosure and reporting requirements, as well as the SEC's views on the application of pushdown accounting for companies considering **business combinations**.

The EITF is currently discussing EITF Issue No. 12-F, "Recognition of New Accounting Basis (Pushdown) in Certain Circumstances," which may result in amendments to existing guidance. An exposure draft has been issued and if finalised would provide additional guidance for SEC registrants and private companies on when pushdown accounting should be applied.

13.2.1 Definition of a business

The Standard's definition of a **business** is broader than the SEC's definition. As a result, a separate evaluation of whether a transaction involves the acquisition of a business under the criteria in Rule 11-01(d) of SEC Regulation S-X should be performed for determining whether reporting under Item 2.01 of Form 8-K is required.

13.2.2 Disclosures required in interim financial statements

The disclosure requirements of the Standards are applicable for business combinations that occur either during the current reporting period, or after the reporting date but before the financial statements are issued. The disclosure requirements of the NCI Standards are applicable for each reporting period. Therefore, the disclosures required by the Standards and the NCI Standards should be included in interim financial statements, as applicable, subject to materiality considerations.

In addition, Rule 10-01(a)(5) of SEC Regulation S-X, *Interim Financial Statements*, requires that in an interim period SEC registrants disclose (1) their adoption of new accounting principles and practices, (2) details of accounts that have changed significantly in amount or composition, and (3) other significant changes that have occurred since the end of the most recent fiscal year. Rule 10-01(b)(4) of SEC Regulation S-X requires certain pro forma financial information, such as pro forma revenues, net income, and net income per share, among others, to be provided for material business combinations that have occurred during the period.

Though the intent of the Article 10 pro forma disclosures is to require pro forma information in interim statements that is consistent with the pro forma information required by U.S. GAAP in annual financial statements, certain differences exist. The SEC staff has stated that it would not object to a company applying Article 10 to their interim statements in a manner consistent with the guidance in ASC 805-10-50-2h, while the staff considers ways to update Article 10 to be consistent with U.S. GAAP.

13.2.3 Measurement period adjustments

A company should retrospectively record measurement period adjustments made to provisional amounts as if the accounting was completed at the **acquisition date**. The **acquirer** shall revise comparative information for prior periods presented in the financial statements as needed, including making any change in depreciation, amortisation, or other income effects recognised in completing the initial accounting.

The retrospective nature of measurement period adjustments and the resulting need to revise historical financial information has reporting implications for SEC registrants. For example, assume a company reporting under U.S. GAAP with a calendar year-end acquires an entity on 1 October 20X9, and on 31 May 2X10 new information related to facts that existed at the acquisition date arises that leads to a measurement period adjustment. The company has already filed its Form 10-K for the year ended 31 December 20X9 and a Form 10-Q for the quarterly period ended 31 March 2X10. The company must take the following actions in its 30 June 2X10 Form 10-Q:

- Retrospectively adjust the 31 December 20X9 balance sheet
- Retrospectively adjust the income statement, cash flow statement, and statement of changes in shareholders' equity (if applicable) for the six-month period ended 30 June 2X10
- Disclose the nature and amount of the measurement period adjustment

The company also must perform the following to properly reflect the subsequent adjustments of the provisional amounts in the 31 December 2X10 Form 10-K:

- ◻ Retrospectively adjust the 31 December 20X9 balance sheet
- ◻ Retrospectively adjust the income statement, cash flow statement, and statement of changes in shareholders' equity for the year ended 31 December 20X9
- ◻ Retrospectively adjust the 20X9 amounts in the selected financial data section and in the MD&A
- ◻ Retrospectively adjust the selected quarterly data in the footnotes to the financial statements for the quarterly periods ended 31 December 20X9 and 31 March 2X10
- ◻ Disclose the nature and amount of the measurement period adjustment

13.2.3.1 Impact of measurement period adjustments on previously issued annual financial statements included or incorporated by reference in proxy statements, registration statements, and offering memoranda

Companies that plan to file a proxy, new or amended registration statement, or offering memorandum will need to consider whether any retrospective changes need to be made to the previously filed financial statements for measurement period adjustments. If a company made or determined that it needed to make a material adjustment to provisional amounts previously recorded, the company would need to revise the previously filed financial statements included or incorporated by reference in the proxy, registration statement, or offering memorandum to reflect the material adjustment. The requirement to revise the prior financial statements included or incorporated by reference in the proxy, registration statement, or offering memorandum applies even if the acquirer has not yet filed financial statements that include the period in which the measurement period adjustments were identified.

The previously filed financial statements that must be revised will depend on the timing of the acquisition, as well as the timing of when the measurement period adjustments are identified. If the provisional acquisition accounting amounts were recorded in a prior annual period, then the annual financial statements for that period must be revised. Additionally, if subsequent financial statements have been issued for one or more interim periods, then the latest interim period financial statements (and the corresponding year-to-date period financial statements) must also be revised (if they do not already reflect the material measurement period adjustment).

Companies that are incorporating previously issued financial statements by reference should consult their counsel about the appropriate way to place their revised financial statements on file. Some companies include their revised financial statements in the document being filed, whereas others include the financial statements in a Form 8-K, which is then incorporated by reference. We believe companies generally would not be required to amend prior Form 10-Ks and Form 10-Qs, as the financial statements were correct at the time they were filed. Companies should also consider the need to include and revise other previously filed information, such as the selected financial data table and MD&A in their Form 8-K.

13.2.4 *Significance test*

When an SEC registrant acquires a business, the registrant must evaluate whether the business is significant as prescribed by Rule 3-05 of Regulation S-X. Additional information may need to be provided in a filing with the SEC if the business is significant to the registrant. Rule 3-05 of Regulation S-X requires that a registrant determine the significance of an acquired (or to be acquired) business using the three significance tests described in Rule 1-02(w) of Regulation S-X: the asset test, the investment test, and the income test. Depending on the level of significance, the registrant may be required to file with the SEC up to three years of audited historical financial statements of the acquired business. All three tests of significance should be performed, and the test yielding the highest level of significance should be used to determine the number of periods for which audited historical financial statements must be filed.

Acquisitions that are determined to be significant under the guidelines of Rule 3-05[1] of Regulation S-X will also require presentation of pro forma financial information to reflect the pro forma effect of the acquisition in accordance with Article 11[1] of Regulation S-X.

Registrants are required to report the acquisition by filing with the SEC a current report on Form 8-K within four business days of consummating the acquisition, but may file the required audited historical financial statements of the acquired business and pro forma financial information prepared in accordance with Article 11 of Regulation S-X via an amendment to the initial Form 8-K within 71 calendar days of the initial Form 8-K due date.

When performing the investment test of significance, the registrant's investment in the acquired business is compared to the registrant's total assets. The SEC has indicated in section 2015.5 of the SEC Division of Corporation Finance Financial Reporting Manual (SEC FRM) that the investment amount used in this test should be the purchase price or consideration transferred as determined by applying the guidance of ASC 805. Under ASC 805, the fair value of consideration transferred includes the fair value of any **contingent consideration** recorded as part of the transaction, but excludes acquisition costs. Consideration transferred should not include debt or other liabilities included in the acquired company's pre-acquisition balance sheet and assumed by the acquiring entity. In addition, the SEC generally would not require a revision of the purchase price used in the investment test when a measurement period adjustment is recorded, as long as a good faith estimate of the purchase price was made at the time of the acquisition.

The financial statements of a non-public company (e.g., a wholly-owned subsidiary acquired by a non-public company in a prior business combination) may not reflect pushdown accounting because pushdown accounting is not required for non-public companies. However, if that non-public subsidiary is subsequently acquired by an SEC registrant, the registrant must perform the significance tests (i.e., asset test and

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[1] A smaller reporting company, as defined in Regulation S-K 10(f), Securities Act Rule 405 and Exchange Act Rule 12b-2 is permitted to apply certain scaled financial reporting requirements described in Article 8 of Regulation S-X in lieu of the requirements of Rule 3-05 and Article 11 of SEC Regulation S-X.

income test) as if pushdown accounting had been applied to the acquired company's financial statements by the original acquirer if pushdown accounting is required under the SEC rules. Further, any financial statements of the acquired entity required to be filed by the registrant (i.e., those filed in accordance with Item 2.01 of Form 8-K and Rule 3-05 of SEC Regulation S-X) may also be required to reflect the application of pushdown accounting, depending on the extent of ownership acquired. See BCG 13.2.10 for further information.

When performing the significance tests, SEC registrants should consider the impact of measurement period adjustments for prior acquisitions, even if those adjustments are not yet reflected in financial statements on file with the SEC. For example, assume an SEC registrant files its Form 10-K in February 2X10 and in March 2X10 identifies a measurement period adjustment related to a November 20X9 business acquisition. If in April 2X10, prior to the filing of its 31 March 2X10 Form 10-Q, the registrant acquires another business, the income and assets of the registrant used in the significance tests for the newly-acquired business should include any retrospective effects of the measurement period adjustments on the registrant's assets or income in the applicable periods.

The calculation of significance can be complex. The information included in this discussion is only a summary of the requirements under Rules 1-02(w) and 3-05 of Regulation S-X. See sections 4400 and 4550 of PwC's SEC guide for additional guidance regarding common complexities encountered in measuring the significance of a business combination.

13.2.5 SEC regulation S-X, article 11 pro forma disclosures

Article 11 of Regulation S-X provides the SEC's requirements for the presentation of pro forma condensed financial information regarding significant business combinations that have occurred during the most recent fiscal year or subsequent interim periods. This information is usually filed under Items 2.01 and 9.01 of Form 8-K. These pro forma disclosures are in addition to the unaudited supplemental pro forma disclosures required in the notes to the financial statements in Forms 10-Q and 10-K, which are prepared pursuant to ASC 805-10-50-2h.

Under Article 11, registrants are required to present (1) a pro forma condensed balance sheet as of the end of the most recent period (unless the transaction is already reflected in the historical balance sheet) and (2) pro forma condensed income statements for the most recent fiscal year and for the period from the most recent fiscal year-end to the most recent interim date for which a balance sheet is required. Comparative pro forma prior year interim information is permissible, but not required.

The pro forma condensed income statement is prepared assuming the transaction was consummated at the beginning of the fiscal year presented. The pro forma condensed balance sheet is prepared assuming the transaction was consummated on the most recent balance sheet date. Because the transaction is assumed to have taken place on different dates in the pro forma condensed income statement and the pro forma condensed balance sheet, the two statements will not precisely correspond with one another.

Pro forma adjustments related to the pro forma condensed income statement under Regulation S-X must meet the following three characteristics:

- Be directly attributable to the transaction
- Be expected to have a continuing impact on the operations[2]
- Be factually supportable

In the June 27, 2012, AICPA SEC Regulations Committee meeting, the SEC staff revised its view of what constitutes "continuing impact." The SEC staff has historically considered items to have a continuing impact if they are expected to impact operations or continue for a period longer than twelve months from the date of initial occurrence. The SEC staff's revised view is that items have continuing impact if they are not one-time in nature. Certain items that previously were not considered to have continuing impact now may be required pro forma adjustments. For example, interest expense incurred for a bridge loan repaid in less than twelve months after the acquisition or amortisation of an acquired intangible asset with a life of less than twelve months.

Pro forma adjustments related to the pro forma condensed balance sheet under Article 11 of Regulation S-X must be directly attributable to the transaction and factually supportable regardless of whether they have a continuing impact or are nonrecurring. Registrants should consider the type of pro forma adjustments needed to reflect the business combination, including:

- Step up to **fair value** (with limited exceptions[3]) of assets and liabilities of the **acquiree**
- Amortisation of intangible assets, and depreciation of tangible assets based on the fair value of assets acquired
- The fair value (in accordance with ASC 718) of stock options exchanged in the transaction included in the **consideration transferred** and as compensation expense in the postcombination period
- Contractual terms of the combination, such as major new compensation contracts with management
- Probable dispositions resulting from the business combination
- Additional financing or repayments of debt as part of the acquisition

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[2] Although nonrecurring adjustments are excluded as pro forma adjustments to the pro forma condensed income statement, registrants are required to disclose the nature and amount of these adjustments in a footnote to the pro forma financial information.

[3] Certain items, such as income taxes, assets held-for-sale and employee benefit plan obligations are exceptions to the fair value measurement principles. See BCG 2.5 for further discussion of these items.

- Adjustments reflecting the new equity structure of the combined company, including the issuance of new equity
- Adjustments to conform the accounting principles of the acquiree to those of the acquirer
- Any tax effects of the transaction

The filing of Article 11 pro forma financial information does not satisfy the requirement to include ASC 805-10-50-2h pro forma disclosures in the notes to the financial statements. In addition, pro forma disclosures required by ASC 805-10-50-2h might be required even when Article 11 pro forma financial information is not required. The reason for this is that the materiality thresholds are different. Article 11 pro forma information is based on the quantitative significance of the acquisition to the acquirer under Rule 1-02(w) of Regulation S-X. ASC 805 disclosure requirements are based on materiality to the financial statements taken as a whole. An acquisition may be material to the financial statements even if it does not meet the SEC's definition for significance.

Figure 13-1 compares the presentation requirements of pro forma information between ASC 805 and Article 11.

Figure 13-1
Pro forma information presentation requirements

Topic	ASC 805	Article 11
Periods to present	ASC 805 requires that U.S. public companies disclose unaudited supplemental pro forma information for the results of operations for the current period, as well as the results of operations for the comparable prior period. (IFRS requires that companies disclose unaudited supplemental pro forma information for the results of operations for the current period only.) **Note:** Pro forma financial information related to results of operations of periods prior to the combination shall be limited to the results of operations for the immediately preceding period.	Article 11 requires a pro forma balance sheet based on the latest balance sheet included in the filing (unless the acquisition is already reflected in the historical balance sheet). The pro forma condensed income statement is based on the latest fiscal year and subsequent interim period included in the filing. Comparative prior year interim period information is permissible, but not required.

Topic	ASC 805	Article 11
Length of time disclosures must be "retained"	Pro forma disclosures should be repeated whenever the year or interim period of the acquisition is presented. For example, assume Company A, a calendar year-end company, acquired Company B on 15 May 20X1, and the acquisition is material to the financial statements of Company A. Company A would present pro forma revenue and earnings as if the acquisition occurred on 1 January 20X0 in the interim financial statements to be included in both its second and third quarter Form 10-Qs in 20X1 and in the annual financial statements to be included in its Form 10-K for 20X1. Company A is required to repeat the pro forma disclosures in the interim financial statements to be included in its second and third quarter Form 10-Qs in 20X2, and its annual financial statements to be included in its Form 10-K for 20X2 and 20X3, because the period of acquisition is presented as comparative 20X1 information. Company A would continue to utilise an assumed acquisition date of 1 January 20X0 when preparing the 20X1 pro forma results for the period of acquisition. No pro forma information is required for each of the quarterly and annual periods in 20X2 and 20X3 because the results of the acquired business are included in the consolidated results of operations for those periods. Company A would not be required to present pro forma information in the financial statements included in the first quarter 20X2 Form 10-Q because the period of acquisition would not be presented in the comparative first quarter 20X1 financial statements. However, Company A would be permitted to include first quarter 20X1 pro forma information and should evaluate whether inclusion of the information would be beneficial to the readers' understanding of the effects of the acquisition on the consolidated financial statements.	In a subsequent registration statement, a pro forma condensed balance sheet is not required if an acquisition is already reflected in the historical balance sheet; however, disclosures related to the acquisition are required. Generally, a pro forma condensed income statement must be presented until the transaction to which the pro forma disclosure relates has been reflected in the audited financial statements for a 12-month period. For example, using the acquisition details noted in the column to the left, if Company A were to file a new or amended registration statement any time before the Form 10-K for 20X2 is filed, depending upon the effective date of the registration statement, Company A may be required to include an updated pro forma condensed income statement for the six months ended 30 June 20X1, the nine months ended 30 September 20X1, or the year ended 31 December 20X1. No pro forma information for periods ending after 31 December 20X1 would be required, as Company B would be included in the consolidated financial statements of Company A for all periods ending after that date.

Topic	ASC 805	Article 11
Format	ASC 805-10-50-2h requires disclosure of revenue and earnings amounts on a pro forma basis. Additional line items (e.g., operating income, income from continuing operations) are permissible.[1]	Article 11 requires a pro forma condensed balance sheet, pro forma condensed income statements through income (loss) from continuing operations, and explanatory footnotes, along with an introductory paragraph that provides a description of the transaction, entities involved, and periods for which the pro forma information is presented. **Note:** In light of the changes in the income statement presentation resulting from the NCI Standards, at the 2009 AICPA National Conference on Current SEC and PCAOB Developments, the SEC staff provided alternatives for a registrant to consider in presenting income from continuing operations: Present pro forma information through income from continuing operations (as currently provided in Article 11) Present an adjustment to income from continuing operations for the amount of income attributable to the noncontrolling interest Present a full pro forma condensed income statement, down to net income attributable to the registrant (i.e., including amounts related to extraordinary items and discontinued operations, and an adjustment for the amount of income attributable to noncontrolling interest).
Date of combination	If comparative financial statements are not presented, ASC 805 requires that the pro forma information be prepared for the current reporting period as though the acquisition had occurred as of the beginning of the current annual reporting period. If comparative financial statements are presented, the pro forma information should be prepared as though the acquisition occurred at the beginning of the comparable prior annual reporting period. The "as if" date of the acquisitions would not be revised in the pro forma information in future periods when additional financial statement periods are presented.	Rule 11-02(b)(6) of SEC Regulation S-X states that the pro forma adjustments related to the condensed income statement shall be computed assuming the transaction was consummated at the beginning of the fiscal year presented. The SEC staff has interpreted this to mean that the pro forma adjustments are to be computed for both the annual and interim income statements, assuming that the acquisition occurred at the beginning of the annual period.

Topic	ASC 805	Article 11
Nonrecurring items	ASC 805 requires adjustments that are nonrecurring in nature to be included in the pro forma amounts.	Rule 11-02(b)(5) of SEC Regulation S-X requires that the pro forma condensed income statement adjustments (1) be directly attributable to the transaction in question, (2) have a continuing impact on the operations, and (3) be factually supportable. As a result, charges or credits that result directly from the transaction but do not have a continuing impact (i.e., one-time in nature or nonrecurring) are not included in the pro forma condensed income statement. In addition, nonrecurring charges or credits (e.g., transaction costs) included in the acquirer's or acquiree's historical income statements that are directly attributable to the transaction should be eliminated. Such nonrecurring charges or credits are reflected in retained earnings in the pro forma condensed balance sheet and disclosed in the notes to the pro forma financial information.
Footnotes	ASC 805 requires disclosure of the nature and amount of any material, nonrecurring pro forma adjustments directly attributable to the acquisition included in the reported pro forma revenue and earnings.	Article 11 requires explanatory notes to be sufficiently detailed to enable a clear understanding of the assumptions and calculations involved in developing each of the pro forma adjustments.
Other completed or probable transactions	ASC 805 would allow adjustments for completed business acquisitions but would not permit adjustments for other completed or probable transactions (e.g., a completed or probable significant business disposition).	Article 11 would allow adjustments for other significant completed and probable transactions (e.g., a probable disposition or a probable acquisition) and, therefore, could result in more adjustments than the ASC 805 pro forma disclosures.

[1] Rule 10-01(b)(4) of SEC Regulation S-X also requires the inclusion of certain income per share data in interim financial statements.

13.2.6 *SEC considerations regarding the accounting for certain assets acquired and liabilities assumed*

With limited exceptions, ASC 805 requires that an acquirer record at fair value assets acquired and liabilities assumed in a business combination. In determining fair value (or other measurement basis, where required), the acquirer should evaluate all information available at the date of acquisition, including the historical carrying value recorded by the acquired entity. In some instances, the SEC has expressed the view that significant differences between the acquired entity's historical carrying value and the acquiring entity's estimated fair value of certain assets acquired and liabilities assumed could call into question either the fair value determined by the acquiring entity or the carrying value reported by the acquired entity. If it is determined that the pre-acquisition carrying value was not accurate in the acquired entity's financial statements, the pre-acquisition financial statements may require adjustment. Corrections of the acquired entity's financial statements should not be reflected in the acquiring entity's purchase accounting.

13.2.6.1 SEC considerations regarding the accounting for certain acquired assets with uncertain future cash flows

An acquirer should not recognise a separate valuation allowance as of the acquisition date for assets acquired in a business combination because the effects of uncertainty about future cash flows should already be considered in the fair value measurement. In determining the fair value of certain acquired assets (e.g., loans receivable), companies should give consideration to the acquired company's net carrying value of those assets at the date of acquisition. Although the historical valuation allowances cannot be carried forward by the acquirer, prior management's estimate of collectability is useful information that should be considered when determining the fair value of the acquired assets. Significant differences between the acquiree's net carrying value of the acquired assets and the acquirer's assessment of their fair value may raise questions as to the appropriateness of credit loss assumptions used in deriving the fair value of the acquired assets in the acquirer's acquisition date balance sheet. It may also call into question the appropriateness of the loan valuation allowances previously recognised in the acquiree's historical financial statements. However, it is important to note that the acquiree's valuation allowances for estimated losses will reflect incurred losses, whereas the acquirer's fair value determination will also consider an assumption for expected losses over the life of the loan receivables.

Acquirers should apply similar considerations to other acquired assets such as trade accounts receivable and inventories, among others.

13.2.6.2 SEC considerations regarding the accounting for contingencies in acquisition accounting

In determining liabilities assumed in an acquisition, companies should carefully evaluate contingencies. That evaluation should consider the valuation of contingencies recorded in the acquired entity's historical financial statements, as well as other contingencies not previously identified by the acquiree. The amounts recorded by the acquirer for contingencies in its purchase price allocation may differ from the acquiree's historical carrying values. This difference can be due to the effects of the acquirer's discounting, including differences in interest rates, as well as due to the significant judgment involved in estimating the fair value of loss contingencies or estimating the amount of the probable losses and the different techniques that can be used in a company's approach to such estimation.

If a registrant makes a preliminary estimate of the liability for contingencies but continues to evaluate other information, the registrant should disclose that the purchase price allocation is preliminary. Footnote disclosure describing the contingency and other available information should be made to allow the reader to understand and evaluate the magnitude of any potential liability and the amount of possible loss or range of loss for those contingencies where there is a reasonably possible likelihood of loss. Any adjustments that result from an assumed liability arising from a contingency subsequent to the measurement period should be recognised in the income statement in the period in which the adjustment is determined.

While the amounts recorded by the acquirer for contingencies in its purchase price allocation may differ from the acquiree's historical carrying values, assuming that both companies apply ASC 450 (i.e., the acquirer will not record the contingencies at fair value) and employ a methodology that appropriately considers all relevant facts and circumstances affecting cash flows, the SEC staff has historically indicated that the two estimates of undiscounted cash outflows (and inflows to the extent there are potential recoveries) should not differ by an amount that is material to the financial statements of the acquiree, unless the acquirer will settle the liability in a manner demonstrably different from that of the acquiree. The SEC staff has also questioned recording a liability in acquisition accounting where the acquired company did not previously record a provision for similar obligations it may have had. In these situations, if the difference between the amounts recorded by the acquirer and acquiree is significant, then the propriety of the acquired company's historical financial statements may be questioned. If it is determined that an error existed in the acquired company's historical financial statements, the correction of a seller's application of U.S. GAAP should not occur through the purchase price allocation, but rather the adjustment should be applied to the acquiree's historical financial statements.

On the other hand, the SEC staff may also question how a liability can be estimated and recorded by the acquiree but not the acquirer if the acquirer has similar obligations for which no accrual has been recorded on the basis that such amount cannot be reasonably estimated (or has a fair value of zero).

When obligations are discovered through acquisition-related due diligence, the seller may agree to pay for all or a portion of the obligation. Such provisions are often included in the seller's computation of net gain or loss on the sale; however, the provision should be recorded as an operating expense if, absent the disposal transaction, a provision would have otherwise been necessary.

13.2.7 Rescissions of mergers and other acquisitions of assets

A rescission of a merger transaction is legally possible, but the underlying requirements for a rescission are so rigid that the probability of a rescission occurring is unlikely. In a pure rescission, the parties to the transaction should be restored to their original position. If the original transaction was an exchange of shares, this means the exchange ratios undoing the transaction should be identical to the ratios used to consummate it originally. The parties to the transaction should be the same ones who originally accomplished the merger, and neither party should come out of the transaction with a profit or loss that would not have resulted had the transaction not been entered into in the first place.

Because changes in business conditions and economic factors, which affect the amounts originally recorded in a purchase of assets, almost always occur, reversal or rescission of such a transaction is a rare event. This is particularly true if a long period of time has elapsed. In these circumstances, there usually is a high probability of a need to write down some assets to amounts representing a lower current value. In the few cases taken to the SEC to date, they have pressed the issuer to reflect a charge to income for an impairment in the value of assets prior to their return in a rescinded business combination. In some cases, the SEC has required a charge to income based solely on diminution in the market value of the issuer's shares. Therefore, while ASC 845-10-30-10 indicates that the rescission of a prior business combination should be accounted for at the recorded amount (after reduction, if necessary, for any indicated impairment of value—see ASC 360-10-40-4, *Property, Plant, and Equipment*) of the nonmonetary assets distributed (returned), changed conditions may require more than just a mere reversal of the original transaction.

13.2.8 Disclosures related to goodwill and acquired in-process research and development

Effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011 (with early adoption permitted), entities (both public and private) were permitted to first assess qualitative factors to determine whether the two-step goodwill impairment test is necessary. See BCG 9.1 for further information.

In July 2012, the FASB issued similar amended guidance, which allows entities an option to qualitatively assess whether an indefinite-lived intangible asset is more likely than not impaired before determining whether a quantitative impairment test is required. See BCG 10.4.4.2 for further information on the qualitative analysis for indefinite-lived intangible assets. This guidance was effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012, with early adoption permitted.

This accounting standards update did not change the disclosure requirements under ASC 350, *Intangibles—Goodwill and Other*; however, the amended guidance did clarify that the quantitative disclosures about significant unobservable inputs (Level 3) under ASC 820, *Fair Value Measurements*, are not required for fair value measurements related to the financial accounting and reporting of goodwill after its initial recognition in a business combination. The qualitative disclosures prescribed under that guidance, however, are required.

The SEC staff continues to expect companies to disclose the potential for material write-downs of assets due to the impact of market conditions, even if no impairment has been recognised. For example, SEC FRM 9510.3 describes disclosures that the staff believes should be included in a registrant's critical accounting policies for each reporting unit with material **goodwill** whose fair value is not substantially in excess of its carrying value. Those disclosures should include:

- The percentage by which fair value exceeded the carrying value as of the most recent step-one test
- The amount of goodwill allocated to the reporting unit
- A description of the methodology used to determine fair value

- A description of key assumptions used in determining fair value and how the key assumptions were determined

- A discussion of the uncertainty associated with the key assumptions and any potential events and/or circumstances that could have a negative effect on the key assumptions that may result in a future impairment

To the extent that a registrant's reporting units with significant goodwill are not at risk of failing step one of the goodwill impairment test, a disclosure of that fact should be provided.

Additionally, the SEC staff has requested transparent disclosure related to both the methodology and assumptions used in impairment testing, as well as additional disclosure when impairments are recorded. For example, the SEC staff has suggested that the following disclosures be considered:

- The reporting units for which goodwill is tested for impairment, and the methodology and weighting used to determine the fair value of the reporting unit, including sufficient information to allow a reader to understand why management selected these methods

- How reporting units were identified and goodwill was allocated to those reporting units, and any changes to reporting units or allocations of goodwill and the reasons for such changes

- Description of changes to the assumptions and methodologies, if any, since the company's last impairment test

- Clarification of how negative effects experienced by the company (e.g., significant declines in revenues and net income, declines in expected revenues, and restructuring activities and layoffs) were considered in evaluating the need to perform an interim goodwill impairment test

- The facts and circumstances that resulted in an impairment being recognised, as well as information about the existence of triggering events (if such disclosures are not provided, the timing of the company's impairment charge may be questioned)

- Whether the impairment has changed the company's expectations for future earnings or cash flow projections, including the related assumptions (disclosure of what the impairment did not impact (e.g., cash flows, debt covenants) is not as useful as a disclosure about what was impacted)

When acquired in-process research and development (IPR&D) is material, the SEC staff expects the following disclosures to be provided in a note to the financial statements:

- Appraisal method (e.g., based on discounted probable future cash flows on a project-by-project basis)

- Significant assumptions, such as:
  - Period in which material net cash inflows from significant projects are expected to commence
  - Anticipated material changes from historical pricing, margins, and expense levels
  - The risk-adjusted discount rate applied to the project's cash flows

In addition, the SEC staff believes the following disclosures should be provided in MD&A by major project:

- Specific disclosures describing the nature of the projects acquired
- Where multiple projects are involved, a summary of values assigned to IPR&D by technology/project
- The status of the development and the complexity or uniqueness of the work completed at the acquisition date
- The stage of completion at the acquisition date
- The nature and timing of the remaining efforts for completion
- The anticipated completion date and the date the registrant will begin benefiting from the IPR&D
- Projected costs to complete by project (or category of projects)
- The risks and uncertainties associated with completing development within a reasonable period of time
- The risks involved if the IPR&D is not completed on a timely basis
- In subsequent filings, disclosure of the status of the registrant's efforts to complete the R&D project(s) and the impact on the registrant from any delays
- In subsequent filings, an explanation of material variations between projected results and actual results and how failure to achieve projected results impacted (or will impact) expected return on investment, future results, and financial condition

Similar to goodwill, the revision of the impairment standard for indefinite-lived intangible assets did not change the disclosure requirements under ASC 350. However, the amended guidance did clarify that a *non-public* entity is not required to disclose the quantitative information about significant unobservable inputs (Level 3) required by ASC 820 for an indefinite-lived intangible asset after its initial recognition. This revision did not change disclosure requirements for public entities.

Therefore, public entities are required to disclose the quantitative information regarding significant unobservable inputs related to indefinite-lived intangible assets.

13.2.9 Reverse mergers—Securities Act and Exchange Act reporting

A reverse merger may be either a reverse acquisition or a reverse recapitalisation. The key distinction between the two is that in a reverse acquisition, the legal acquirer/issuer is a business; and in a reverse recapitalization, the legal acquirer/issuer is a public shell company. A reverse acquisition is accounted for as a business combination, while a reverse recapitalisation is treated as a capital transaction. The discussion that follows relates only to reverse acquisitions.

Reverse acquisitions present certain unique accounting and SEC reporting considerations. The unique accounting considerations are discussed in BCG 2.10 while the SEC reporting considerations are discussed below and in further detail within SEC 7050.

For reverse acquisitions, the financial statements of the legal acquiree ("accounting acquirer") become the financial statements of the registrant ("legal acquirer/accounting acquiree") after the transaction is consummated. That is, the registrant's historical financial statements for periods subsequent to the acquisition are those of the accounting acquirer. In reverse acquisitions in which the issuer of the stock is a registrant, we believe the financial statements of the accounting acquirer should be S-X compliant for all periods presented.

The Exchange Act rules do not address directly the periodic reporting requirements in reverse acquisitions. The accounting acquirer is treated as the continuing reporting entity for financial statement purposes. However, there is no change of registrant. Therefore, the registrant should ensure that its filings with the SEC continue to result in timely, continuous reporting, with no lapse in periods presented in the financial statements and no audited period exceeding 12 months.

Refer to SEC 7050 for additional SEC reporting considerations as it relates to reverse acquisitions, including consideration of:

- SEC reporting requirements before a reverse merger is completed (i.e., Proxy statement/Form S-4 reporting requirements)
- SEC reporting requirements in connection with the completion of a reverse merger (i.e., Form 8-K reporting requirements for reporting the acquisition)
- Certain other post-consummation reporting requirements, including (1) accelerated filer status following a reverse merger, (2) performing significance tests for acquisitions and dispositions occurring after the completion of a reverse merger, (3) reporting on internal control over financial reporting, (4) changes in auditor, (5) differences in fiscal year-end between the legal acquirer/issuer and the accounting acquirer, and (6) future periodic reporting requirements

13.2.10 *Pushdown accounting*

Pushdown accounting is applicable to companies applying U.S. GAAP, based on guidance from the SEC. Pushdown accounting is not required for SEC registrants that file under IFRS. Pushdown accounting refers to establishing a new basis of accounting in the separate stand-alone financial statements of an acquired entity, based on the acquisition of its equity. If the acquired entity's operations are maintained in a separate subsidiary after a business combination, the question arises as to whether the acquirer's basis resulting from the business combination should be reflected in the separate financial statements of the subsidiary. In addressing this question, the answer will depend on the various facts and circumstances discussed in the sections that follow. Nonpublic clients can also elect to apply pushdown accounting.

If a newly created company is used in a merger, it must be determined whether a business combination or a recapitalisation (subject to pushdown accounting consideration) has taken place. The accounting for the merger may depend on whether the newly created company survives and the nature of its activities prior to the merger. If the newly created company is not determined to be substantive for accounting purposes, the transaction would be accounted for as a recapitalisation subject to pushdown accounting.

13.2.10.1 *SEC views on pushdown accounting*

Staff Accounting Bulletin Topic 5-J expresses the SEC staff's views regarding the application of pushdown accounting [SAB 54, *Push Down Basis of Accounting in Separate Financial Statements of Subsidiaries Acquired in Purchase Transactions* (SAB 54)]. The SEC staff believes that transactions that result in an entity becoming substantially wholly owned (as defined in Rule 1-02(aa) of SEC Regulation S-X) establish a new basis of accounting for the acquired assets and assumed liabilities that should be reflected in the acquired entity's separate financial statements. Therefore, when the form of ownership of the acquired company is within the control of the parent, the SEC staff believes the basis of accounting for acquired assets and assumed liabilities should be the same regardless of whether the entity continues to exist or is merged into the parent's operations. That is, pushdown accounting should be applied and the acquired company's separate financial statements should reflect the new basis of accounting recorded by the parent upon acquisition. In addition to this overall guidance, pushdown accounting may be required, permitted, or precluded based on other specific facts and circumstances.

In general, pushdown accounting is required for SEC registrants if more than 95 percent of the voting securities are acquired in a transaction or a series of transactions (i.e., a significant **noncontrolling interest** does not exist). However, an exception to pushdown accounting exists under SAB Topic 5-J if the acquired entity has significant outstanding public debt or preferred stock that might impact the parent's ability to control the form of ownership. See BCG 13.2.10.2 for further information.

Acquisition of between 80 percent and 95 percent of the voting securities may be considered to result in a subsidiary becoming "substantially wholly-owned," depending on the facts and circumstances. In this situation, pushdown accounting is permitted, and the SEC staff strongly encourages or may require pushdown accounting.

In measuring the ownership percentage of the acquirer, the SEC staff normally looks to the parent and/or the parent's other wholly owned subsidiaries' percentage ownership of the outstanding voting securities of an acquiree. Control of additional shares by agreement or otherwise that would impact the determination of the acquirer's ownership percentage should also be considered.

A company may also be determined to be "substantially wholly owned" as a result of a single transaction or a series of related and anticipated transactions in which investors acquire ownership interests and *both* mutually promote the acquisition and collaborate on the subsequent control of the investee company (the collaborative group). That is, the SEC staff believes that pushdown accounting is required if a company becomes substantially wholly owned by a group of investors who act together as effectively one investor and are able to control the form of ownership of the investee. See BCG 13.2.10.3 for further information.

The SEC staff believes that pushdown accounting is preferable and would not preclude a registrant from making a subsequent elective decision to apply pushdown accounting. For example, a company that previously reached a conclusion not to apply pushdown accounting to an investment in a subsidiary between 80 and 95 percent could apply pushdown accounting at a later date. The SEC staff has indicated that a preferability letter would be required, and the election of such "change-in-entity" accounting requires retrospective application. Once a company has elected pushdown accounting, the financial statements will have to be retrospectively restated from the date of acquisition, and the restated financial statements will need to be included or incorporated by reference in any subsequent registration statements.

It should be noted that an election to reverse a previous decision to pushdown is not permitted, given that pushdown accounting is deemed to be preferable. For example, assume Company A elects to apply pushdown accounting at 80 percent ownership, with the intention to acquire the remaining 20 percent. If Company A does not acquire the remaining 20 percent, it cannot opt out of pushdown accounting in a subsequent reporting period. Once the company has elected to utilise pushdown accounting, it cannot elect to return to its original basis.

If less than 80 percent of the voting securities are acquired, pushdown accounting is not permitted. If pushdown accounting is applicable, the new basis of accounting recorded by the parent company upon acquisition usually should be recorded in any separate financial statement presentation of the acquired company. The subsidiary's basis of accounting for purchased assets and liabilities should be the basis recorded by the parent as of the date control was obtained, adjusted for subsequent activity. When the acquisition occurs in multiple transactions, the date control was obtained may precede the date that pushdown accounting was required. In that case, the parent's basis in the subsidiary at the date control was obtained, adjusted for subsequent activity, would be pushed down. However, the application of pushdown accounting in the subsidiary's financial statements would not occur until pushdown accounting was required (or elected). In the event that pushdown accounting is required subsequent to the adoption of the Standards but the date control was obtained occurred prior to adoption, there are additional complexities that need to be considered that may result in the subsidiary's basis of accounting differing from the parent's basis of accounting on the date control was obtained. Separate presentation of an acquired company's financial statements could appear in SEC filings under various circumstances, including the following: (1) the acquired company's securities are offered in part or in total to the public, (2) the acquired company's securities collateralise an issue registered or being issued (Rule 3-16 of Regulation S-X), or (3) the acquired company is subsequently sold to another registrant and included in that registrant's Form 8-K filing as a significant acquisition (Rule 3-05 of Regulation S-X).

Question 13-1

If Company A acquired 85 percent of Company B in an initial transaction (assuming Company A did not elect to apply pushdown accounting at the initial acquisition date) and acquired an additional 10 percent three years later, should Company A pushdown its basis in Company B as of the date of the initial acquisition or when pushdown accounting was required (i.e., when 95 percent of Company B was acquired)?

PwC response

Company B would not be required to restate its financial statements retrospectively to the initial acquisition date to reflect Company A's basis, since pushdown was only elective at that time. In this fact pattern, Company A has not changed its election with regard to pushdown accounting in prior periods, rather Company A is now required to pushdown as a result of the acquisition of the additional interest in Company B. As a result, Company B would be required to apply pushdown accounting prospectively from the date 95 percent or more of the voting securities are acquired. When applying pushdown accounting in Company B's financial statements, Company B's assets and liabilities should be adjusted to Company A's basis at the time control was obtained (i.e., when the initial 85 percent was purchased), adjusted for subsequent activity. Additionally, Company B's financial statement presentation should be separated by a black line to denote a change in reporting basis. If Company A had not acquired an additional 10 percent interest in Company B and elected to apply pushdown accounting, retrospective application would be required as this would be considered a change in accounting principle.

As discussed in BCG 13.2.10.1, a company may elect to apply pushdown accounting to an earlier period based on the SEC staff's view that pushdown accounting is preferable. If an entity elects to apply pushdown accounting to prior periods, a preferability letter would be required and the election of such "change in entity" accounting would require retroactive application.

Question 13-2

If 95 percent of Company A, a public company, was acquired by Company B through multiple exchange offer transactions, would the exchange offer transactions be considered a "series of purchase transactions" as described by SAB Topic 5-J and therefore possibly require Company A to apply pushdown accounting at a point prior to 95 percent ownership being obtained?

PwC response

An exchange offer may not represent a "series of purchase transactions" as prescribed by SAB Topic 5-J, since an exchange offer is an open offer in the market to buy shares of stock at a certain price. If there is no certainty that Company B will be able to convince the shareholders of Company A to sell their shares, nor are the shareholders of Company A required to participate in the exchange offer, there is no way to determine what portion of the ownership Company B will acquire as a result of these transactions. As a result, these transactions would not be considered a "series of purchase transactions" as contemplated by SAB Topic 5-J. Therefore, pushdown accounting would not be required until at least 95 percent ownership is obtained.

Impact of outside interests

The SEC staff believes that fair value information may generally be more relevant or meaningful to financial statement users than historical cost information. Furthermore, the SEC staff believes that SAB Topic 5-J recognises that as the population of investors or users of financial statements decreases and the majority investor's ability to control the subsidiary's form of ownership increases, fair value information prevails over continuity of the subsidiary's historical cost information. However, the SEC staff recognises that the existence of other significant outside interests in the form of public debt, preferred stock, or a significant noncontrolling interest (i.e., at least five percent) in a subsidiary might impact the parent's ability to control the form of ownership. Although encouraging its use in these circumstances, the SEC staff generally does not insist on the application of pushdown accounting.

In assessing the applicability of pushdown accounting to situations in which the subsidiary has public debt or preferred stock, although not explicitly stated in SAB Topic 5-J, the SEC staff believes that it is reasonable and consistent with the general principles in SAB Topic 5-J to consider the quantitative and qualitative significance of the public debt or preferred stock.

For example, in one specific registrant's fact pattern, the SEC staff concluded that the subsidiary's convertible public debt was neither quantitatively nor qualitatively significant. Quantitatively, the debt amounted to approximately five percent of the subsidiary's net book value and less than one percent of the subsidiary's fair value. The debtholders, in the aggregate, would hold an approximately one percent interest in the subsidiary on an as-if-converted basis. Qualitatively, the debtholders had virtually no ability to control or influence the form of the parent's ownership of its subsidiary, nor did the debtholders have any consent rights regarding the buying out of the existing noncontrolling interests, issuing subsidiary equity, or the subsidiary paying dividends. The SEC staff required the parent to apply pushdown accounting because the outstanding public debt was neither quantitatively nor qualitatively significant.

When evaluating the significance of public debt or preferred stock in the context of the pushdown accounting guidance, there are no "bright lines," and significant judgment will need to be applied to each situation based on specific facts and circumstances. However, as quantitative measures increase in significance, the SEC staff would likely require less emphasis on qualitative factors to conclude pushdown was not required.

In addition, an assessment of whether the application of pushdown is required needs to be reassessed as the entity's circumstances change. For example, if an entity that did not apply pushdown accounting due to the existence of significant public debt subsequently repays the public debt while remaining a voluntary registrant, pushdown would be required. Pushdown accounting should be applied retrospectively beginning in the reporting period when it would otherwise have been required, absent the significant public debt. As discussed in BCG 13.2.10.1 above, once an entity applies pushdown accounting, it must continue to apply pushdown accounting.

Acquisition by a group of investors

In some situations, a small number of investors may acquire 95 percent or more of a target public company, the level of ownership at which pushdown accounting is required. When a group of investors agree to mutually promote the acquisition and to collaborate on the subsequent control of the registrant, the SEC staff believes that such situations should be viewed effectively as one investor, referred to as a "collaborative group." If the collaborative group acquires 95 percent or more of a registrant, pushdown accounting is generally required. ASC 805-50-S99-2 provides the SEC staff views as to whether an investor is part of a collaborative group of investors.

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 a company, is part of a collaborative group with the other investors. Determination of whether such a presumption is rebutted involves consideration of all pertinent facts and circumstances. At the 2005 AICPA National Conference on Current SEC and PCAOB Developments, the SEC staff noted the following questions that should be asked to foster a better understanding of the relationship among the investors in assessing whether a collaborative group exists:

- How did the various investors come together to make the investment?
- Hypothetically, if one of the investors backed out of the deal, would the deal still go through?
- How are the 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?

- What evidence supports that sale restrictions (of the investors interests) are considered reasonable and customary?

In addition, the SEC staff provided detail in ASC 805-50-S99-2 as to the factors it believes are indicative of an investor not being part of a collaborative group. Those factors are as follows:

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 investors that are material to either investor.

Risk of ownership

- The investor is investing at fair value.

- The investor invests funds from its own resources.

- 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.

- 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.

Promotion

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

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, etc.

- 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).

Fundamentally, the SEC staff's view is that if an investor is doing more than simply investing and obtaining and exercising rights similar to any other investor with similar ownership interests, and is expressly linked to other investors, the investor is a member of the collaborative group.

Question 13-3

If Company A owns 100 percent of Subsidiary B and subsequently sells 98 percent of Subsidiary B to the public, should Subsidiary B reflect a new basis of accounting due to the change in ownership?

PwC response

Generally, Subsidiary B should not reflect a new basis of accounting in its financial statements. Because no one individual or group of individuals acting in concert has acquired control, a new basis of accounting ordinarily should not be reflected in Subsidiary B's financial statements.

However, if a group of individual investors acting as a "collaborative group" (defined based on the guidance in ASC 805-50-S99-2) acquired 98 percent of the shares of Subsidiary B, pushdown accounting would be required using one of the two approaches described in Question 13-4.

Question 13-4

If the members of a collaborative group acquire a 100 percent ownership interest in a company, what is the basis of accounting for the assets and liabilities to be pushed down to the acquired company?

PwC response

SAB Topic 5-J does not specifically address the application of pushdown accounting by a collaborative group. Applying pushdown accounting when there is a collaborative group can be challenging.

For example, assume Investors A, B, and C act together effectively as one investor and constitute a collaborative group as defined in ASC 805-50-S99-2. On 1 June, 20X9 the collaborative group acquires Company A, with Investor A purchasing 60 percent for

CU750 and Investors B and C each purchasing 20 percent of Company A for CU250. On 1 June 20X9, Investor A recognises a business combination and records 100 percent of Company A's net assets at fair value (CU1,250), including controlling interest of CU750 and noncontrolling interest of CU500.

Applying SAB Topic 5-J could lead to two views on how to think about the basis of accounting for the assets and liabilities to be pushed down to an acquired company's financial statements. In this case, the answer under both views will be the same, since the date that Investor A obtained control of Company A and the date that the collaborative group was formed are the same.

One view is that the basis of accounting for the assets and liabilities to be pushed down is the new basis of accounting for the assets and liabilities of CU1,250 recorded by Investor A on 1 June 20X9, the date control was obtained. The other view is that the basis of accounting for the assets and liabilities to be pushed down is the basis of accounting for the assets and liabilities of CU1,250 that would have been recorded by the hypothetical collaborative group acquirer as of 1 June, 20X9, the date the collaborative group acquired control of Company A. In the event that members of the collaborative group obtain interests over a period of time and/or there are changes in the collaborative group's interests, the basis to be pushed down would differ depending upon the view that is applied.

13.2.10.2 Pushdown accounting for non-SEC registrants—U.S. GAAP

ASC 805-50-25-3 states that pushdown accounting is not required for entities that are not SEC registrants. Therefore, if a subsidiary of an SEC registrant is not required to file separate financial statements with the SEC in the parent's SEC filing or its own stand-alone filing, the subsidiary itself is not considered a registrant and is not required to apply pushdown accounting.

ASC 805-50-25-3 does not address circumstances in which pushdown accounting may be applied by non-SEC registrants. Currently, pushdown accounting generally is considered to be acceptable, but not required, for enterprises that are not SEC registrants when 80 percent or more of the enterprise's voting securities are acquired in a transaction. In addition, consideration should be given to the facts and circumstances of the particular situation to determine whether pushdown accounting should be applied by a private company.

Question 13-5

Is pushdown accounting required to be applied to a subsidiary of a public company that is not itself an SEC registrant even though it may be considered a public company as defined in the ASC Glossary?

PwC response

No. A company may be considered a public company as defined in the ASC Glossary, such as when applying the accounting guidance for its share-based awards contained in ASC 718; if it is not considered an SEC registrant, U.S. GAAP does not require an acquirer's basis to be pushed down to the separate financial statements of the acquired entity as indicated in ASC 805-50-25-3.

Consideration for pushdown accounting for non-SEC registrants

If the acquired entity is involved in a statutory merger or other legal reorganisation, or if it is otherwise party to the acquisition transaction, it may be appropriate (and, to reflect the economics of the transaction, perhaps essential) to reflect the new basis of accounting (i.e., pushdown) in the financial statements of the subsidiary, since the transaction is not among shareholders or outside the corporate entity. For example, a newly created company (that is not substantive for accounting purposes) may merge with the acquired entity with the acquired entity surviving and becoming wholly owned by a new parent. The merger may be a vehicle for effecting a 100 percent acquisition in a single transaction, or it may be the final step in a **step acquisition**. In either case, it extinguishes all of the former outside common interests in the acquired entity. In these mergers, the acquired entity is clearly a party to a legal reorganisation, and pushdown accounting should be considered.

If the consideration transferred by the new parent in the acquisition is passed through the newly created subsidiary or through the acquired entity to the sellers, arguments for pushdown of basis become most compelling. Authoritative accounting literature is silent on this question. Example 13-1 provides a simplified example illustrating the evaluation of whether the parent's basis in a subsidiary should be pushed down to the subsidiary's separate financial statements that will be filed with the SEC for periods in which the subsidiary was owned by the parent.

EXAMPLE 13-1

Pushdown accounting considerations

Company A acquired 100% of Company S (which became Subsidiary S) in 20X1; both Company A and Subsidiary S are non-public companies. Company A was not required to, and did not, apply pushdown accounting to Subsidiary S's financial statements. In 20X3, Company B (a public company) enters into an agreement to acquire from Company A 100% of Subsidiary S. Company B determined that it must file the separate pre-acquisition historical financial statements of Subsidiary S as a significant business acquisition pursuant to Item 2.01 of Form 8-K and Rule 3-05 of Regulation S-X (see note below).

Analysis

The pre-acquisition historical financial statements of Subsidiary S to be filed with the SEC must be prepared in accordance with SEC Regulation S-X for all periods presented (except that financial statement schedules are not required). Those financial statements must comply with all applicable Staff Accounting Bulletins, including SAB Topic 5-J. SAB Topic 5-J indicates that purchase transactions that result in an entity becoming substantially wholly-owned (as defined in Rule 1-02(aa) of Regulation S-X) establish a new basis of accounting for the purchased assets and liabilities. Accordingly, pushdown accounting should be applied in the separate financial statements of Subsidiary S, reflecting Company A's basis in Subsidiary S from the date of acquisition by Company A. See BCG 13.9.1 and 13.9.2 for further information.

Note: Company A's basis of accounting for the purchased assets and liabilities of Subsidiary S must be reflected in Subsidiary S's account balances utilised in calculating the significance of Subsidiary S to Company B under Rule 3-05 of Regulation S-X.

Even if a decision is made to not pushdown the parent's basis to an acquired subsidiary in a business combination, the deferred taxes of the subsidiary may still require adjustment in accordance with ASC 740-10-45-21 and ASC 740-20-45-11. The guidance provides that the tax effects of all changes in tax bases of assets and liabilities that are caused by transactions among or with shareholders should be included in equity. This includes the separate financial statements of an acquired entity that does not employ pushdown accounting in a situation in which an investor company acquires 100 percent of the shares (i.e., a non-taxable transaction) of the acquired entity in a transaction that is accounted for in the **consolidated financial statements** as an acquisition and as a taxable purchase for tax purposes. If, in these circumstances, a valuation allowance was initially required for certain **deferred tax assets**, the effect of recording such a valuation allowance should also be recognised in equity. Changes in the valuation allowance that occur in subsequent periods, however, would be included in the income statement.

Consideration against pushdown accounting for non-SEC registrants

If the old basis of accounting is continued in the subsidiary's accounts, the accounting between parent and subsidiary will not be uniform. The primary rationale for retaining the old basis is that a transaction may only be between the acquiring entity and former shareholders of the acquired entity, not involving the acquired entity itself.

The survival of outside interests in the acquired entity would argue for retention of the old basis. Therefore, the survival of the noncontrolling interest would justify and probably require continuance of the old basis. In addition, absent a reorganisation, the existence of outstanding debentures may justify carrying forward the old basis. To do otherwise would interrupt the historical reporting to the continuing outside interests and, in the case of outstanding debentures, might make it possible for a company to incur (or clear) a default under an indenture agreement as a result of the change in its ownership. It should be noted, however, that the SEC staff has generally not been persuaded by these types of considerations, and therefore, these considerations would not be applicable for SEC registrants.

13.2.10.3 Financial statement presentation

The application of pushdown accounting represents the termination of the old accounting entity and the creation of a new one. Accordingly, it would not be appropriate for financial statements for a given period to combine pre- and post-pushdown periods. For example, it would be inappropriate for a company with a 31 December 20X9 year-end, for which pushdown was applied effective 1 July 20X9, to present an income statement for the 12 months ended 31 December 20X9. This would also be applicable for the statements of cash flows, changes in shareholders' equity, and of comprehensive income. In addition, the relevant footnotes would also be presented for the two distinct accounting periods. Typically this would involve separate footnote disclosures for the pre- and post-pushdown periods.

For both the financial statements and in instances where footnote disclosure is presented in a tabular format, the registrant would generally include a vertical black line between the predecessor and successor columns to highlight to the reader that there are two different entities for the pre- and post-pushdown periods. The columns related to the two accounting entities are generally labelled "Predecessor Company" and "Successor Company," or similar designations. Also included would be a discussion of the presentation in the footnotes, such as in the Basis of Presentation or Merger footnote, to notify the reader that as a consequence of pushdown accounting, the company's results of operations and cash flows after the merger are not comparable with those prior to the merger, and therefore have been segregated in the respective financial statements.

In addition, when pushdown accounting is applied, the retained earnings of the predecessor company are not carried forward because a new basis of accounting has been established.

For the circumstances described in the first paragraph of this section, when pushdown accounting is applied, management should consider disclosing the *pro forma* information relating to business combinations that is described in ASC 805, *Business Combinations*, and Rule 10-01(b)(4) of Regulation S-X in order to demonstrate the effects of the acquisition and related pushdown accounting on the acquired entity. If that pro forma information is presented, it should be presented for the entire fiscal period (i.e., reflecting the impact of the business combination and related pushdown accounting for the entire fiscal period). The pro forma information should not be presented separately for the successor and predecessor periods. Pro forma information for the prior year comparative period(s) should also be included.

In predecessor/successor situations an auditor would generally have two separate audit reports, one covering the predecessor financial statements and one covering the successor financial statements.

Question 13-6

If pushdown accounting has been applied in the acquired subsidiary's separate financial statements, should the assignment of goodwill by the parent company to its reporting units, which may include operations outside of the operations of the acquired subsidiary, impact the assignment of goodwill to the subsidiary's reporting units?

PwC response

No, the parent's assignment of goodwill to reporting units other than those that include the operations of the acquired subsidiary is a requirement of ASC 350 solely for the purpose of testing for impairment of the goodwill that is included in the parent's financial statements. Therefore, the parent's assignment of goodwill to its reporting units should not impact the assignment of goodwill by Company B in applying pushdown accounting.

For example, assume Company A acquires 96 percent of Company B (a public company) for CU100 million, which results in Company A recognising CU50 million of goodwill. Pursuant to ASC 350, Company A (1) allocates CU30 million of goodwill to a new reporting unit, in which all of the operations of Company B will be included; and (2) allocates the remaining CU20 million of the goodwill to another reporting unit, which is expected to benefit from the synergies of the acquisition. Because of its remaining four percent public ownership interest, Company B will continue to issue separate financial statements.

Company B must apply pushdown accounting as prescribed by SAB Topic 5-J and should therefore include the entire CU50 million of goodwill in its stand-alone financial statements. When assessing the CU50 million of goodwill for impairment, Company B should assign the goodwill to its reporting units in accordance with ASC 350.

13.2.10.4 Pushdown accounting related to parent company debt

When a parent company uses borrowed funds to finance the acquisition of a subsidiary or to finance a subsidiary's operations, the question arises as to whether the debt should be included in the subsidiary's financial statements. In SAB Topic 5-J, the SEC staff stated that the parent's debt, related interest expense, and allocable debt issue costs should be included in the subsidiary's financial statements if either:

- The subsidiary is to assume the parent's debt either presently or in a planned transaction in the future,
- The proceeds of a debt or equity offering of the subsidiary will be used to retire all or a part of the parent's debt, or
- The subsidiary guarantees or pledges its assets as collateral for the parent's debt [SAB 73, *Pushdown Basis of Accounting for Parent Company Debt Related to Subsidiary Acquisition* (SAB 73)].

On the other hand, the SEC staff will not insist that the parent's debt be reflected in the subsidiary's financial statements when other relationships exist between the parent and subsidiary, such as the pledge of the subsidiary's stock as collateral for the parent's debt, even though it may be clear that the subsidiary's cash flows will service all or part of the parent's debt. While the SEC would not insist on the debt being pushed down, the SEC would expect that the registrant provide full and prominent disclosure of the relationship between parent and subsidiary and the actual or potential cash flow commitment [SAB 73].

In instances where more than one subsidiary is acquired and pushdown of the debt is required, the acquisition related debt should be pushed down to all acquired subsidiaries. The SEC staff has discussed the following alternatives on how to pushdown the debt to multiple subsidiaries:

- Pushdown 100 percent of the debt to each subsidiary

- Allocate the debt to the subsidiaries on a pro rata basis

The SEC staff has noted that there is no prescribed approach and that each of the alternatives above (as well as others) might be acceptable based on the facts and circumstances and on the informational needs of investors. Companies should disclose the approach used and the basis for using that approach. The principles in SAB 73 are applicable to both Securities Act and Exchange Act filings.

In contrast to the pushdown of parent company debt, to the extent joint and several obligations exist amongst multiple subsidiaries and/or the parent, a determination should be made as to whether these obligations fall within the scope of Accounting Standards Update 2013-04, *Obligations Resulting from Joint and Several Liability Arrangements for Which the Total Amount of the Obligation Is Fixed at the Reporting Date*. To the extent obligations fall within the scope of this standard, they are to be measured as the sum of (a) the amount the reporting entity agreed with its co-obligors that it will pay and (b) any additional amount the reporting entity expects to pay on behalf of its co-obligors. The corresponding entry or entries (i.e., cash, an expense, a receivable, equity, or another account) will depend on the specific facts and circumstances of the transaction.

13.2.11 Leveraged recapitalisation transactions

Certain transactions at the entity level may give rise to a change in control; for example, a share buyback which results in an investor obtaining control of the entity. While this is a business combination for the investor who obtains control of the entity that would be reflected in its consolidated financial statements, the transaction may not result in a new basis of accounting in the financial statements at the entity level. An example is a leveraged recapitalisation transaction. This transaction typically includes new debt financing, treasury share repurchases, and issuances of new shares to new shareholders by a company, resulting in the company becoming substantially wholly owned by a collaborative group of new shareholders. See BCG 13.2.10.1 for further information.

13.3 Internal control implications

Companies should consider the impact of their **business combination** activities when they evaluate the effectiveness of their internal control over financial reporting and disclosure controls and procedures. Companies that have not recently engaged in business combinations may need to design and implement controls over merger and acquisition processes with a thoughtful focus on risk assessment, and taking into account quantitative and qualitative materiality.

When applying the Standards and NCI Standards, companies should perform a risk assessment with respect to the accounting for business combinations and the consolidation process, focusing on the risk of a reasonable possibility of a material misstatement at both the financial statement account and relevant assertion levels. If the risk assessment process indicates an elevated or significant risk of a material misstatement, companies should consider the need to reassess the design of their internal control over financial reporting and disclosure controls and procedures related to business combinations and consolidations. For example, an entity electing to apply a qualitative impairment assessment to one or more of its reporting units or indefinite-lived intangible assets for the first time may require a reassessment of internal control relating to goodwill or indefinite-lived intangible asset impairment tests.

Engaging in business combination and consolidation activities requires significant coordination of information and communication across an organisation. Companies should gain an understanding of how interdepartmental activities with respect to business combination and consolidation activities will impact the design and operating effectiveness of their internal control over financial reporting and disclosure controls and procedures. Companies, in conjunction with due diligence, may also need to assess the design and operating effectiveness of the target business' internal control as it relates to the acquiring company's internal control over financial reporting and disclosure controls and procedures. This will determine what steps are necessary to ensure that the controls of the business acquired are operating at a level that will prevent and detect any material misstatement in the acquirer's financial statements on a timely basis. Evaluating such controls during the due diligence process will also assist the acquirer in implementing processes and controls designed to ensure that information is accumulated and communicated to the acquirer's management to facilitate timely decisions regarding required disclosure and timely reporting consistent with Securities and Exchange Commission rules or other applicable stock exchange or regulatory rules. If the acquirer's intent is to integrate some or all of the processes and controls of the acquiree, separate management assessment procedures may be less extensive with respect to the internal control and disclosure controls and procedures of the acquiree.

The acquirer's controls and procedures related to business combinations are included as part of management's assessment of the effectiveness of internal control over financial reporting. However, as it relates to SEC registrants, acquirers may apply SEC FAQ No. 3, which permits management to exclude the controls of the acquiree from management's evaluation of the effectiveness of internal control over financial reporting for the first year following the acquisition. See BCG 13.3.3.2 for further information.

13.3.1 Controls over acquisition accounting and the consolidation process

Companies should ensure that internal control over acquisitions and consolidation accounting is designed and operating effectively, especially if acquisition-related accounts and disclosures are significant to the financial statements.

Companies should assess the risk profile of their business combination transactions and consolidation processes. Based on their risk assessment, companies should design and document key controls and supporting processes. This is true with respect to internal control over financial reporting, as well as disclosure controls and procedures associated with acquisitions and consolidations. These controls should address all relevant assertions for all significant accounts and disclosures.

Implementing effective controls over the consolidation process and the reporting of business combinations requires the coordination of several stakeholders within the company. Generally, these stakeholders include the corporate development/ acquisitions department and representatives from finance, accounting, legal, treasury, human resources, executive management, and information technology.

Some companies, especially those that frequently enter into acquisitions, may find that their controls are adequately designed and operating effectively. Other companies may need to enhance the design of their internal control with respect to business combination accounting. Companies should inventory all of their acquisition and consolidation-related control activities to assess the sufficiency of the design and operating effectiveness of their controls with respect to mergers and acquisitions. A company's control descriptions and related process narratives or other documentation should clearly evidence a detailed description of the design of all key financial reporting controls.

13.3.2 Review controls over business combinations

Some companies' important controls for business combinations are described as high level review controls to be tested by management or others on behalf of management (e.g., "The controller reviews and approves all business combination adjustments"). These types of controls typically contain many important and distinct control activities and serve as important controls addressing the completeness and accuracy of reported business combinations, the subsequent accounting (i.e. impairments) and the related disclosures, as described below. Companies may need to disaggregate a review control into these detailed control activities in order to perform a meaningful assessment of the design of the review control and to develop an appropriate plan for testing the review control. Furthermore, management should gain an understanding of and test *all* important control activities associated with such a review control.

In the case of business combination review controls, there may be several control activities associated with the review of key inputs to fair value determinations, related purchase price allocations for assets and liabilities acquired, and review of resulting accounting entries. For example, consider a review control described as follows: "The controller reviews and approves all valuations performed in connection with business combinations." One of the underlying control activities associated with this review control may include the controller's review of the valuation model, review of the projected future cash flows, and other key inputs such as the royalty rate, discount rate, and tax rate used in valuing intangible assets acquired. Each of these control activities potentially entails different levels of evidence, and the review of this information is most effectively performed at a granular level of detail (assuming they could have a material effect on recorded amounts and/or disclosures of the intangible assets). In other words, the review of the valuation model, the review of the cash flow projections, and the review of the key inputs performed by the controller each constitute a separate control activity that should be separately executed and also separately tested by management.

When documenting and/or evaluating the design of review controls, at a sufficient level of detail, management should consider the following guidelines:

- The design of each control should be mapped to the applicable significant accounts and related financial statement assertions and information processing objectives (i.e. the specific control activities and procedures performed in the execution of the control).

- The design of each control should provide a clear indication as to the level of precision of the control as established by the expectations and thresholds set to identify variances (i.e. the level of variances or exceptions that will require follow-up and resolution). This precision of the control should be sufficient to prevent or detect a material misstatement of the related accounts and financial statement assertions. In situations where review controls are not performed at a sufficiently precise level, management will likely need to implement additional controls in order to obtain sufficient comfort that the risk of misstatement is adequately addressed. Management should consider the end-to-end process and workflow associated with each control. This includes the process for identifying, investigating and resolving review findings. This will typically require detailed process and control documentation for each relevant point in the process, not just for important controls, including:

  - Whether the review control activities or the combination of review control activities and other controls appropriately mitigate reasonably possible sources of misstatement associated with accounting for the business combination.

  - For controls that are qualitative in nature, the specific control objectives to be achieved (given the lack of quantitative thresholds) to ensure the control sufficiently addresses the risks to be mitigated by the control.

  - Where the data necessary to execute the control is obtained and how to ensure completeness and accuracy of that data, including any reports utilized.

  - The design documentation for each control should include a description of the documentation that is required to be retained from the performance of the control as evidence of its effective operation.

  - A clear indication of who has responsibility for executing the control, ensuring that the documentation demonstrates that the assigned individual(s) possess(es) the appropriate competence and authority to effectively execute the control. For controls involving significant complex estimates or assumptions, management should also consider whether a subject matter expert should be consulted to assist in performing some parts of the control procedure.

Furthermore, when performing management testing of the design effectiveness of review controls, the testing plan should consider each of the above guidelines. Likewise, management's testing of the operating effectiveness of review controls should include an evaluation of how each control activity was executed in accordance with the design of the control and should ensure there is adequate, documented evidence available to demonstrate how each of the control activities was executed. Without such clear documentation, it will be difficult for the management tester to conclude that the control activities have been adequately executed.

The level of evidence required to be obtained in connection with a control activity will vary based on a number of factors, including risk. If the planned level of evidence cannot be obtained, management should reassess its ability to rely on the review control. In addition to directly testing the operating effectiveness of review controls, testers should consider whether there is any other evidence that may reflect positively or negatively on the operating effectiveness of the control. For example, a financial statement error may provide evidence that a particular review control did not operate effectively to detect or prevent the misstatement.

Figure 13-2 provides examples of some of the business-combination-related processes that may support control objectives of key company functions involved in the reporting of consolidations and business combinations. Of course, these processes will only support effective controls if appropriate control activities are part of their design.

Figure 13-2
Examples of business combination related processes

Corporate development/acquisitions

- Perform due diligence procedures
- Maintain purchase agreements
- Maintain due diligence documentation
- Maintain documentation supporting the fair value determinations, including support for underlying valuation methods and assumptions
- Maintain records of consideration transferred, contingent consideration, and noncompete agreements
- Determine the fair value of acquiree assets and liabilities
- Determine models for valuing assets with no available markets
- Propose which assets to dispose of as a result of acquisitions
- Communicate business developments that may indicate asset impairments timely

Finance/accounting

- Determine whether the acquisition requires the application of business combination accounting
- Review acquiree's accounting policies and conform to acquirer's policies, as applicable

Finance/accounting	
□ Review appropriateness of methods, detailed assumptions, and other data inputs used in fair value measurements	□ Assess the reliability of the financial statements of the acquiree
□ Understand tax consequences of transaction and related accounting	□ Determine the appropriate measurement period adjustments
□ Record contingent liabilities, including legal accruals, after consultation with legal department	□ Calculate and report earnings per share
□ Record and adjust environmental reserves	□ Gather information and prepare disclosures
□ Assess the reasonableness of the fair value for acquired assets and liabilities	□ Determine whether assets to be disposed of should be classified as assets held-for-sale or discontinued operations
□ Monitor, review, and record changes to fair values	□ Determine useful lives of tangible and intangible assets
□ Calculate bargain purchase gain and/or goodwill from the acquisition	□ Perform impairment tests of goodwill and intangible assets
□ Assign goodwill to reporting units	□ File pro forma financial statements and press releases (if applicable)
□ Record, review, and approve journal entries in the general ledger	□ Assess internal control over financial reporting for subsidiaries and equity investees
□ Measure and record any purchase-price adjustments	□ Assess Sarbanes-Oxley Act compliance (if applicable)
□ Monitor the fair value of contingent consideration and record adjustments	□ Monitor business developments and financial performance of reporting units for potential impairment analysis and/or triggering events
□ Record noncontrolling interest	

Legal/corporate secretary	
◻ Obtain approval from the Board of Directors for the acquisition and make any disposals necessary to consummate the acquisition	◻ Review terms of acquisition contracts and other related agreements ◻ Obtain regulatory approval of business combinations
◻ Determine impact of outstanding legal issues and communicate to financial reporting	◻ Assess regulatory compliance of transactions ◻ Coordinate with finance/accounting to assess relevant SEC reporting requirements and disclosures (if applicable) ◻ Record in the minutes the approval of the transaction

Treasury	
◻ Obtain approval for payment of consideration	◻ Retain records of payment consideration
◻ Transfer payment of consideration	◻ Assume cash and debt activity of target

Human resources	
◻ Integrate employees of acquiree into acquirer payroll	◻ Execute employment contracts
◻ Evaluate actuarial assumptions used in determining benefit obligations	◻ Execute non-compete contracts
◻ Evaluate acquiree's benefit plan for conformity to acquirer's and amend plans as necessary	◻ Communicate and administer termination benefits
◻ Administer healthcare benefits to employees of acquiree ◻ Administer postretirement benefits, including defined benefit plans, to employees	◻ Issue options/equity securities or other share-based payments in coordination with finance/accounting

Information technology

- ☐ Assess and support existing IT controls of acquiree if systems are retained
- ☐ Provide server support
- ☐ Assess legacy systems
- ☐ Add/delete users and user profiles to applications
- ☐ Integrate systems with acquirer
- ☐ Upgrade software
- ☐ Assess adequacy of IT staffing levels
- ☐ Maintain, develop, modify, and enhance applications
- ☐ Assign laptops/desktops to new employees
- ☐ Implement training programs
- ☐ Back up data
- ☐ Provide IT user support
- ☐ Store data
- ☐ Determine vendors providing support (i.e., for cloud based applications) and vendor due diligence programs in place
- ☐ Implement and communicate IT policies
- ☐ Provide network access
- ☐ Implement interfaces
- ☐ License software

Executive management

- ☐ Review significant judgment/assumptions used in financial reporting
- ☐ Understand and approve acquisition decisions and terms of acquisition
- ☐ Review financial statements and disclosures related to acquisitions included in applicable filings
- ☐ Review impairment analyses
- ☐ Communicate business/economic developments that could lead to asset impairments
- ☐ Review press releases

External service provider (if applicable)

- ☐ Provide valuation services to assist management in determining fair value for the initial purchase price allocation
- ☐ Remeasurement of contingent consideration fair value and measurement period adjustments and any impairment analyses

In addition to the preceding processes and activities, management may make various journal entries and adjustments during the period-end financial reporting process in conjunction with accounting for acquisitions and consolidations as a result of:

- Recording the acquisition
- Preparing consolidating entries
- Preparing intracompany and intercompany elimination entries
- Adjusting for changes in fair value
- Accounting for changes in ownership interests
- Accounting for goodwill, including any measurement period adjustments
- Accounting for tangible and intangible assets
- Accounting for acquired income tax effects of the acquisition and subsequent impacts

Journal entries associated with these adjustments are likely to be manual and nonrecurring in nature and, therefore, present an increased risk of misstatement in the financial statements. As a result, companies will need to ensure that their period-end financial reporting controls address all journal entries and adjustments recorded in conjunction with acquisition and consolidation accounting. The company should ensure that adequate documentation to support journal entries and adjustments is maintained and that accounting judgments are well supported.

Additionally, companies should ensure that thorough and meaningful reviews are performed of acquisition and consolidation-related journal entries and adjustments. Reviews of journal entries and adjustments should be performed with sufficient rigor and at an appropriate level of precision to prevent and detect material financial statement misstatements, whether due to error or fraud. In a company's evaluation of the design and operating effectiveness of controls over acquisition and consolidation accounting, management should assess the technical competency of the personnel performing such control activities related to business combinations and consolidations (including fair value measurements). In making such assessments, management should consider the educational levels, years of experience, training, and technical accounting expertise of personnel who perform and evaluate the design and operating effectiveness of control activities related to business combinations and consolidations. Similar to the considerations related to review controls, controls addressing journal entries should be designed and tested in a manner such that it is clearly evidenced that they operate at an appropriate level of precision and with the rigor necessary to prevent or detect material misstatement. Individuals responsible for reviewing journal entries and adjustments should have a higher level of technical competency and authority in the organisation than those responsible for preparing such entries. Companies should also ensure that there is sufficient restricted access to accounting systems, programmes, and data to prevent unauthorised journal entries and adjustments.

In addition, companies should ensure that the ability to create a journal entry is segregated from the review and posting of the same entry. Oftentimes enterprise resource planning or other accounting/general ledger systems have built-in workflow tools, which can be used to require each entry to be reviewed and approved by an appropriate person before affecting the account balances. In the absence of the segregation of the creation and posting of journal entries, companies should design controls to obtain reasonable assurance around the validity, completeness, and accuracy of all journal entries that have been posted with potentially incompatible functions.

13.3.2.1 Use of specialists

Many companies do not have personnel with the expertise necessary to determine the fair value of an acquiree's assets and liabilities, contingent consideration or noncontrolling interest. They may need to engage a specialist, or subject matter expert, to assist with fair value determinations, actuarial measurements, legal, regulatory, and other compliance matters. When using an outside specialist, management should:

- Evaluate the specialist's professional credentials (i.e., professional certification, license, or other evidence of competence in the stated field of service) and work experience
- Assess the specialist's professional reputation
- Assess the validity, completeness, and accuracy of the specialist's work. Management should understand the nature of the work performed and consider:
    - The objectives and scope of the specialist's work
    - The specialist's relationship to the company for which he or she is providing a service (i.e., to ascertain the objectivity of the specialist(s))
    - The reasonableness of the methods or assumptions used
    - The methods and assumptions used this period versus those used in the preceding period and the appropriateness of using the specialist's work for the intended purpose
    - The form and content of the specialist's findings
- Maintain controls to ensure that complete and accurate data is provided to the specialist and that the specialist's findings are (a) reviewed at an appropriate level of precision based on the estimation uncertainty involved, and (b) approved at the appropriate level within the finance/accounting organization(s) and maintain appropriate documentation of the results of all of the above procedures

Although companies may rely on specialists to provide valuation and other expert services, management is ultimately responsible for the effectiveness of the controls used to provide reasonable assurance that complete, accurate, and valid data is provided to specialists. Similarly, companies are also responsible for the appropriateness of the accounting and reporting of fair value, regardless of whether they obtain the assistance of a specialist in performing fair value measurements.

13.3.2.2 Use of spreadsheets

Many companies use spreadsheets to assist with calculating and tracking changes in the fair value of the acquiree's assets and liabilities. Companies may also use spreadsheets to perform reconciliations and **impairment** analyses of assets (including the calculation of the carrying value of reporting unit(s), track balances of the **noncontrolling interest**, and prepare consolidations). Due to the potential financial statement misstatements that can result from spreadsheet errors, companies should ensure that they have appropriate controls in place for the development and maintenance of spreadsheets that are critical to the accounting for business combinations and to the period-end financial reporting processes.

Companies should carefully evaluate spreadsheet controls that support any significant assumptions, accounts, and disclosures. This evaluation requires companies to determine specifically where material misstatements of the financial statements, whether due to error or fraud, could occur as a result of the use of spreadsheets. Controls must be designed to operate effectively to ensure that (1) formulas and input data are valid, complete, and accurate; (2) access is restricted; (3) changes are properly authorised; and (4) review is performed over the output calculated by the spreadsheet. Knowing where and how key financial reporting spreadsheets are used in the evaluation of the design and operating effectiveness of key spreadsheet-related controls is important in management's evaluation of the effectiveness of the company's internal control over financial reporting and disclosure controls and procedures as they relate to business combinations and consolidations.

13.3.3 Other control related considerations

This section provides additional considerations with regard to internal controls over financial reporting, including the assessment of internal controls as part of the due diligence process, unique reporting considerations with regard to the acquired business' internal controls, and a potential deferral of reporting under SEC rules.

13.3.3.1 Due diligence

If acquiring a business, a company should assess (1) the sufficiency of the design of the controls the acquiree has in place and (2) whether the acquiree's controls require changes to align them with the structure and control objectives of the acquirer. Some companies formulate their due diligence plans to integrate internal control assessments into their due diligence processes. The assessment of internal control in conjunction with due diligence procedures often helps to identify at an early stage, aspects of the target's internal control structure which may need to be addressed. Assessing internal control during due diligence may also provide a preliminary assessment of the time necessary for management to evaluate the design and test the operating effectiveness of the acquiree's internal control over financial reporting (to the extent such controls will be maintained after the acquisition).

When evaluating the design and operating effectiveness of an acquiree's internal control over financial reporting, management should:

- Establish clear communication protocols across senior management, legal, corporate development, financial reporting, and information technology departments

- Perform an initial assessment of the internal control of the acquiree

- Consider performing internal control testing as a result of the initial assessment in the period between reaching agreement on the acquisition terms and closing the transaction

- Consider closing transactions at the beginning, rather than the end, of a quarter. This will provide executive management with more time to consider the design and operating effectiveness of acquiree controls, in conjunction with quarterly officer certifications, as to the effectiveness of a company's disclosure controls and procedures in accordance with Section 302 of the Sarbanes-Oxley Act of 2002

Given the importance of preventing and detecting financial statement misstatements, whether due to error or fraud, due diligence procedures should extend to a consideration of the design and operating effectiveness of a target's entity-level controls, particularly the control environment. Because the control environment is the foundation for the other components of internal control and establishes the "tone at the top," which, in turn, influences the control consciousness of the entire organisation, a target's entity-level controls will likely be of particular importance to a potential acquirer. Further, companies should assess any target entity's antifraud programmes and controls in the course of performing due diligence. The potential acquirer may also conclude that thorough background checks and other fraud risk assessment procedures should be performed for key members of the target entity's management.

13.3.3.2 Reporting on internal control over financial reporting under section 404 of the Sarbanes-Oxley Act of 2002

Management performs an evaluation of the Company's internal controls to enable them to report on its internal control over financial reporting. Management's report will need to extend to the design and operating effectiveness of controls at consolidated business entities.

Integrating an acquired business' internal control with that of the acquirer can be time consuming and complex. It may require numerous resources, as well as the effective interdepartmental coordination of information and communication. A company's materiality assessments, significant account determinations, and risk assessments may also change as a result of a business combination.

The SEC staff acknowledges that it may not be practicable to assess an acquired business' internal control in conjunction with management's evaluation of the effectiveness of internal control over financial reporting and disclosure controls and procedures for the period between the **acquisition date** and the date of management's evaluation. In such instances, a company that files with the SEC may be able to exclude an acquired business from its report on internal control over financial reporting in the year of acquisition (SEC's Frequently Asked Question 3, regarding Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, or SEC FAQ No. 3). Companies should note that the definition of a "business" for the purposes of management's evaluation of internal control is different under the SEC rules (which refer to Article 11, Rule 11-01(d) of Regulation S-X and is the basis for the term as used in SEC FAQ No. 3) than under the Standards.

If a company applies SEC FAQ No. 3 and excludes the acquired business' internal control from management's evaluation, the company should disclose this fact. Any known material weaknesses at the acquired business must be disclosed even if management has applied SEC FAQ No. 3. Additionally, if a company applies SEC FAQ No. 3, both management and its auditor must disclose the acquired business(es) excluded, as well as indicate the significance of the acquired business(es) to the company's **consolidated financial statements** (i.e., the acquired business' percent of consolidated total revenues and total assets, respectively). The SEC permits a company's auditors to exclude a recently acquired business' controls from the scope of its audit of the effectiveness of the acquiring company's internal control over financial reporting if management excludes the controls from their assessment, but the auditor is not permitted to exclude the recently acquired business from the scope of the audit of the acquiring company's financial statements.

In accordance with SEC FAQ No. 3, the period for which management may exclude the controls of a recently acquired business from its evaluation of the effectiveness of internal control over financial reporting may not extend beyond one year from the date of the acquisition. Similarly, such exclusion may not be made for more than one annual management report on internal control over financial reporting, even if there is a change in the acquirer's fiscal year end. A company must also disclose any material changes to its internal control over financial reporting pursuant to the SEC's rules (Item 308(c) of Regulation S-K) each fiscal quarter, including those related to the acquired business, even if management has applied SEC FAQ No. 3. As an alternative to ongoing disclosure for changes in internal control over financial reporting resulting from acquired businesses or their integration, a company is permitted to disclose all such changes in the annual report in which its assessment that encompasses the acquisition is included.

Companies that qualify for the FAQ No. 3 scope exception but decide not to take advantage of it should be aware that they may be accepting a greater risk of identifying a significant deficiency or material weakness, particularly if integration activities are still ongoing. Some companies may benefit from the additional time provided by the FAQ No. 3 scope exception to fully integrate and/or further evaluate the internal control of the acquired entity.

13.4 Insurance industry considerations

This section highlights the key accounting issues that companies in the insurance industry may encounter when entering into a **business combination**. The specific facts and circumstances surrounding the transaction will result in other challenges and issues not addressed in this section.

Active IASB and FASB projects may result in amendments to existing guidance. These possible amendments may impact the guidance in this chapter. Specifically, these include the IASB's project to develop a standard that will address recognition, measurement, presentation, and disclosure for insurance contracts. Redeliberations by the IASB are planned for 2014. The FASB's project involves separate considerations related to short duration and long duration contracts. For short duration insurance contracts, the FASB is considering potential enhanced disclosures. For long duration contracts, the FASB is considering targeted charges to the recognition and measurement models. Redeliberations by the FASB are planned for 2014.

13.4.1 Accounting for business combinations

The Standards provide some insurance-specific guidance for business combinations, principally:

- Requiring the **acquisition method** in accounting for combinations of mutual insurance entities [ASC 805-30-55-3 through 55-5].

- Requiring that insurance contracts acquired in a business combination be considered by the **acquirer** as new contracts for measurement and accounting purposes [ASC 944-805-25-1].

- Carrying forward the **acquiree's** classification of an acquired contract as an insurance or reinsurance contract or a deposit contract (and thus not evaluating whether the contracts transfer significant insurance risk) based on the terms of the contract at contract inception or, if that classification changes due to subsequent modification of those terms (which may occur at the acquisition date), based on the modified terms [ASC 805-20-25-8, ASC 944-805-25-2, IFRS 3.17].

- Recognising the fair value of the assets and liabilities arising from the rights and obligations of the insurance contract in two components. These components consist of (1) assets and liabilities measured in accordance with the acquirer's existing accounting policies and (2) an intangible asset (or other liability) recognised for the difference between the fair value of the insurance and reinsurance contracts and the amount recognised in accordance with the acquirer's existing accounting policies (hereafter referred to as the "insurance contract intangible asset"). The recognition of the insurance contract intangible asset is required for U.S. GAAP companies and is optional for IFRS companies. IFRS companies have a policy choice of whether to use this expanded presentation [ASC 944-805-30-1; IFRS 4.31].

- Requiring contingent commissions and claim liability guarantees to be accounted for in the same manner as other contingencies in the Standards [ASC 944-805-25-4, ASC 944-805-25-5].

- Affirming that insurers using IFRS should apply IFRS 4 to insurance contracts acquired in a business combination [IFRS 3.BC189,BC196].

The application of acquisition accounting to insurance transactions presents unique issues due to the limited insurance-specific guidance in the Standards. These include:

- Distinguishing between a business combination, a reinsurance transaction (including a portfolio transfer), and **asset acquisitions**.
- Recording insurance contracts at fair value and determining the allocation between the insurance contract liabilities and related insurance contract intangible asset.
- Identifying and recording any other separately **identifiable intangible assets** at fair value, including renewal rights on short-duration contracts, customer relationships, and distribution relationships.
- Determining the postacquisition amortisation approaches for the insurance contract intangible asset and for any other separately identified intangible assets.

13.4.2 Distinguishing between a business combination, a reinsurance transaction, and an asset acquisition

Transactions in the insurance industry may take various legal forms. It is not uncommon for a transaction to include one or more indemnification or novation reinsurance transactions along with the acquisition of renewal rights, the purchase of certain legal entities, the purchase of assets, or various combinations thereof. In many cases, the acquired items taken as a whole, including the reinsurance components, may meet the definition of a **business** and, therefore, will be accounted for as a business combination under the Standards. Factors to consider in making that determination include whether the rights and obligations of the in-force block of insurance and investment contracts have been transferred, and whether various other components of the business have been transferred, such as the employees and staff, the policy administration function, financial reporting functions, or distribution systems.

If the transaction does not qualify as a business combination, asset acquisition (or liability assumption) accounting is applied based on the fair value(s) determined at the acquisition date. No **goodwill** is recognised, and any acquired in-force blocks of insurance/investment contracts are assessed for contract classification in accordance with reinsurance risk transfer guidance under U.S. GAAP and contract classification guidance under IFRS. For liabilities assumed in a transaction accounted for as reinsurance (referred to as "portfolio transfers" under IFRS), the expanded presentation, similar to that noted previously for business combinations, is common practice under U.S. GAAP and is permissible under IFRS. That is, the difference between the consideration received and the liabilities recorded is presented as an intangible asset. Asset acquisitions would include the purchase of identifiable intangible assets and other assets, which would be subject to the guidance in ASC 350 and ASC 360 for U.S. GAAP, and IAS 16 and IAS 38 for IFRS.

13.4.3 Acquired insurance and reinsurance contracts are recorded at fair value

Acquired insurance and reinsurance contracts are recorded at fair value and are considered to be new contracts for measurement and accounting purposes (i.e., a fresh start basis applies). However, there is no reassessment of the classification of contracts as insurance, reinsurance, or deposit contracts on the acquisition date (i.e., no reassessment of whether the contracts transfer significant insurance risk), unless the contracts were modified substantively in the business combination [ASC 805-20-25-8, ASC 944-805-25-2; IFRS 3.17]. Consistent with the general notion of acquisition accounting and fair value, deferred costs of the acquiree, such as deferred acquisition costs and unearned premiums that do not represent future cash flows, are not carried forward by the acquirer in acquisition accounting [ASC 944-805-30-1]. See BCG 13.4.4 for further information on the accounting for unearned premiums by the acquirer under U.S. GAAP.

Both U.S. GAAP (ASC 820) and IFRS 13 (which is effective prospectively for business acquisitions beginning in 2013) require the use of an exit price approach to measure fair value. That is, fair value is the price that would be received to sell an asset, or paid to transfer a liability in an orderly transaction between **market-participants** at the measurement date. The fair value measurement technique commonly used for acquired insurance contracts under an exit price approach is the **income approach** (i.e., a discounted cash flow technique). Due to a lack of uniform guidance for measuring the fair value of acquired in-force blocks of insurance, multiple variations of cash flow valuation techniques exist in practice. An exit price approach creates challenges for determining the fair value of insurance contracts and any separately identifiable intangible assets for which there are no quoted market prices. It requires the use of assumptions that a market-participant would use to value each of the acquired assets and assumed liabilities in an orderly transaction to sell the acquired asset or transfer the assumed liabilities at the measurement date under current market conditions. The use of entity-specific assumptions would not be appropriate when measuring the fair value of the assets acquired and liabilities assumed.

See BCG 7 for a discussion of general valuation techniques and approaches.

13.4.4 Insurance contract intangible assets and liabilities related to insurance contracts acquired in a business combination

For all U.S. GAAP companies, and IFRS companies choosing a similar presentation approach, the fair value of the acquired insurance contracts is divided into two basic components: (1) assets and liabilities measured in accordance with the acquirer's accounting policies for insurance and reinsurance contracts that it issues or holds and (2) the insurance contract intangible asset described in BCG 13.4.1. In addition, U.S. GAAP explicitly acknowledges that the second component may be an additional liability (rather than an asset) on those occasions where the fair value of the insurance contract exceeds the value of the insurance contract liability measured in accordance with the acquirer's accounting policies, whereas IFRS is silent on this matter [ASC 944-805-30-1; IFRS 4.31].

For IFRS companies, there is no requirement to measure the acquired insurance liabilities using the acquirer's accounting policies. That is, IFRS 4 allows insurers to continue to use non-uniform accounting policies for insurance contracts of **subsidiaries**, but it does not allow a change in accounting policies among subsidiaries that would introduce more diversity. The Standards do not provide specific guidance on how to determine the assets and liabilities measured in accordance with the acquirer's accounting policies, except that under U.S. GAAP, the amounts are based on the acquirer's accounting policies for insurance contracts that it issues or holds.

13.4.4.1 Insurance contract intangible asset and liabilities related to acquired non-life short-duration and financial guarantee insurance contracts under U.S. GAAP

Non-life short-duration insurance contracts

ASC 944-805-30-1 requires that assets and liabilities be measured in accordance with the acquirer's accounting policies for insurance and reinsurance contracts that it issues or holds. The guidance notes that examples of liabilities include a liability to pay future contract claims and expenses on the unexpired portion of the acquired contracts, and a liability to pay incurred contract claims and claims expenses. Similarly, recorded liabilities for non-life short-duration contracts in non-acquisition situations typically include both a claim liability (for reported claims as well as for incurred but not reported claims) and an unearned premium liability relating to the unexpired portion of an insurance contract.

As noted in BCG 13.4.3 above, there is no reassessment of the classification of contracts as insurance, reinsurance, or deposit contracts on the acquisition date, unless the contracts were modified substantively in the business combination. However, as also noted above, under U.S. GAAP, insurance contracts acquired in a business combination are considered by the acquirer as new contracts for measurement and accounting purposes (ASC 944-805-25-1). We interpret this to mean that for contracts for which the coverage period of the underlying contracts has ended, there is no reassessment by the acquirer of the acquiree's initial determination of insurance versus deposit. However, from the acquirer's perspective, it should account for the newly acquired contracts, and specifically any ceded reinsurance contracts, as prospective, even though the coverage relates to past events. Similarly, if the acquirer enters into a retrocession concurrently with the acquisition, the retrocession should also be accounted for as prospective ceded reinsurance. IFRS 4 does not distinguish between prospective and retroactive coverage; IFRS 4 acknowledges that for insurance events that have already occurred, the insurance event is the discovery of those ultimate claims. As IFRS 4 does not differentiate between prospective and retroactive coverage, there is no requirement under IFRS to treat any acquired contracts as prospective.

Incurred claim liability

In the past, the SEC staff expressed a view that the undiscounted cash flows relating to a non-life short-duration claim liability established in acquisition accounting should usually be the acquiree's recorded claim liability value just before the acquisition. That is, the best estimate of the claim liability made by the acquiree should be the best estimate that the acquirer uses, unless the acquirer will settle the liability in a manner demonstrably different from the manner in which the acquiree had planned to do so.

The SEC staff was concerned about increases in liabilities made by acquirers only to be released in earnings in subsequent reporting periods. The staff generally expressed a view that the acquired entity has the best information for establishing a best-estimate projection of cash flows with a presumption that, barring an error by the acquired entity, the amounts should be the same for the acquirer. A complete understanding of the facts and circumstances and the exercise of professional judgment is required in circumstances where the acquirer seeks to increase the value of the undiscounted claims liability of the acquired entity as compared to the undiscounted amount reported by the acquired entity prior to the acquisition.

The SEC's historical position referred to above was based on an analogy to the guidance for loan loss reserves contained in SAB Topic 2.A.5, "Adjustments to Allowances for Loan Losses in Connection with Business Combinations." SAB 112 removes Topic 2.A.5. because of the guidance in ASC 944-805, which requires an entity to record acquired receivables, including loans, at fair value and precludes an acquirer from recognising a separate valuation allowance as of the acquisition date (because the effects of uncertainty about cash flows are already included in the fair value measure). The removal of Topic 2.A.5 does not necessarily indicate that the SEC's view regarding insurance loss reserve consistency has changed, because unlike loans, insurance liabilities are still presented gross, using the best estimate of the claim liability as one component and the insurance contract intangible asset as another component of the fair value of the contract.

Liability for unexpired portion of coverage

The Standards require that the liability relating to the acquired insurance contracts be measured based on the acquirer's accounting for insurance contracts that it issues or holds. Consistent with this concept, and consistent with prior practice for business combinations involving non-life short-duration contracts, U.S. GAAP companies should record an unearned premium revenue liability for the unexpired portion of acquired insurance contracts and then recognise that revenue over the remaining coverage period, consistent with the policy for business that it issues or holds.

Based on the guidance in ASC 944-805-30-1, we believe there is more than one acceptable presentation approach for the liability relating to the unexpired portion of coverage. We believe that one acceptable approach would be to establish an unearned premium revenue liability based on the unexpired portion of premium that the acquiree had received from the policyholder. An alternative sub-approach would be to establish an unearned premium revenue liability for the amount the acquirer would hypothetically charge the policyholder at the acquisition date for the remaining coverage, which is essentially an entry value. In most situations we would not expect these two approaches to yield significantly different unearned premium revenue liabilities. In either version of this approach, an insurance contract intangible asset would be recognised for the difference between the unearned premium revenue liability and the fair value of that obligation (essentially the difference between the gross premium and the fair value of expected future claim costs and expenses on the unexpired portion of the contract). The intangible would be amortised over the remaining coverage period of the contract.

The example provided in ASC 944-805-30-1 describes establishing "a liability to pay future contract claims and claims expenses on the unexpired portion of the acquired contracts," which we believe could also support an alternative approach of establishing a liability equal to the fair value of expected future contract claims and claims expenses on the unexpired portion of the acquired contracts (i.e., a net premium rather than a gross premium approach). However, we believe grossing up this exit value to the entry value gross premium and reflecting an insurance contract intangible asset is more consistent with the gross presentation required by ASC 805 (and optional presentation under IFRS).

Furthermore, given the wording in ASC 944-805-30-1, we could also support an alternative approach of establishing an unearned premium revenue liability equal to the fair value of expected future contract claims and claims expenses on the unexpired portion of the acquired contracts. Such an approach would not result in the recording of an insurance contract intangible asset for the unearned premium revenue liability. In addition, the exclusion of a margin would result in certain premium-based industry ratios commonly used to assess company performance (e.g., loss, expense, and combined ratios) being less comparable between companies and between periods for the same company and thus less relevant to financial statement users.

Financial guarantee insurance contracts

Application of the ASC 944-805-30-1 general guidance that requires recording "future contract claims and expenses on the unexpired portion of the acquired contracts" and "incurred contract claims and claims expenses" is complicated for financial guarantee contracts. The financial guarantee model is an expected loss rather than an incurred loss model. The "expected loss" claim liability is defined as an amount in excess of the unearned premium revenue liability. One view is that the acquirer would carry over the claim liability of the acquiree and then determine the unearned premium revenue liability. An alternative view would be to first measure the unearned premium revenue liability as the amount the acquirer would hypothetically charge the policyholder at the acquisition date for coverage and then derive the claim liability in accordance with ASC 944-40. We understand that in at least one instance the SEC staff believed it was more appropriate to carry over the claim liability of the acquiree and then determine the unearned premium revenue liability.

13.4.4.2 Insurance contract intangible asset and liabilities related to acquired long-duration insurance contracts under U.S. GAAP

For long-duration life insurance benefit liabilities, U.S. GAAP companies have applied various approaches for establishing the recorded contract liability component, depending on the type of contract (e.g., traditional whole-life contract, limited pay contract, universal life contract, or payout annuity). For example, the liability measurement for a traditional whole-life contract is a function of the premium. For an existing traditional whole-life contract that is part way through the premium-collection period, determining the liability using the traditional net level premium method presents some practical challenges. Several methods are used in practice, including the defined initial reserve method and the defined valuation premium method. The defined initial reserve method carries forward the existing acquiree liability and computes a new net benefit premium ratio at the acquisition date to be used prospectively. The defined valuation premium method recomputes the liability at the acquisition date. For a universal life contract, the recorded liability would typically be its account balance. All methods for establishing long-duration life insurance benefit liabilities in postcombination accounting generally use current market data and updated insurance assumptions (e.g., mortality, expense, and lapse assumptions) at the acquisition date.

A question has arisen in practice whether the recognition of the fair value of an insurance contract between the two components noted previously is applicable to contracts that are classified for U.S. GAAP purposes as investment contracts rather than insurance contracts. That is, should a contract such as a deferred annuity be recorded at its account balance, with the remaining difference between that balance and its fair value recorded as an **intangible asset** (or other liability), in accordance with the Standard for insurance contracts, or should the entire fair value be recorded as a liability, in accordance with financial instrument accounting?

Prior to the adoption of the Standard, U.S. GAAP addressed the accounting for the intangible asset recognised upon acquisition as representing the "present value of future profits" (PVFP) embedded in acquired insurance contracts. That guidance was applicable to life insurance contracts or "other long-duration contracts" covered by insurance accounting guidance. In practice, PVFP was typically established for all long duration contracts, including investment contracts. Our understanding is that the Standard was not intended to change practice in the insurance industry. In addition, there are other areas of insurance accounting under U.S. GAAP where the guidance for insurance contracts is followed for investment contracts as well, including the accounting for deferred acquisition costs. As a result, we believe it is acceptable for an acquirer to allocate the fair value of an investment contract into two components, consistent with the guidance for insurance contracts. However, the Standard explicitly refers to "insurance contracts," and as a result, we believe it would be an acceptable alternative to conclude that insurance contract requirements should not be required for investment contracts. Companies should make a policy election and apply that policy consistently. Where a company chooses to record the entire fair value as a liability at the business combination date, that fair value liability may be less than the investment contract "account balance" that is payable on demand. If the subsequent accounting for the investment contract is amortized cost (i.e., the fair value option is not elected), it would be appropriate to amortize to earnings [profit or loss] the difference between the acquisition date fair value and the account balance in a systematic and rational manner. This approach is consistent with the subsequent accounting for liabilities arising from contingencies and with the accounting for the insurance contract intangible asset (or liability) discussed in BCG 13.4.1 and 13.4.4.1.

An issue that may arise for either an insurance contract or an investment contract is whether there are any embedded derivatives (which would be accounted for under the guidance of ASC 815) to be separated from the host contract upon a business acquisition. This analysis becomes particularly significant in lower interest rate environments. Embedded derivatives can exist due to minimum interest rate guarantees in acquired contracts. They can also exist for contracts that effectively have a substantial discount or premium; for example, due to having been originally issued to policyholders in a higher interest rate environment than currently exists. The embedded derivative related to the ability of the counterparty to lapse the contract or effectively put the contract must be assessed.

13.4.4.3 Insurance contract intangible asset and liabilities related to acquired insurance contracts under IFRS

The current practice for measuring recorded insurance liabilities under IFRS can differ across IFRS reporting entities because of the ability to continue measuring insurance liabilities using the entity's pre-existing accounting policies. Practices vary depending on the accounting frameworks that have been used to develop the entity's pre-IFRS 4 accounting policies. For IFRS reporting entities that have developed their accounting policies with reference to U.S. GAAP, the approaches described above for contracts meeting the definition of insurance contracts under IFRS are appropriate alternatives.

However, contracts that are classified for IFRS purposes as investment contracts rather than insurance contracts are not within the scope of IFRS 4, and other relevant IFRS guidance should be followed. For example, a unit-linked investment contract acquired in a business combination is required to be recorded at fair value. In addition, these contracts will also have a customer contractual relationship intangible asset that represents the future profit margins to be earned on the investment management services under the contract. Subsequent to the business combination, the unit-linked investment contract liability will be accounted for under IAS 39, and the customer contractual relationship will be recognised and amortised as an intangible asset under IAS 38.

13.4.4.4 Postcombination accounting for insurance contract intangible asset and liabilities related to insurance contracts acquired in a business combination

Under the insurance standards, after a business combination, the insurance contract intangible asset (or, as noted for U.S. GAAP, this would occasionally be an additional liability) is required to be measured on a basis consistent with the related insurance or reinsurance liability [ASC 944-805-35-1; IFRS 4.31(b)].

For example, for many property/casualty short-duration contracts, companies typically amortise any insurance contract intangible asset relating to the unearned premium component consistent with the amortisation of the related unearned premium liability. ASC 944-805-35-2 suggests that amortisation of the insurance contract intangible asset associated with undiscounted claim liabilities using the interest method (because the intangible asset includes the fair value adjustment for the time value of money) may be an appropriate method. In practice, amortisation methods vary. Some companies unlock the pattern and/or term of amortisation if reliable updated information is available indicating that actual results differ from original estimates; while others establish an amortisation pattern and term, and do not unlock unless there is a significant change in the expected life. When unlocking is done, some companies use a retrospective method, while others use a prospective method. Other companies may use the effective yield method for amortising the pure discount/time value of the money element and a separate amortisation schedule for the risk margin component, if separately determinable, under the premise that expiration of risk is not consistent with an effective yield approach.

For long-duration life insurance contracts, the insurance contract intangible asset is typically amortised in a manner similar to the amortisation of deferred acquisition costs for similar products. For example, for U.S. GAAP companies with traditional whole-life insurance contracts subject to ASC 944, amortisation of the insurance contract intangible asset is based on premium revenue. For U.S. GAAP companies with universal life insurance contracts subject to ASC 944, amortisation of the insurance contract intangible asset is generally based on estimated gross profits. Under the Standards, acquired contracts are considered newly purchased contracts. As a result, amortisation of the insurance contract intangible asset is based on premiums or expected gross profit (or expected gross margins) from the acquisition date forward and not from the original policyholder contract inception date.

13.4.5 Other intangible assets recognised in a business combination

Other intangible assets must be identified, recognised, and measured at fair value. Business combinations involving insurance companies typically include the acquisition of various types of intangible assets, including:

- Customer relationships, such as renewal rights on short-duration insurance contracts, cross-selling opportunities, and customer/member lists
- Distribution channels (including the ability to generate new business from new customers)
- Brand names and trademarks
- Insurance licenses
- Service contracts and healthcare provider contracts
- Computer software

Issues involved in accounting for such intangibles, recorded in conjunction with a business combination or as stand-alone purchases, include identification, valuation, and postcombination accounting. Two major challenges include avoiding use of overlapping cash flows when determining the fair value for more than one intangible asset (e.g., customer relationships and distribution channels) and ensuring that all significant intangibles are identified. In terms of determining fair value, the most common methods used are the discounted cash flow method and the **market approach** (i.e., market transaction multiple method). Estimating intangible assets relating to customer relationships can be an especially challenging valuation area, given that such estimates are based on customer behaviour, which is often difficult to predict. Valuation specialists, including actuaries, will typically be required for this exercise. See BCG 4 and BCG 7 for further information on the recognition and valuation of intangible assets.

Accounting issues in the postcombination period include the selection of an amortisation pattern and term for finite-lived intangibles. The method of amortisation for finite-lived intangibles should reflect the pattern in which the economic benefits of the asset are consumed. The assigned useful lives can vary considerably based on the type of intangible, the type of business, and the specifics of the acquired portfolios. Judgment is needed in selecting an appropriate **useful life** and pattern of amortisation based on the nature of the intangible asset and the benefits derived from that asset.

In the postcombination period, both finite- and indefinite-lived assets are subject to **impairment** testing. Indefinite-lived assets are subject to impairment testing at least annually, while finite-lived assets are subject to impairment testing only upon a “triggering” event. Issues surrounding the impairment of intangible assets, whether finite- or indefinite-lived assets (e.g., certain insurance licenses that can be maintained indefinitely without substantial cost), are discussed in Chapter 10 of this BCG for U.S. GAAP, and Chapter 12 of this BCG for IFRS.

13.4.6 Contingent commissions and sellers’ claim liability guarantees

Contingent commissions and sellers’ claim liability guarantees for insurance contracts do not fall under the insurance contract guidance in the Standards. Contingencies other than claim liability guarantees, such as contingent commissions paid to agents, are not part of the insurance or reinsurance contract; and, therefore, are required to be accounted for under the Standards in the same manner as other noninsurance contingencies (e.g., as contingencies for contingent commissions arising from distribution agreements) [ASC 944-805-25-4]. See BCG 2.5.13 for information on initial and subsequent recognition and measurement of noninsurance contingencies.

Indemnification agreements relating to the adequacy of acquired claim liabilities, which may be in the form of reinsurance contracts, are accounted for on the acquisition date consistent with other indemnification assets in accordance with ASC 805-20-25-27 through 28 [per ASC 944-805-25-5] and paragraphs 27 and 28 of IFRS 3. The guidance in ASC 944-805 on indemnification agreements has been carried forward from previous guidance, which provided examples of both a direct seller indemnification and a seller indemnification achieved through negotiation of a reinsurance contract with a third party reinsurer contemporaneous with, and in contemplation of, the business combination. We believe both of those indemnifications would continue to be accounted for under ASC 805-20-25-27 through 25-28.

In subsequent accounting periods, any asset relating to an indemnification agreement existing at the acquisition date would be measured on the same basis as the indemnified item to which it relates, subject to any contractual limitations on its amount and an assessment of collectibility [ASC 805-20-35-4; IFRS 3.57]. For example, for an indemnification of acquired claim liabilities that are classified as insurance contracts, the measurement of the indemnification asset would be consistent with that of the claim liability.

ASC 944-805-S99 notes that any receivable from the seller relating to an indemnification agreement should not be netted against the related liability in the balance sheet or in supporting information such as footnotes or disclosures in SEC Industry Guide 6 (SEC 6940), *Disclosures Concerning Unpaid Claims and Claim Adjustment Expenses of Property Casualty Insurance Underwriters*. The SEC staff indicated that although it is preferable to present the effects of the loss guarantee on a gross rather than net basis, it would not object to claim losses and loss adjustment expenses being reported net of the effect of the reserve guarantee in the income statement. A net presentation is appropriate only if the effects of the reserve guarantee are disclosed separately in the notes to the financial statements, in the SEC Industry Guide 6 disclosures including the reconciliation of claims reserves, and in the loss ratio information. In addition, the SEC staff believes the effects of such an arrangement on operations and cash flows should be clearly disclosed in management's discussion and analysis.

From the perspective of the seller, an indemnification agreement relating to the adequacy of acquired claim liabilities falls within the scope of ASC 460. Therefore, the seller would recognize and measure the fair value of the guarantee and record a liability for the obligation. The offsetting entry would likely affect the gain or loss on the transaction as a whole. In addition, the seller would be required to comply with disclosure requirements of ASC 460-10-50-4- through 50-6. Under IFRS, there is no specific guidance on the seller's accounting for an indemnification agreement relating to acquired claim liabilities. Entities will need to develop an appropriate accounting policy which could be based upon IAS 37 or IFRS 4.

Appendices

Appendix A: Professional literature

The PwC guides provide in-depth accounting and financial reporting guidance for various topics, as outlined in the preface to this guide. The PwC guides summarize the applicable accounting literature, including relevant references to and excerpts from the FASB's Accounting Standards Codification (the Codification) and standards issued by the International Accounting Standards Board. They also provide our insights and perspectives, interpretative and application guidance, illustrative examples, and discussion on emerging practice issues. The PwC guides supplement the authoritative accounting literature. This appendix provides further information on authoritative U.S. generally accepted accounting principles and International Financial Reporting Standards.

U.S. generally accepted accounting principles

The Codification is the primary source of authoritative U.S. financial accounting and reporting standards (U.S. GAAP) for nongovernmental reporting entities (hereinafter referred to as "reporting entities"). Additionally, guidance issued by the SEC is a source of authoritative guidance for SEC registrants.

Updates and amendments to the Codification arising out of the FASB's standard-setting processes are communicated through *Accounting Standards Updates* (ASUs). The Codification is updated concurrent with the release of a new ASU, or shortly thereafter. PwC has developed a *FASB Accounting Standards Codification Quick Reference Guide* which is available on CFOdirect. The quick reference guide explains the structure of the Codification, including examples of the citation format, how new authoritative guidance will be released and incorporated into the Codification, and where to locate other PwC information and resources on the Codification. The quick reference guide also includes listings of the Codification's "Topics" and "Sections" and a list of frequently referenced accounting standards and the corresponding Codification Topics where they now primarily reside.

In the absence of guidance for a transaction or event within a source of authoritative U.S. GAAP (i.e., the Codification and SEC guidance), a reporting entity should first consider accounting principles for similar transactions or events within a source of authoritative U.S. GAAP for that reporting entity and then consider non-authoritative guidance from other sources. Sources of non-authoritative accounting guidance and literature include:

- FASB Concepts Statements
- AICPA Issues Papers
- International Financial Reporting Standards issued by the International Accounting Standards Board

- Pronouncements of other professional associations or regulatory agencies
- Technical Information Service Inquiries and Replies included in AICPA Technical Practice Aids
- PwC accounting and financial reporting guides
- Accounting textbooks, guides, handbooks, and articles
- Practices that are widely recognized and prevalent either generally or in the industry

While other professional literature can be considered when the Codification does not cover a certain type of transaction or event, we do not expect this to occur frequently in practice.

SEC guidance

The content contained in the SEC sections of the FASB's Codification is provided for convenience and relates only to SEC registrants. The SEC sections do not contain the entire population of SEC rules, regulations, interpretive releases, and staff guidance. Also, there is typically a lag between when SEC guidance is issued and when it is reflected in the SEC sections of the Codification. Therefore, reference should be made to the actual documents published by the SEC and SEC Staff when addressing matters related to public reporting entities.

International Financial Reporting Standards

International Financial Reporting Standards (IFRS) is a single set of accounting standards currently used in whole or in part in approximately 130 jurisdictions worldwide.

IFRS standards are developed by the International Accounting Standards Board (IASB), an independent standard setting body. Members of the IASB are appointed by international trustees and are responsible for the development and publication of IFRS standards as well as approving interpretations of the IFRS Interpretations Committee. The IFRS Interpretations Committee is responsible for evaluating the impact of implementing IFRS and other emerging issues that result from application of IFRS and undertaking projects to provide supplemental guidance or amend existing guidance.

The authoritative guidance issued by the IASB (and its predecessor organizations) are in the form of:

- IFRS pronouncements
- International Accounting Standards (IAS) pronouncements
- IFRS interpretations issued by the IFRS Interpretations Committee

- Standing Interpretation Committee of the IASC (SIC) interpretations
- IFRS for small and medium-sized entities (SMEs) - restricted application by small and medium-sized entities as defined

The IASB has a variety of advisory organizations representing different constituents who provide insight into implementation issues for completed standards, feedback on draft standards, and suggestions on potential agenda items as examples. The IFRS Advisory Council and the Accounting Standards Advisory Forum are examples of such organizations.

IFRS standards may automatically apply upon publication in certain jurisdictions, while others require endorsement or undergo other modifications prior to application. For example, companies in the European Union (EU) would not apply a newly issued IFRS to their consolidated public financial statements until the pronouncement was endorsed.

In addition to the authoritative guidance, PwC's Manual of Accounting is published annually, and should be used along with each of the PwC global accounting guides to assist in interpreting IFRS. While not authoritative guidance, the Manual of Accounting can be used as a practical guide in applying IFRS.

Appendix B: Technical references and abbreviations

The following tables provide a list of the technical references and definitions for the abbreviations and acronyms used within this guide.

Technical references

AICPA Goodwill guide	AICPA Accounting and Valuation Guide – *Testing Goodwill for Impairment*
ASC 230	Accounting Standards Codification 230, *Statement of Cash Flows*
ASC 250	Accounting Standards Codification 250, *Accounting Changes and Error Corrections*
ASC 260	Accounting Standards Codification 260, *Earnings per Share*
ASC 270	Accounting Standards Codification 270, *Interim Reporting*
ASC 280	Accounting Standards Codification 280, *Segment Reporting*
ASC 310	Accounting Standards Codification 310, *Receivables*
ASC 320	Accounting Standards Codification 320, *Investments—Debt and Equity Securities*
ASC 323	Accounting Standards Codification 323, *Investments—Equity Method and Joint Ventures*
ASC 350	Accounting Standards Codification 350, *Intangibles—Goodwill and Other*
ASC 360	Accounting Standards Codification 360, *Property, Plant, and Equipment*
ASC 420	Accounting Standards Codification 420, *Exit or Disposal Cost Obligations*
ASC 450	Accounting Standards Codification 450, *Contingencies*
ASC 470	Accounting Standards Codification 470, *Debt*
ASC 480	Accounting Standards Codification 480, *Distinguishing Liabilities from Equity*

ASC 605–35	Accounting Standards Codification 605-35, *Construction—Type and Production Type Contracts*
ASC 710	Accounting Standards Codification 710, *Compensation—General*
ASC 712	Accounting Standards Codification 712, *Compensation—Nonretirement Postemployment Benefits*
ASC 715	Accounting Standards Codification 715, *Compensation—Retirement Benefits*
ASC 718	Accounting Standards Codification 718, *Compensation—Stock Compensation*
ASC 730	Accounting Standards Codification 730, *Research and Development*
ASC 740	Accounting Standards Codification 740, *Income Taxes*
ASC 805	Accounting Standards Codification 805, *Business Combinations*
ASC 810	Accounting Standards Codification 810, *Consolidation*
ASC 815	Accounting Standards Codification 815, *Derivatives and Hedging*
ASC 820	Accounting Standards Codification 820, *Fair Value Measurements and Disclosures*
ASC 830	Accounting Standards Codification 830, *Foreign Currency Matters*
ASC 835	Accounting Standards Codification 835, *Interest*
ASC 840	Accounting Standards Codification 840, *Leases*
ASC 845	Accounting Standards Codification 845, *Nonmonetary Transactions*
ASC 860	Accounting Standards Codification 860, *Transfers and Servicing*
ASC 932	Accounting Standards Codification 932, *Extractive Activities—Oil and Gas*
ASC 944	Accounting Standards Codification 944, *Financial Services—Insurance*
ASC 958	Accounting Standards Codification 958, *Not-for-Profit Entities*

ASC 976	Accounting Standards Codification 976, *Real Estate—Retail Land*
ASC 985	Accounting Standards Codification 985, *Software*
IAS 1	International Accounting Standards 1, *Presentation of Financial Statements*
IAS 2	International Accounting Standards 2, *Inventories*
IAS 7	International Accounting Standards 7, *Statement of Cash Flows*
IAS 8	International Accounting Standards 8, *Accounting Policies, Changes in Accounting Estimates and Errors*
IAS 11	International Accounting Standards 11, *Construction Contracts*
IAS 12	International Accounting Standards 12, *Income Taxes*
IAS 16	International Accounting Standards 16, *Property, Plant and Equipment*
IAS 17	International Accounting Standards 17, *Leases*
IAS 18	International Accounting Standards 18, *Revenue*
IAS 19	International Accounting Standards 19, *Employee Benefits*
IAS 21	International Accounting Standards 21, *The Effects of Changes in Foreign Exchange Rates*
IAS 27	International Accounting Standards 27, *Consolidated and Separate Financial Statements*
IAS 27 (2011)	International Accounting Standards 27 (Revised 2011), *Separate Financial Statements*
IAS 28 (2011)	International Accounting Standards 28 (Revised 2011), *Investments in Associates and Joint Ventures*
IAS 31	International Accounting Standards 31, *Interests in Joint Ventures*
IAS 32	International Accounting Standards 32, *Financial Instruments: Presentation*
IAS 33	International Accounting Standards 33, *Earnings Per Share*
IAS 36	International Accounting Standards 36, *Impairment of Assets*

IAS 37	International Accounting Standards 37, *Provisions, Contingent Liabilities and Contingent Assets*
IAS 38	International Accounting Standards 38, *Intangible Assets*
IAS 39	International Accounting Standards 39, *Financial Instruments: Recognition and Measurement*
IAS 40	International Accounting Standards 40, *Investment Property*
IAS 41	International Accounting Standards 41, *Agriculture*
IFRIC 17	International Financial Reporting Interpretations Committee 17, *Distributions of Non-cash Assets to Owners*
IFRS 2	International Financial Reporting Standard 2, *Share-Based Payment*
IFRS 3	International Financial Reporting Standard 3 (Revised 2008), *Business Combinations*
IFRS 4	International Financial Reporting Standard 4, *Insurance Contracts*
IFRS 5	International Financial Reporting Standard 5, *Non-current Assets Held for Sale and Discontinued Operations*
IFRS 7	International Financial Reporting Standard 7, *Financial Instruments: Disclosures*
IFRS 8	International Financial Reporting Standard 8, *Operating Segments*
IFRS 9	International Financial Reporting Standard 9, *Financial Instruments*
IFRS 10	International Financial Reporting Standard 10, *Consolidated Financial Statements*
IFRS 11	International Financial Reporting Standard 11, *Joint Arrangements*
IFRS 12	International Financial Reporting Standard 12, *Disclosure of Interests in Other Entities*
IFRS 13	International Financial Reporting Standard 13, *Fair Value Measurement*
IPR&D guide	AICPA Accounting and Valuation Guide—*Assets Acquired to Be Used in Research and Development Activities*

SAB 54	Staff Accounting Bulletin No. 54, *Pushdown Basis of Accounting in Separate Financial Statements of Subsidiaries Acquired in Purchase Transactions*
SAB 73	Staff Accounting Bulletin No. 73, *Pushdown Basis of Accounting Required in Certain Limited Circumstances*
SAB 93	Staff Accounting Bulletin No. 93, *Accounting and Disclosures Relating to Discontinued Operations*
SAB 112	Staff Accounting Bulletin No. 112, *Amendments Resulting From FAS 141(R) and FAS 160*
SIC 12	Standing Interpretations Committee 12, *Consolidation—Special Purpose Entities*
EITF 95-3	EITF Issue No. 95-3, *Recognition of Liabilities in Connection with a Purchase Business Combination*
EITF 00-23	EITF Issue No. 00-23, *Issues Related to the Accounting for Stock Compensation under APB Opinion No. 25 and FASB Interpretation No. 44 and FAS 160*
EITF 02-5	EITF Issue No. 02-5, *Definition of "Common Control" in Relation to FASB Statement No. 141*

Other abbreviations

AICPA	American Institute of Certified Public Accountants
AOCI	Accumulated other comprehensive income
APB	Accounting Principles Board
APIC	Additional paid-in capital
ARB	Accounting Research Bulletin
ASC	Accounting Standards Codification
ASU	Accounting Standards Update
BCG	PwC's Business combinations guide
BEV	Business enterprise value
CDI	Core deposit intangibles
CEO	Chief executive officer

CGM	Constant growth method
CGU	Cash generating unit
CODM	Chief operating decision maker
CON	Statements of Financial Accounting Concepts
CTA	Cumulative translation account
CU	Currency unit
DCF	Discounted cash flow
DTA	Deferred tax asset
DTL	Deferred tax liability
EBITDA	Earnings before interest, taxes, depreciation, and amortization
EITF	Emerging Issues Task Force
EPA	Environmental Protection Agency
EPS	Earnings per share
FAQ	Frequently asked questions
FAS	Financial Accounting Standards
FASB	Financial Accounting Standards Board
FCC	Federal Communications Commission
FIN	FASB Interpretation
FSP	FASB Staff Position
FTB	FASB Technical Bulletin
FTC	Foreign tax credit
FVLCOD	Fair value less costs of disposal
FVLCTS	Fair value less costs to sell
FVTPL	Fair value through profit or loss
GAAP	Generally accepted accounting principles (and practices)

HR	Human resources
IAS	International Accounting Standard
IASB	International Accounting Standards Board
IFRIC	International Financial Reporting Interpretations Committee
IFRS	International Financial Reporting Standards
IPR&D	In-process research and development
IRR	Internal rate of return
IT	Information technology
LIFO	Last-in first-out
MEEM	Multiperiod excess earnings method
NCI	Noncontrolling interest
NOL	Net operating loss
OCI	Other comprehensive income
PCAOB	Public Company Accounting Oversight Board
PCC	Private Company Council
PCS	Post contract support
PFI	Projected financial information
PHEI	Previously held equity interest
PTD	Preliminary temporary difference
PV	Present value
RCN	Replacement cost new
RCNLD	Replacement cost new less depreciation
REIT	Real estate investment trust
RFR	Relief-from-royalty method
ROI	Return on investment

RU	Reporting unit
R&D	Research and development
SAB	Staff Accounting Bulletin
SEC	United States Securities & Exchange Commission
SIC	Standing Interpretations Committee
SOP	Statement of Position
SPE	Special purpose entity
TV	Terminal value
U.S.	United States
VIE	Variable interest entity
VIU	Value in use
WACC	Weighted average cost of capital
WARA	Weighted average return analysis
W/WO	With and without method

Appendix C: Key terms

The following table provides definitions for key terms used within this guide.

Term	Definition
Acquired group	An acquired group of assets and related activities, referred to in the Standards as an integrated set of activities and assets.
Acquiree	The business or businesses that the acquirer obtains control of in a business combination [U.S. GAAP only—This term also includes a nonprofit activity or business that a not-for-profit acquirer obtains control of in an acquisition by a not-for-profit entity.] [ASC 805-10-20; IFRS 3.A].
Acquirer	The entity that obtains control of the acquiree. [U.S. GAAP only—However, in a business combination in which a variable interest entity is acquired, the primary beneficiary of that entity always is the acquirer.] [ASC 805-10-20; IFRS 3.A].
Acquisition date	The date on which the acquirer obtains control of the acquiree [ASC 805-10-20; IFRS 3.A].
Acquisition method	An entity shall account for each business combination by applying the acquisition method. The acquisition method requires all of the following steps [Applying the acquisition method requires]: a. Identifying the acquirer; b. Determining the acquisition date; c. Recognizing and measuring the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree; and d. Recognizing and measuring goodwill or a gain from a bargain purchase [ASC 805-10-05-4; IFRS 3.4-5].
Amortizable units of goodwill	Unit of accounting for assigning and amortising goodwill for private companies that adopt the **goodwill alternative**.
Asset acquisition	An acquisition of an asset or group of assets that does not meet the definition of a business.

Term	Definition
Asset group (U.S. GAAP only)	Unit of accounting for a long-lived asset(s) to be held and used, which represents the lowest level for which identifiable cash flows are largely independent of the cash flows of other groups of assets and liabilities [ASC 360-10-20 and ASC Glossary].
Associate (IFRS Only)	An entity over which the investor has significant influence [IAS 28R.3].
Blockage discount	The difference between the market value of a security and its sale price when purchased under a large quantity of securities.
Book base	When determining deferred taxes by comparing the amount of the asset or liability recorded in the financial statements to the amount attributed to that asset or liability for tax purposes, the book base is the amount recorded in the financial statements.
Business	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 [ASC 805-10-20; IFRS 3.A].
Business combination	A transaction or other event in which an acquirer obtains control of one or more businesses. Transactions sometimes referred to as "true mergers" or "mergers of equals" are also business combinations [as that term is used in this IFRS] [ASC 805-10-20; IFRS 3.A].
Business combination achieved in stages	Also known as a step acquisition. When an acquirer obtains control of an acquiree in which it held an equity interest immediately before the acquisition date [ASC 805-10-25-9; IFRS 3.41].
Business enterprise value (BEV)	Often referred to as "Market Value of Invested Capital," "Total Invested Capital," or "Enterprise Value," and represents the fair value of an entity's interest-bearing debt and shareholders' equity (e.g., the fair value of the entity as a whole).
Call option	**U.S. GAAP—**A contract that allows the holder to buy a specified quantity of stock from the writer of the contract at a fixed price for a given period [ASC Glossary]. **IFRS—**A financial instrument that gives the holder the right to purchase ordinary shares [IAS 33.5].

Term	Definition
Carryforward	A deduction or credit that cannot be utilised on the tax return during the current year but that may be used to reduce taxable income or taxes payable in a future year. An operating loss carryforward is an excess of tax deductions over gross income in a year; a tax credit carryforward is the amount by which tax credits available for utilisation exceed statutory limitations. Different tax jurisdictions have different rules about whether excess deductions or credits may be carried forward and the length of the carryforward period. The terms *carryforward*, *operating loss carryforward*, and *tax credit carryforward* refer to the amounts of those items, if any, reported in the tax return for the current year [ASC Glossary]. (A similar concept exists in IFRS, IAS 12.)
Carrying amount	The amount at which an asset is recognised after deducting any accumulated depreciation (amortisation) and accumulated impairment losses thereon [IAS 36.6]. (A similar concept exists in U.S. GAAP, ASC 350, and ASC 360).
Carryover basis	The carrying amounts of assets and liabilities in a contributing investor's financial statements (e.g., when being contributed to a joint venture). (A similar concept exists in IFRS, known as **predecessor-values method**.)
Cash-generating unit (CGU) (IFRS only)	The smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets [IAS 36.6].
Change in the reporting entity	A change that results in financial statements that, in effect, are those of a different 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 pursuant to ASC 810, is a change in reporting entity [ASC 250-10-20]. (A similar concept exists in IFRS.)

Term	Definition
Combined financial statements	The financial statements of a combined group of commonly controlled entities or commonly managed entities presented as those of a single economic entity. The combined group does not include the parent [ASC Glossary].
Common control	While not defined in U.S. GAAP or IFRS, common control transactions are transfers and exchanges between entities that are under the control of the same parent, or are transactions in which all of the combining entities are controlled by the same party or parties before and after the transaction and that control is not transitory. The extent of a noncontrolling interest is not relevant.
Component (U.S. GAAP only)	A component of an operating segment is a reporting unit if the component constitutes a business for which discrete financial information is available and segment management, as that term is defined in ASC 280-10-50-7, regularly reviews the operating results of that component [ASC 350-20-35-34].
Consideration transferred	The amount exchanged by the buyer (e.g., cash, other assets, liabilities assumed, contingent consideration, subsidiary or business of the buyer transferred to the seller, common or preferred equity securities, options, warrants and member interests of mutual entities to acquire a business) for the proportionate share of net assets acquired in a business combination.
Consolidated financial statements	**U.S. GAAP**—The financial statements of a consolidated group of entities that include a parent and all its subsidiaries presented as those of a single economic entity [ASC Glossary]. **IFRS**—The financial statements of a group in which the assets, liabilities, equity, income, expenses, and cash flows of the parent and its subsidiaries are presented as those of a single economic entity [IAS 27R.4].
Consolidated group	A parent and all its subsidiaries [ASC Glossary; IFRS 10.A].
Contingent consideration	Usually is 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 [ASC 805-10-20; IFRS 3.A].

Term	Definition
Contractual indemnity	Indemnity based on contractual agreement between the parties. The contractual terms can include a party agreeing to indemnify, defend and/or hold the other party harmless.
Contractual-legal criterion	See definition of *Identifiable*.
Control	**U.S. GAAP**—Ownership of a majority voting interest and therefore, as a general rule, ownership by one reporting entity directly or indirectly, of over 50 percent of the outstanding voting shares of another entity is a condition pointing toward consolidation. However, there are exceptions to this general rule. A majority owned subsidiary shall not be consolidated if control does not rest with the majority owner (for instance, if the subsidiary is in legal reorganization or in bankruptcy or operates under foreign exchange restrictions, controls, or other governmentally imposed uncertainties so severe that they cast significant doubt on the parent's ability to control the entity) [ASC 810-10-15-8 and ASC 810-10-15-10]. **IFRS**—An investor controls an investee when the investor is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee [IFRS 10.A].
Control premium	A control premium generally represents the amount paid by a new controlling shareholder for the benefits resulting from synergies and other potential benefits derived from controlling the enterprise.
Controlling interest	The equity (residual interest) in a subsidiary attributable, directly or indirectly, to the parent and the parent's affiliates.
Corporate assets	Assets other than goodwill that contribute to the future cash flows of both the cash-generating unit under review and other cash-generating units [IAS 36.6]. (A similar concept exists in U.S. GAAP, ASC 350.)
Cost approach	A valuation technique based on the amount that currently would be required to replace the service capacity of an asset (often referred to as current replacement cost) [ASC Glossary; IFRS 13.A].
Defensive intangible asset	An acquired intangible asset in a situation in which an entity does not intend to actively use the asset but intends to hold (lock up) the asset to prevent others from obtaining access to the asset [ASC Glossary].

Term	Definition
Deferred tax asset	**U.S. GAAP**—The deferred tax consequences attributable to deductible temporary differences and carryforwards. A deferred tax asset is measured using the applicable enacted tax rate and provisions of the enacted tax law. A deferred tax asset is reduced by a valuation allowance if, based on the weight of evidence available, it is more likely than not that some portion or all of a deferred tax asset will not be realized [ASC Glossary]. **IFRS**—The amounts of income taxes recoverable in future periods in respect of: a. deductible temporary differences; b. the carryforward of unused tax losses; and c. the carryforward of unused tax credits [IAS 12.5].
Deferred tax liability	**U.S. GAAP**—The deferred tax consequences attributable to taxable temporary differences. A deferred tax liability is measured using the applicable enacted tax rate and provisions of the enacted tax law [ASC Glossary]. **IFRS**—The amounts of income taxes payable in future periods in respect of taxable temporary differences [IAS 12.5].
Disposal group	**U.S. GAAP**—A disposal group for a long-lived asset or assets to be disposed of, by sale or otherwise, represents assets to be disposed of together as a group in a single transaction and liabilities directly associated with those assets that will be transferred in the transaction [ASC 360-10-20]. **IFRS**—A group of assets to be disposed of, by sale or otherwise, together as a group in a single transaction, and liabilities directly associated with those assets that will be transferred in the transaction. The group includes goodwill acquired in a business combination if the group is a cash-generating unit to which goodwill has been allocated in accordance with the requirements of paragraphs 80-87 of IAS 36 or if it is an operation within such a cash-generating unit [IFRS 5.A].
EBITDA (Earnings before interest, taxes, depreciation, and amortisation)	Represents earnings before interest, taxes, depreciation, and amortisation, which approximates a company's operating cash flow.
Entry price	The price paid to acquire an asset or received to assume a liability in an exchange transaction [ASC 820-10-20; IFRS 13.A].

Term	Definition
Equity interest	Used broadly to mean ownership interests of investor-owned entities and owner, member, or participant interests of mutual entities [U.S. GAAP only—and owner or member interests in the net assets of not-for-profit entities] [ASC 805-10-20; IFRS 3.A].
Equity-linked instrument	A hybrid instrument that contains an embedded component linked to the equity of the issuer. A convertible debt instrument is an example of an equity-linked instrument.
Exit price	The price that would be received to sell the asset or paid to transfer the liability [ASC 820-10-20; IFRS 13.A].
Fair value	The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date [ASC 805-10-20; IFRS 13.9].
Fair value less costs of disposal (FVLCOD)	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, less costs of disposal, which are incremental costs directly attributable to the disposal of an asset or cash generating unit, excluding finance costs and income tax expense. [IAS 36.6]. (A similar concept exists in U.S. GAAP, ASC 360-10-35-38, and ASC 360-10-35-43.)
Fair value method	In partial acquisitions in which control is obtained, the noncontrolling interest is recorded at its fair value. As a result, all of the acquiree's goodwill, including goodwill related to the controlling and noncontrolling interests, is recognized on the acquisition date. For U.S. GAAP companies, this method is required. For IFRS companies, this method can be chosen on a transaction by transaction basis and is not a policy election (see also proportionate share method below).
Favourable contract	A contract that is favourable in terms of current market terms. Favourable contracts are recognized as assets and are measured at fair value including the impact of renewal provisions (except reacquired rights) [ASC 805-10-55-20 through 55-23; IFRS 3.B36].
Finite useful life	The foreseeable limit on the period of time over which an asset is expected to contribute directly or indirectly to future cash flows.

Term	Definition
Freestanding financial instrument	A financial instrument that either (a) is entered into separately and apart from any of the entity's other financial instruments or equity transactions or (b) is entered into in conjunction with some other transaction and is legally detachable and separately exercisable.
Goodwill	An asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognised [ASC Glossary; IFRS 3.A].
Goodwill alternative	A private company accounting alternative for goodwill which permits amortisation of goodwill and provides an alternative model for assessing potential impairment (ASU 2014-02, *Accounting for Goodwill*).
Greenfield method	A variation of the income approach that is used for valuation of intangible assets. Under the greenfield method, the subject intangible asset is valued using a hypothetical cash flow scenario of developing an operating business in an entity that at inception only holds the subject intangible asset.
Held-and-used	While not defined in U.S. GAAP or IFRS, the term *held-and-used* is generally used to mean a long-lived asset that an entity: i. Uses in operations and does not plan to sell; ii. Plans to sell but has not yet satisfied the conditions in paragraph[s] ASC 360-10-45-9 [6-12 of IFRS 5] that must be met to classify the asset as held for sale; or iii. Plans to abandon, exchange for a similar productive long-lived asset, or distribute to owners in a spin-off.

Term	Definition
Held for sale	A long-lived asset (disposal group) to be sold shall be classified as held for sale in the period in which all of the following criteria are met: a. Management, having the authority to approve the action, commits to a plan to sell the asset (disposal group). b. The asset (disposal group) is available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such assets (disposal groups). c. An active program to locate a buyer and other actions required to complete the plan to sell the asset (disposal group) have been initiated. d. The sale of the asset (disposal group) is probable, and transfer of the asset (disposal group) is expected to qualify for recognition as a completed sale, within one year, except as permitted by ASC 360-10-45-11. e. The asset (disposal group) is being actively marketed for sale at a price that is reasonable in relation to its current fair value. The price at which a long-lived asset (disposal group) is being marketed is indicative of whether the entity currently has the intent and ability to sell the asset (disposal group). A market price that is reasonable in relation to fair value indicates that the asset (disposal group) is available for immediate sale, whereas a market price in excess of fair value indicates that the asset (disposal group) is not available for immediate sale. f. Actions required to complete the plan indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn [ASC 360-10-45-9]. (A similar concept exists in IFRS, IFRS 5.6-8).
Host instrument	The non-derivative component of a hybrid instrument which "hosts" an embedded derivative feature.

Term	Definition
Identifiable	An asset is identifiable if it meets either of the following criteria: a. It is separable, that is, capable of being separated or divided from the entity and sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract, identifiable asset, or liability, regardless of whether the entity intends to do so (separability criterion); [or] b. It arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations (contractual-legal criterion) [ASC 805-10-20; IFRS 3.A].
Impairment [loss]	**U.S. GAAP**—The condition that exists when the carrying amount of a long-lived asset (asset group) exceeds its fair value [ASC 360-10-20]. (A similar concept exists for indefinite lived intangible assets and goodwill in ASC 350.) **IFRS**—The amount by which the carrying amount of an asset or a cash generating unit exceeds its recoverable amount [IAS 36.6].
Income approach	Uses valuation techniques to convert future amounts (for example, cash flows or earnings) to a single present amount (discounted). The measurement is based on the value indicated by current market expectations about those future amounts [ASC Glossary; IFRS 13.A].
Indefinite useful life	**U.S. GAAP**—If no legal, regulatory, contractual, competitive, economic, or other factors limit the useful life of an intangible asset to the reporting entity, the useful life of the asset shall be considered to be indefinite. The term indefinite does not mean the same as infinite or indeterminate [ASC 350-30-35-4]. **IFRS**—When, based on an analysis of all of the relevant factors, there is no foreseeable limit to the period over which the asset is expected to generate net cash inflows for the entity [IAS 38.88].
Intangible assets	**U.S. GAAP**—Assets (not including a financial asset) that lack physical substance. (The term *intangible assets* is used to refer to intangible assets other than goodwill.) [ASC 805-10-20] **IFRS**—An identifiable nonmonetary asset without physical substance [IFRS 3.A].

Term	Definition
Internal rate of return (IRR)	The rate of return that would make the present value of future cash flows plus the final market value of an investment or business opportunity equal the current market price of the investment or opportunity.
Joint arrangement (IFRS only)	An arrangement where two or more parties contractually agree to share control [IFRS 11.A].
Market approach	A valuation technique that uses prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities (including a business) [ASC Glossary; IFRS 13.A].
Market participant	Buyers and sellers in the principal (or most advantageous) market who are independent, knowledgeable, and willing and able to transact for the asset or liability [ASC 820-10-20; IFRS 13.A].
Multiperiod excess earnings method	A variation of the income approach that is used for the valuation of intangible assets. Intangible assets are generally used in combination with other tangible and intangible assets to generate income. The other assets in the group are often referred to as "contributory assets," which contribute to the realisation of the intangible asset's value. Under this method, an estimate of an intangible asset's fair value starts with an estimate of the expected net income of a particular asset group. "Contributory asset charges" or "economic rents" are then deducted from the total net after-tax cash flows projected for the combined group to obtain the residual or "excess earnings" attributable to the intangible asset. The fair value of the asset is the present value of the excess earnings attributable to the intangible asset over its economic life.
Mutual entity	An entity other than an investor-owned entity that provides dividends, lower costs, or other economic benefits directly to its owners, members, or participants. Mutual insurance entities [companies], credit unions, and farm and rural electric cooperatives [cooperative entities] are examples of mutual entities [ASC 805-10-20; IFRS 3.A].
Net cash settlement	A form of settling a financial instrument under which the entity with a loss delivers to the entity with a gain cash equal to the gain.
Net operating losses (for income taxes)	Excess tax deductions over gross income in a year that results in tax losses.

Term	Definition
Net share settlement	A form of settling a financial instrument under which the entity with a loss delivers to the entity with a gain shares with a current fair value equal to the gain.
Noncontrolling interest (NCI)	The portion of equity (net assets) in a subsidiary not attributable, directly or indirectly, to a parent [ASC 805-10-20; IFRS 3.A].
Nonperformance risk	Nonperformance risk refers to the risk that the obligation will not be fulfilled and affects the value at which the liability is transferred. Nonperformance risk includes but may not be limited to the reporting entity's own credit risk [ASC Glossary]. (A similar concept exists in IFRS.)
Nonrecourse debt	Debt that is *secured* by a pledge of *collateral*, typically real property. If the borrower *defaults*, the issuer can seize the collateral, but the lender's recovery is limited to the collateral.
Nontaxable transaction	A business combination that for tax purposes is treated as the purchase and sale of an entity's stock. The tax bases of the acquired assets and liabilities carry over and are not stepped up (or down) to fair value.
Not-for-profit entities (U.S. GAAP only)	An entity that possesses the following characteristics, in varying degrees, that distinguish it from a business entity: a. Contributions of significant amounts of resources from resource providers who do not expect commensurate or proportionate pecuniary return b. Operating purposes other than to provide goods or services at a profit c. Absence of ownership interests like those of business entities Entities that clearly fall outside this definition include the following: a. All investor-owned entities b. Entities that provide dividends, lower costs, or other economic benefits directly and proportionately to their owners, members, or participants, such as mutual insurance entities, credit unions, farm and rural electric cooperatives, and employee benefit plans [ASC 958-10-20]
Onerous contract (Loss contract)	A contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it [ASC 805-10-55-21; IAS 37.10].

Term	Definition
Owners	**U.S. GAAP**—Used broadly to include holders of ownership interests (equity interests) of investor-owned entities, mutual entities, or not-for-profit entities. Owners include shareholders, partners, proprietors, or members or participants of mutual entities. Owners also include owner and member interests in the net assets of not-for-profit entities [ASC 805-10-20]. **IFRS**—Used broadly to include holders of equity interests of investor-owned entities and owners, members of, or participants in, mutual entities. This definition of owners is only to be used for purposes of IFRS 3 [IFRS 3.A].
Parent	**U.S. GAAP**—An entity that has a controlling financial interest in one or more subsidiaries. (Also, an entity that is the primary beneficiary of a variable interest entity.) [ASC Glossary] **IFRS**—An entity that controls one or more entities [IFRS 10.A].
Partial acquisition	The acquisition of a controlling interest that is less than 100 percent of the equity interest of the acquiree in which the acquirer did not have a previously held equity interest immediately before the acquisition date.
Physical settlement	A form of settling a financial instrument under which (a) the party designated in the contract as the buyer delivers the full stated amount of cash or other financial instruments to the seller and (b) the seller delivers the full stated number of shares of stock or other financial instruments or nonfinancial instruments to the buyer.
Predecessor-values Method (IFRS only)	Accounting method that can be adopted to account for business combinations between entities under common control. Financial statements under this method are required to be prepared using predecessor book values without any step up to fair value.
Preexisting relationship	A relationship that existed before the acquirer and acquiree contemplated a business combination. A preexisting relationship between the acquirer and acquiree may be contractual (for example, vendor and customer, or licensor and licensee) or noncontractual (for example, plaintiff and defendant) [ASC 805-10-55-20; IFRS 3.B51].
Preferred shares	An equity security that has preferential rights compared to common shares.

Term	Definition
Previously held equity interest	The equity interest in a subsidiary that was held by the parent company immediately before the acquisition date when a step acquisition occurs.
Principal market	The market with the greatest volume and level of activity for the asset or liability, which is presumed to be the market in which the reporting entity normally transacts, unless there is evidence to the contrary.
Proportionate share method (IFRS only)	In partial acquisitions in which control is obtained, the noncontrolling interest is measured at its proportionate share of the identifiable net assets of the acquiree at the acquisition date. As a result, goodwill is not recognized for the noncontrolling interest. Chosen on a transaction by transaction basis, not a policy election [IFRS 3.19].
Prospective financial information	Financial forecasts or financial projections, including the summaries of significant assumptions.
Pushdown accounting (U.S. GAAP only)	Use of the acquiring entity's basis of accounting in the preparation of the acquired entity's financial statements [ASC Glossary].
Put option	**U.S. GAAP**—A contract that allows the holder to sell a specified quantity of stock to the writer of the contract at a fixed price during a given period [ASC Glossary]. **IFRS**—Contracts that give the holder the right to sell ordinary shares at a specified price for a given period [IAS 33.5].
Reacquired right	The acquisition of a right that the acquirer had previously granted to the acquiree to use one or more of the acquirer's recognized or unrecognized assets [ASC 805-20-25-14; IFRS 3.B35].
Recoverable amount (IFRS only)	The higher of the fair value less costs of disposal of an asset or CGU and its value in use [IAS 36.6].
Relief from royalty method	A variation of the income approach that is used for valuation of intangible assets. The fundamental concept underlying this method is that in lieu of ownership, the acquirer can obtain comparable rights to use the subject asset via a license from a hypothetical third-party owner. The fair value of the asset is the present value of license fees avoided by owning it (i.e., the royalty savings) over its economic life.
Replacement award	An award of share-based compensation that is granted (or offered) concurrently with the cancellation of another award [ASC Glossary]. (A similar concept exists in IFRS).

Term	Definition
Replacement cost new	The indicated value of current labour and materials necessary to construct or acquire an asset of similar utility to the asset being measured.
Replacement cost new less depreciation	**Replacement cost new** adjusted to reflect any losses in value due to physical deterioration and/or functional obsolescence of the asset.
Reporting unit (U.S. GAAP only)	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) [ASC Glossary].
Research and development activities	**U.S. GAAP**—Research is planned search or critical investigation aimed at discovery of new knowledge with the hope that such knowledge will be useful in developing a new product or service (referred to as product) or a new process or technique (referred to as process) or in bringing about a significant improvement to an existing product or process. Development is the translation of research findings or other knowledge into a plan or design for a new product or process or for a significant improvement to an existing product or process whether intended for sale or use. It includes the conceptual formulation, design, and testing of product alternatives; construction of prototypes; and operation of pilot plants. It does not include routine or periodic alterations to existing products, production lines, manufacturing processes, and other on-going operations even though those alterations may represent improvements; and it does not include market research or market testing activities [ASC Glossary and ASC 730-10-15-4]. **IFRS**—Research is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding. Development is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems, or services before the start of commercial production or use [IAS 38.8].
Residual value	**U.S. GAAP**—The estimated fair value of an intangible asset at the end of its useful life to an entity, less any disposal costs [ASC Glossary]. **IFRS**—The estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life [IAS 38.8].

Term	Definition
Reverse acquisition	**U.S. GAAP**—An acquisition in which an entity that issues securities (the legal acquirer) is identified as the acquiree for accounting purposes based on the guidance in ASC 805-10-55-11 through 55-15. The entity whose equity interests are acquired (the legal acquiree) must be the acquirer for accounting purposes for the transaction to be considered a reverse acquisition [ASC 805-10-20]. **IFRS**—An acquisition where the acquirer is the entity whose equity interests have been acquired and the issuing entity is the acquiree. This might be the case when, for example, a private entity arranges to have itself 'acquired' by a smaller public entity as a means of obtaining a stock exchange listing [IFRS 3.21].
Separability criterion	See definition of *Identifiable*.
Spinoff	The transfer of assets that constitute a business by an entity (the spinnor) into a new legal spun-off entity (the spinnee), followed by a distribution of the shares of the spinnee to its shareholders, without the surrender by the shareholders of any stock of the spinnor [ASC Glossary].
Split-off	A transaction in which a parent entity exchanges its stock in a subsidiary for parent entity stock held by its shareholders [ASC Glossary].
Step acquisition	Also known as a business combination achieved in stages. When an acquirer obtains control of an acquiree in which it held an equity interest immediately before the acquisition date [ASC 805-10-25-9; IFRS 3.41].
Subsidiary	**U.S. GAAP**—An entity, including an unincorporated entity such as a partnership or trust, in which another entity, known as its parent, holds a controlling financial interest. (Also, a variable interest entity that is consolidated by a primary beneficiary.) [ASC Glossary] **IFRS**—An entity that is controlled by another entity [IFRS 10.A].
Tax base	When determining deferred taxes by comparing the amount of the asset or liability recorded in the financial statements to the amount attributed to that asset or liability for tax purposes, the tax base is the amount attributable to the asset or liability recorded in the financial statements.

Term	Definition
Taxable transaction	A business combination that for tax purposes is an asset transaction (purchase and sale of assets) or a stock transaction treated as an asset transaction (an election to do this is agreed to by both the seller and acquirer) and that for financial reporting purposes is considered the acquisition of a business. The tax bases of the acquired assets and liabilities are stepped up (or down) to fair value.
Temporary difference	**U.S. GAAP**—A difference between the tax basis of an asset or liability computed pursuant to the requirements in ASC 740-10 for tax positions, and its reported amount in the financial statements that will result in taxable or deductible amounts in future years when the reported amount of the asset or liability is recovered or settled, respectively [ASC Glossary]. **IFRS**—Differences between the carrying amount of an asset or liability in the statement of financial position and its tax base. Temporary differences may be either: i. taxable temporary differences, which are temporary differences that will result in taxable amounts in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled; or ii. deductible temporary differences, which are temporary differences that will result in amounts that are deductible in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled [IAS 12.5].
Total service period	The sum of the following amounts: a. the part of the requisite service period for the acquiree award that was completed before the acquisition date and b. the postcombination requisite service period, if any, for the replacement award. The requisite service period includes explicit, implicit, and derived service periods during which employees are required to provide service in exchange for the award (consistent with the requirements of ASC 718) [ASC 805-30-55-8 through 55-9]. (A similar concept exists in IFRS.)

Term	Definition
Unfavourable contract	A contract that is unfavourable in terms of current market terms. Unfavourable contracts are recognized as liabilities and are measured at fair value including the impact of renewal provisions. It is not necessarily a loss contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it [ASC 805-10-55-21; IFRS 3.B36].
Unit of account	That which is being measured by reference to the level at which an asset or liability is aggregated (or disaggregated) for recognition purposes [ASC 820-10-20; IFRS 13.A].
Unit of valuation	The level at which fair value of an asset is measured based on its use together with other assets as a group.
Useful life	**U.S. GAAP**—The period over which an asset is expected to contribute directly or indirectly to future cash flows [ASC Glossary]. **IFRS**—Either (i) the period of time over which an asset is expected to be used by the entity; or (ii) the number of production or similar units expected to be obtained from the asset by the entity [IAS 36.6].
Value in use	**U.S. GAAP**—The amount determined by discounting the future cash flows (including the ultimate proceeds of disposal) expected to be derived from the use of an asset at an appropriate rate that allows for the risk of the activities concerned [ASC Glossary]. **IFRS**—Present value of the future cash flows expected to be derived from an asset or cash generating unit [IAS 36.6].
Variable interest entity (U.S. GAAP only)	A legal entity subject to consolidation according to the provisions of the Variable Interest guidance in ASC 810-10 [ASC 810-10-20 and ASC Glossary].
Vesting conditions	The conditions that must be satisfied for the counterparty to become entitled to receive cash, other assets, or equity instruments of the entity, under a share-based payment arrangement. Vesting conditions include service conditions, which require the counterparty to complete a specified period of service, and performance conditions, which require specified performance targets to be met (such as a specified increase in the entity's profit over a specified period of time). A performance condition might include a market condition [IFRS 2.A].

Term	Definition
Vesting period	The period during which all the specified vesting conditions of a share-based payment arrangement are to be satisfied [IFRS 2.A].
Voting interest entity (U.S. GAAP only)	An entity that is not a variable interest entity, but one in which the equity investment is deemed sufficient to absorb the expected losses of the entity, and the equity investment has all of the characteristics of a controlling financial interest.
Weighted average cost of capital (WACC)	An average representing the expected return on all of a company's securities. Each source of capital, such as stocks, bonds, and other debt, is weighted in the calculation according to its prominence in the company's capital structure.
With and without method	A variation of the income approach that is used for valuation of intangible assets. The fundamental concept underlying this method is that the value of the subject intangible asset is the difference between an established, on-going business and one where the subject intangible asset does not exist. Under the with and without method, the value of the subject intangible asset is calculated by taking the difference between the business value estimated under two sets of cash flow projections: □ The value of the business with all assets in place at the valuation date □ The value of the business with all assets in place except the subject intangible asset at the valuation date Also, a method of allocating goodwill to a reporting unit that is not assigned any of the assets from a business combination but is expected to benefit from synergies.

Appendix D: Summary of significant changes

The 2014 global edition of *Business Combinations and Noncontrolling Interests* has been updated as of April 30, 2014, to reflect new and updated authoritative and interpretative guidance since the issuance of the 2013 edition. This appendix includes a summary of the noteworthy revisions to this guide.

Chapter 1: Scope

- **Section 1.3.4** was updated to reflect the most recent IFRS IC discussions regarding the accounting for mandatory tender offers.

- **Section 1.6.4** was added to highlight the issuance of the new investment entity standard under U.S. GAAP.

Chapter 2: Acquisition method

- **Section 2.5.7.2** was enhanced to provide further guidance related to measuring the fair value of an asset retirement obligation in a business combination.

- **Section 2.6.4.2** was updated to reflect the new guidance that clarifies the accounting for contingent consideration under IFRS.

- **Section 2.6.5.1** was updated to provide guidance for private companies on the classification of certain equity securities under U.S. GAAP.

- **Section 2.6.6.1** was expanded to enhance guidance regarding the accounting for puts and calls related to noncontrolling interests under U.S. GAAP.

- **Section 2.6.6.2** was expanded to enhance guidance regarding the accounting for puts and calls related to noncontrolling interests under IFRS.

- **Section 2.7.3** was enhanced by adding Example 2-25 to illustrate the settlement of a preexisting relationship for an inter-entity debt.

- **Section 2.10.1** was updated to reflect the most recent IFRS guidance regarding the accounting for reverse acquisitions involving a nonoperating public shell and a private operating entity.

- **Section 2.10.3** was enhanced by adding Example 2-33 to illustrate the presentation of shareholders' equity following a reverse acquisition.

- **Section 2.13** was added to include transition requirements related to certain assets and liabilities acquired or assumed prior to the effectiveness date of the Standards. This guidance was included in BCG 8.7 of the 2013 edition.

Chapter 4: Intangible assets acquired in a business combination

- **Section 4.3.5.1** was updated to highlight the issuance of the AICPA's IPR&D Guide.

Chapter 5: Income tax implications in business combinations

- **Sections 5.4.4 and 5.4.4.2** were updated to clarify the accounting for deferred taxes resulting from contingent consideration in a nontaxable transaction.

Chapter 6: Partial acquisitions, step acquisitions, and accounting for changes in the noncontrolling interest

- **Section 6.10** was updated to enhance the discussion of EPS considerations when the noncontrolling interest in the parent company's consolidated balance sheet is in the form of subsidiary preferred stock.

Chapter 7: Valuation

- **Section 7.6.1.1 (formerly Section 7.4.1.1)** was expanded to address the distributor method for valuing customer relationships.

- **Section 7.7.3 (formerly Section 7.5.3)** was updated. This guidance is now included in PwC's accounting and financial reporting guide for *Fair value measurements, a global edition*.

- **Section 7.9.1 (formerly Section 7.8.1)** was updated to include key considerations in determining fair value when measuring impairment.

Chapter 8: Business combinations presentation, disclosure and continuing transition requirements

- **Chapter 8** disclosure information was removed. This guidance is now included in PwC's accounting and financial reporting guide for *Financial statement presentation*.

- **Section 8.7** which addresses transition guidance was moved to Section 2.13.

Chapter 9: Noncontrolling interest presentation and disclosure requirements

- **Chapter 9** presentation and disclosure guidance was removed. This guidance is now included in PwC's accounting and financial reporting guide for *Financial statement presentation*.

Chapter 10: Accounting for tangible and intangible assets postacquisition—U.S. GAAP

- **Section 10.2.6.1** was added and **Sections 10.4.4.3 and 10.4.5.1** were updated to reflect guidance included in the recently issued AICPA IPR&D Guide.

Chapter 11: Accounting for goodwill postacquisition—U.S. GAAP

- **Section 11.4.4** was enhanced by adding Example 11-11 to illustrate the reassignment of goodwill when there is a change in reporting structure that causes a change in reporting units.

- **Sections 11.5.1.1, 11.5.8.1, 11.5.8.2, and 11.5.8.6** were updated to reflect guidance included in the recently issued AICPA Goodwill Guide.

- **Section 11.5.9.2** was enhanced to illustrate how the ownership structure of an entity may impact whether a noncontrolling interest shares in the benefits of synergies available to a parent company when measuring the fair value of a reporting unit.

- **Section 11.8** was added to address the new alternative model available to private companies for amortization and impairment testing of goodwill.

Chapter 12: Postacquisition accounting issues—IFRS

- **Section 12.3.2** was updated to reflect the new guidance clarifying the accounting for contingent consideration under IFRS.

Appendix A: Common control transactions under U.S. GAAP

- **Appendix A and Appendix B** were combined and renumbered Chapter 8.

- **Section 8.2.3.4** was updated to enhance the discussion related to the accounting for downstream mergers.

- **Section 8.2.4.3** was added to reflect the accounting for nonreciprocal transfers to owners.

Appendix B: Common control transactions under IFRS

- **Appendix A and Appendix B** were combined and renumbered Chapter 8.

Appendix C: Asset acquisitions

- **Appendix C** was renumbered Chapter 9.

Appendix D: Disclosure, reporting and push down accounting considerations for companies filing under United States Securities and Exchange Commission (SEC) rules

- **Appendix D, Appendix E, and Appendix F** were combined and renumbered Chapter 13: Other business combination considerations.

- **Section 13.2.7** was added to include discussion on the accounting for rescissions of mergers.

- **Section 13.2.10.4** was updated to highlight the recently issued FASB guidance on accounting for obligations resulting from joint and several liability arrangements.

Appendix E: Internal control implications

- **Appendix D, Appendix E, and Appendix F** were combined and renumbered Chapter 13: Other business combination considerations.

- **Section 13.3.2** was updated to enhance the discussion about review controls for business combinations.

Appendix F: Insurance industry considerations

- **Appendix D, Appendix E, and Appendix F** were combined and renumbered Chapter 13: Other business combination considerations.

- **Section 13.4.4.1** was updated to enhance the discussion related to the accounting for acquired insurance contracts for which the coverage period of the underlying contracts has ended.

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About PwC's National Accounting Services Group

The Accounting Services Group (ASG) within the Firm's National Quality Organization leads the development of Firm perspectives, points of view, and client impacts used to inform the capital markets, regulators, and policy makers. The team of experienced Partners, Directors, and Senior Managers helps develop talking points, perspectives, and presentations for when Senior Leadership interacts with the media, policy makers, academia, regulators, etc. ASG assesses and communicates the implications of technical and professional developments on the profession, clients, investors, and policy makers. The team consults on complex accounting and financial reporting matters and works with clients to resolve issues raised in SEC comment letters. They work with the standard setting and regulatory processes through communications with the FASB, SEC, and others. The team provides market services such as quarterly technical webcasts and external technical trainings, including our alumni events. The team is also responsible for sharing their expert knowledge on topics through internal and external presentations and by authoring various PwC publications. In addition to working with the U.S. Market, ASG also has a great deal of involvement in global issues. The ASG team has a large global team that is vastly involved in the convergence of U.S. GAAP and IFRS standards, and that has developed strong relationships with the IASB.

About PwC

PwC United States helps organizations and individuals create the value they're looking for. We're a member of the PwC network of firms in 158 countries with close to 169,000 people. We're committed to delivering quality in assurance, tax, and advisory services. Tell us what matters to you and find out more by visiting us at www.pwc.com/US.

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