PROFESSOR’S DISCUSSION MATERIALS

Objectives of the Case

This case gives students an opportunity to determine whether a transaction is part of the exchange for an acquiree or is separate from the business combination.

Applicable Professional Pronouncements

ASC 405-20, Liabilities: Extinguishments of Liabilities (ASC 405-20)

ASC 470-50, Debt: Modifications and Extinguishments (ASC 470-50)

ASC 805-10, Business Combinations: Overall (ASC 805)

ASC 805-20, Business Combinations: Identifiable Assets and Liabilities, and Any Noncontrolling Interest (ASC 805-20)

ASC 805-30, Business Combinations: Goodwill or Gain From Bargain Purchase, Including Consideration Transferred (ASC 805-30)

IFRS 3 (Revised 2008), Business Combinations (IFRS 3)

Discussion 1

Should the extinguishment of Healthy Hearts’ debt (i.e., the Notes) be included in Healthy Hearts’ precombination financial statements or Cool Care’s postcombination consolidated financial statements? Depending on the answer, determine the gain or loss on the extinguishment of debt to be recognized. (Note that for this question, the precombination financial statements represent Healthy Hearts’ operations before the Acquisition and the postcombination financial statements represent Cool Care’s consolidated financial statements after the Acquisition.)

Alternative 1 — The extinguishment of debt and related gain should be recorded in Healthy Hearts’ precombination financial statements.

Under this alternative, Healthy Hearts should derecognize the carrying value of the Notes and record a gain or loss from the extinguishment of debt for the difference between the net carrying value of the Notes and cash paid to redeem the Notes in its financial statements that precede the combination (i.e., the precombination financial statements).

Proponents of Alternative 1 point to the following guidance:

Professor’s Note: Once the students have had an opportunity to examine the facts of the case, it may be helpful to instruct them to review the guidance in ASC 805-10-25-20 and 25-21 before they begin discussing the required questions.
ASC 805-10-25-20 provides the following principle for determining what should be included as part of the accounting for the business combination transaction and states, in part:

[T]he acquirer shall identify any amounts that are not part of what the acquirer and the acquiree (or its former owners) exchanged in the business combination, that is, amounts that are not part of the exchange for the acquiree. **The acquirer shall recognize as part of applying the acquisition method only the consideration transferred for the acquiree and the assets acquired and liabilities assumed in the exchange for the acquiree. Separate transactions shall be accounted for in accordance with the relevant generally accepted accounting principles (GAAP).** [Emphasis added]

Because Healthy Hearts was the party that redeemed the Notes under the terms of the Tender Offer, and since the redemption was completed contemporaneously with the Acquisition, the Notes should not be considered part of the consideration transferred or liabilities assumed in the exchange for the acquiree pursuant to ASC 805-10-25-20 (above). Rather, Healthy Hearts should account for the redemption of the Notes and for the extinguishment gain or loss in its precombination financial statements.

ASC 405-20-40-1¹ states that “a debtor shall derecognize a liability if and only if it has been extinguished. A liability has been extinguished if . . . [t]he debtor pays the creditor and is relieved of its obligation for the liability.” In this case, Healthy Hearts has settled its liability because of the Tender Offer and it should therefore derecognize the debt obligation as part of preparing its final balance sheet as of the time of the closing.

The guidance continues in ASC 470-50-40-2 regarding the treatment of the gain or loss on extinguishment of debt, stating that “[a] difference between the reacquisition price of debt and the net carrying amount of the extinguished debt shall be recognized currently in income of the period of extinguishment as losses or gains and identified as a separate item. Gains and losses shall not be amortized to future periods.” Accordingly, Healthy Hearts recognizes the gain or loss on extinguishment at the time it reacquires the Notes pursuant to the Tender Offer.

**Alternative 2 — The extinguishment of debt should be recorded by Cool Care in its postcombination consolidated financial statements.**

Under this alternative, Cool Care should account for the redemption of the Notes in its postcombination consolidated financial statements as either part of the consideration transferred or as the settlement of a liability.

The support for this conclusion is included in ASC 805-10-25-20, which provides the following principle for determining what is part of a business combination transaction:

[T]he acquirer shall identify any amounts that are not part of what the acquirer and the acquiree (or its former owners) exchanged in the business combination, that is, amounts that are not part of

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¹ FASB Accounting Standards Update (ASU) No. 2016-04, Liabilities — Extinguishments of Liabilities (Subtopic 405-20): Recognition of Breakage for Certain Prepaid Stored-Value Products, which amended ASC 405-20-40-1, is effective for fiscal years ending after December 15, 2017. However, the pending content of this paragraph does not have an impact on this case or analysis.
the exchange for the acquiree. **The acquirer shall recognize as part of applying the acquisition method only the consideration transferred for the acquiree and the assets acquired and liabilities assumed in the exchange for the acquiree. Separate transactions shall be accounted for in accordance with the relevant generally accepted accounting principles (GAAP).** [Emphasis added]

ASC 805-10-55-18 (included below) provides further interpretive guidance on factors to consider when evaluating what is part of a business combination.

[T]he acquirer should consider the following factors, which are neither mutually exclusive nor individually conclusive, to determine whether a transaction is part of the exchange for the acquiree or whether the transaction is separate from the business combination:

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 the 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. [Emphasis added]

The settlement of the Notes was initiated by Cool Care during negotiations of the Acquisition because Cool Care could obtain cheaper financing elsewhere. However, Cool Care would not have settled Healthy Hearts’ debt in the absence of the Acquisition transaction. This suggests that the settlement is part of the business combination and a postacquisition event (i.e., should be recorded in Cool Care’s postcombination consolidated financial statements).
The case does not explicitly state whether Cool Care legally assumed the Notes as part of the business combination. If Cool Care legally assumed the Notes as part of the acquisition, the fair value of the Notes would be recognized as a liability assumed in acquisition accounting, which were then immediately settled. If Cool Care did not legally assume the Notes, no liability for the Notes would be recognized as part of the acquisition accounting. The consideration transferred would be higher by the settlement amount of the Notes. The accounting is as if Cool Care paid the seller of Healthy Hearts and the seller then repaid the Notes themselves. Regardless, the amount of goodwill recognized in the Acquisition would be the same.

**Professor’s Note:** ASC 805-20 requires that an acquirer should measure assumed liabilities at their acquisition-date fair value. However, ASC 805 does not provide explicit guidance regarding whether debt that is extinguished simultaneously with the closing of the business combination should be reflected as an extinguishment by the acquirer or the acquiree. The guidance in ASC 805-30-30-9 through 30-11 (included below) on an acquirer’s accounting for share-based payment awards exchanged for acquiree awards in a business combination provides a useful analogy.

Occasionally, acquirers substitute their own share-based payment awards for those of the acquiree. Although this is not the situation in this case, it can provide a useful analogy to compare the accounting for the replacement of these awards with the “replacement” of Healthy Hearts’ Notes.

ASC 805-30-30-9 through 30-11 state, in part:

**30-9** If the acquirer is obligated to replace the acquiree awards, either all or a portion of the fair-value-based measure of the acquirer’s replacement awards shall be included in measuring the consideration transferred in the business combination.

**30-10** In situations in which acquiree awards would expire as a consequence of a business combination and the **acquirer replaces those awards even though it is not obligated to do so, all of the fair-value-based measure of the replacement awards shall be recognized as compensation cost in the postcombination financial statements.**

**30-11** The portion of the fair-value-based measure of the replacement award that is part of the consideration transferred in exchange for the acquiree equals the portion of the acquiree award that is attributable to precombination vesting. [Emphasis added]

This guidance notes that when an acquirer is obligated to replace share-based payment awards because of terms in the award agreement, it should consider such costs part of the business combination.

**Solution**

Alternative 2 is the most appropriate solution because while Healthy Hearts redeemed the Notes, the decision to redeem the Notes was made by Cool Care for its benefit.
ASC 805-20-30-1 requires that an acquirer should measure assumed liabilities at their acquisition-date fair value. Accordingly, if Cool Care legally assumed the Notes, it would (1) initially record the Notes at their acquisition-date fair value and (2) recognize any difference between the acquisition-date fair value of the Notes and the consideration paid to redeem the Notes as an extinguishment gain or loss in its postcombination consolidated financial statements pursuant to ASC 470-50-40. As indicated in the case facts, the acquisition-date fair value of the Notes was equal to the amount paid to redeem the Notes; therefore, Cool Care would not recognize a gain or loss from the extinguishment of debt.

**Discussion 2**

Are there differences between IFRS 3 and ASC 805 that should be considered?

**Solution**

*ASC 805 and IFRS 3 are consistent under this fact pattern.*

The guidance under IFRS 3 that should be applied to the fact pattern is parallel to ASC 805, and therefore the accounting considerations under ASC 805 and IFRS 3 for this fact pattern are consistent. Note that the FASB and IASB jointly developed the current guidance on business combinations, and the resulting standards present parallel guidance for determining what should be accounted for as part of the business combination.

Specifically, paragraphs 51 and 52 of IFRS 3 state, in part:

**51** The acquirer and the acquiree may have a pre-existing 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, i.e., 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 IFRSs.

**52** A transaction entered into by or on behalf of the acquirer or primarily for the benefit of the acquiree or the combined entity, rather than primarily for the benefit of the acquiree (or its former owners) before the combination, is likely to be a separate transaction. The following are examples of separate transactions that are not to be included in applying the acquisition method:
a. a transaction that in effect settles pre-existing relationships between the acquirer and acquiree;
b. a transaction that remunerates employees or former owners of the acquiree for future services; and
c. a transaction that reimburses the acquiree or its former owners for paying the acquirer's acquisition-related costs.

Paragraphs B56 through B58 of IFRS 3 also provide similar guidance regarding the replacement of share-based payment awards, stating, in part:

**B56** If the acquirer replaces the acquiree awards, either all or a portion of the market-based measure of the acquirer's replacement awards shall be included in measuring the consideration transferred in the business combination. Paragraphs B57–B62 provide guidance on how to allocate the market-based measure.

However, in situations in which acquiree awards would expire as a consequence of a business combination and if the acquirer replaces those awards **when it is not obliged to do so**, all of the market-based measure of the replacement awards shall be recognised as remuneration cost in the post-combination financial statements in accordance with IFRS 2. [Emphasis added]

**B57** To determine the portion of a replacement award that is part of the consideration transferred for the acquiree and the portion that is remuneration for post-combination service, the acquirer shall measure both the replacement awards granted by the acquirer and the acquiree awards as of the acquisition date in accordance with IFRS 2. The portion of the market-based measure of the replacement award that is part of the consideration transferred in exchange for the acquiree equals the portion of the acquiree award that is attributable to pre-combination service.

**B58** The portion of the replacement award attributable to pre-combination service is the market-based measure of the acquiree award multiplied by the ratio of the portion of the vesting period completed to the greater of the total vesting period or the original vesting period of the acquiree award. The vesting period is the period during which all the specified vesting conditions are to be satisfied. Vesting conditions are defined in IFRS 2.

Therefore, Cool Care and Healthy Hearts should account for the extinguishment of the Notes in the same manner under IFRSs as they would under U.S. GAAP.
**Professor’s Note:** After reviewing the guidance in ASC 805 and IFRS 3, students may note that there is a Basis for Conclusions section within IFRS 3 that does not exist within ASC 805. Although some students may assert that this could provide a basis for alternative accounting treatment under IFRS 3, it should be noted that the guidance in the Basis for Conclusions only clarifies the IASB’s rationale for the actual authoritative guidance in the standard and is not intended to provide incremental guidance. Also, although the Basis for Conclusions is not codified under U.S. GAAP, FASB Statement No. 141(R), *Business Combinations* (the original pronouncement that serves as the primary source of ASC 805), does include a Basis for Conclusions that mirrors that section in IFRS 3. The original FASB Statement 141(R) can be accessed under the superseded standards section of the FASB’s Web site. Although not authoritative, the Basis for Conclusions sections in the FASB’s original source pronouncements are still referred to in practice in much the same way as they are in IFRSs.