Publications in Deloitte’s Roadmap Series

Business Combinations
Business Combinations — SEC Reporting Considerations
Carve-Out Transactions
Comparing IFRS Standards and U.S. GAAP
Consolidation — Identifying a Controlling Financial Interest
Contingencies, Loss Recoveries, and Guarantees
Contracts on an Entity’s Own Equity
Convertible Debt
Current Expected Credit Losses
Debt
Distinguishing Liabilities From Equity
Earnings per Share
Environmental Obligations and Asset Retirement Obligations
Equity Method Investments and Joint Ventures
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Fair Value Measurements and Disclosures (Including the Fair Value Option)
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Guarantees and Collateralizations — SEC Reporting Considerations
Impairments and Disposals of Long-Lived Assets and Discontinued Operations
Income Taxes
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Preface

November 2020

To our clients, colleagues, and other friends:

We are pleased to present the 2020 edition of *A Roadmap to Accounting for Business Combinations*. This Roadmap provides Deloitte’s insights into and interpretations of the guidance in ASC 805 on business combinations, pushdown accounting, common-control transactions, and asset acquisitions as well as an overview of related SEC reporting requirements. The Roadmap reflects guidance issued through November 25, 2020, as well as several active FASB projects that may result in changes to current requirements. Appendix H highlights all new content in the Roadmap as well as any substantive revisions to previous content.

Subscribers to the Deloitte Accounting Research Tool (DART) may access any interim updates to this publication by selecting the Roadmap from the Roadmap Series page on DART. If a “Summary of Changes Since Issuance” displays, subscribers can view those changes by clicking the related links or by opening the “active” version of the Roadmap.

The accounting frameworks for business combinations, pushdown accounting, common-control transactions, and asset acquisitions have been in place for many years. However, views on the application of the frameworks continue to evolve, and entities may need to use significant judgment in applying them to current transactions.

While this Roadmap is intended to be a helpful resource, it is not a substitute for consultation with professional advisers. We hope that we will have the opportunity to serve you as you complete your business combination transactions.

Sincerely,

Deloitte & Touche LLP

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1 For a list of the titles of standards and other literature referred to in this publication, see Appendix F. For a list of abbreviations used in this publication, see Appendix G.
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Chapter 1 — Overview of Accounting for Business Combinations

In the first phase of its business combinations project, which was completed in 2001, the FASB issued Statements 141 and 142. Statement 141 required that a single method — the purchase method — be used to account for all acquisitions of businesses and eliminated the pooling-of-interest method of accounting for business combinations. Statement 142 (codified in ASC 350) introduced new criteria for recognizing intangible assets separately from goodwill, provided criteria for testing goodwill for impairment, and eliminated the amortization of goodwill.

In December 2007, the FASB completed the second phase of the project, addressing the accounting rules for business combinations that were not reconsidered in the first phase. The second phase ultimately resulted in the issuance of two standards: Statement 141(R) (codified in ASC 805) and Statement 160 (codified in ASC 810-10).

ASC 805 introduces the term “acquisition method of accounting” (or “acquisition method”), which refers to the approach used to account for a business combination. This term was intended to be broader than the former term, “purchase method,” and to align with the revised definition of a business combination, which includes any transaction or event in which an acquirer obtains control of a business, not just a transaction in which a business is purchased.

The underlying premise of ASC 805 is that when an entity obtains control of a business, it becomes accountable for all of its assets and liabilities and therefore should recognize the assets acquired and liabilities assumed at their fair values on the acquisition date. Accordingly, the recognition and measurement of the assets acquired and liabilities assumed should be the same regardless of whether the acquirer obtains a 100 percent or lesser controlling interest in a business.

In a manner consistent with that premise, ASC 805 has two key principles, known as the “recognition principle” and the “measurement principle.” According to the recognition principle, an acquirer must “recognize, separately from goodwill, the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree.” Under the measurement principle, the acquirer must then measure “the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree at their acquisition-date fair values.” The objective of the principles is to provide guidance that an acquirer can apply when ASC 805 does not provide specific recognition or measurement guidance for a particular asset or liability. Although ASC 805 includes a number of exceptions to the recognition principle, the measurement principle, or both (e.g., exceptions for preacquisition contingencies, employee benefits, and income taxes), in the absence of a specific exception, an acquirer is expected to apply the principles in accounting for the items exchanged in a business combination.
The FASB worked with the International Accounting Standards Board (IASB®) on the second phase of the business combinations project. The boards concurrently deliberated and reached the same conclusions on most issues. As a result, the FASB’s and IASB’s standards on business combinations are substantially converged. Appendix E of this publication summarizes significant differences between the two sets of standards.

Since issuing Statement 141(R) (codified in ASC 805) in December 2007, the FASB has issued updates to the accounting requirements in ASC 805 for business combinations. Those updates are discussed throughout this publication.

1.1 Summary of Accounting for Business Combinations

1.1.1 Identifying a Business Combination

Before an entity can apply the acquisition method, it must determine whether a transaction meets the definition of a business combination. The ASC master glossary defines a business combination as "[a] transaction or other event in which an acquirer obtains control of one or more businesses." Typically, a business combination occurs when an entity purchases the equity interests or the net assets of one or more businesses in exchange for cash, equity interests of the acquirer, or other consideration. However, the definition of a business combination applies to more than just purchase transactions: it incorporates all transactions or events in which an entity or individual obtains control of a business.

Control has the same meaning as “controlling financial interest,” and an entity applies the guidance in ASC 810-10 to determine whether it has obtained a controlling financial interest in a business. Under ASC 810-10, an entity determines whether it has obtained a controlling financial interest by applying the variable interest entity (VIE) model or the voting interest entity model. Chapter 2 of this publication addresses the determination of whether a transaction should be accounted for as a business combination.

1.1.2 Determining Whether the Acquiree Meets the Definition of a Business

For a transaction to meet the definition of a business combination, the entity or net assets acquired must meet the definition of a business in ASC 805. In January 2017, the FASB issued ASU 2017-01 to clarify the definition of a business because the previous definition in ASC 805 was often applied so broadly that transactions that were more akin to asset acquisitions were being accounted for as business combinations. The ASU introduces a screen for determining when a set of activities and assets is not a business. An entity uses the screen to assess whether substantially all of the fair value of the gross assets acquired (or disposed of) is concentrated in a single identifiable asset or group of similar identifiable assets. If so, the set is not a business. The screen is intended to reduce the number of transactions that an entity must further evaluate to determine whether they are business combinations or asset acquisitions.

If the screen is not met, a set cannot be considered a business unless it includes an input and a substantive process that together significantly contribute to the ability to create outputs. Under the previous definition of a business, it was not always clear whether an element was an input or a process or whether a process had to be substantive to affect the determination. Therefore, the ASU provides a framework to help entities evaluate whether both an input and a substantive process are present.

Chapter 2 of this publication addresses whether the entity or the net assets acquired meet the definition of a business.
1.1.3 Steps to Applying the Acquisition Method

As described in ASC 805-10-05-4, applying the acquisition method requires all the following steps:

1. “Identifying the acquirer” — see Section 1.1.4 below.
2. “Determining the acquisition date” — see Section 1.1.5 below.
3. “Recognizing and measuring the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree” — see Section 1.1.6 below.
4. “Recognizing and measuring goodwill or a gain from a bargain purchase” — see Section 1.1.7.

1.1.4 Identifying the Acquirer

The acquisition method includes four steps, the first of which is identifying the acquirer. The ASC master glossary defines an acquirer as “[t]he entity that obtains control of the acquiree.” The process of identifying the acquirer begins with consideration of the guidance in ASC 810-10, which will often clearly indicate which of the parties is the acquirer. However, if it is not clear which of the combining entities has obtained control of the other after the guidance in ASC 810-10 has been considered, entities should identify the acquirer by applying the factors in ASC 805. Chapter 3 of this publication addresses the determination of the acquirer.

1.1.5 Determining the Acquisition Date

The second step in the acquisition method is determining the acquisition date, which is the date on which the acquirer obtains control of the acquiree and usually is the date on which the acquirer legally transfers the consideration to the seller, receives the assets, and incurs or assumes the liabilities (i.e., the closing date). However, in unusual circumstances, the acquisition date can be before or after the closing date. Chapter 3 of this publication addresses the determination of the acquisition date.

1.1.6 Recognizing and Measuring the Identifiable Assets, Liabilities, and Noncontrolling Interests in the Acquiree

The third step in the acquisition method is recognizing and measuring the identifiable assets, liabilities, and any noncontrolling interest in the acquiree. According to the recognition principle in ASC 805-20-25-1, an acquirer must “recognize, separately from goodwill, the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree.” Under the measurement principle in ASC 805-20-30-1, the acquirer must then “measure the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree at their acquisition-date fair values.” However, certain assets or liabilities are exceptions to the recognition principle, the measurement principle, or both, and are measured in accordance with other GAAP. For example:

- Income taxes are recognized and measured in accordance with ASC 740.
- Acquired contingencies whose fair value is not determinable during the measurement period are recognized only if they are probable and reasonably estimable.
- Assumed pension and postretirement benefit obligations are measured and recognized in accordance with ASC 715. The effects of expected terminations, curtailments, or amendments of an assumed acquiree benefit plan are not included in acquisition accounting.
- Indemnification assets associated with assets or liabilities recognized in a business combination are recognized and measured by using assumptions that are consistent with those used to measure the item they are related to, subject to any contractual limitations on the indemnification amount and management’s assessment of collectibility.
Chapter 4 of this publication addresses the measurement and recognition of identifiable assets, liabilities, and noncontrolling interests.

1.1.7 Recognizing and Measuring the Consideration Transferred and Goodwill or Bargain Purchase Gains

The fourth and final step in the acquisition method is recognizing and measuring goodwill or a gain from a bargain purchase. Because goodwill is not separately identifiable, it cannot be measured directly. Goodwill is measured as a residual and is calculated as the excess of the sum of (1) the consideration transferred, (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 acquiree’s previously held equity interest in the acquiree over the net of the acquisition-date amounts of the identifiable assets acquired and liabilities assumed. If the sum of items (1) through (3) above is less than the net assets acquired, the acquirer recognizes a gain, referred to as a bargain purchase gain, in earnings, but only after reassessing whether the items exchanged in the business combination were appropriately recognized and measured.

The consideration transferred by the acquirer to the seller can take many forms, including cash, other tangible or intangible assets, contingent consideration, and the acquirer’s equity interests such as common or preferred shares, options, warrants, and share-based payment awards. It can also include noncash assets, which may or may not stay within the combined entity after the acquisition. Items of consideration transferred in a business combination are measured at fair value on the acquisition date, with the exception of acquirer share-based payment awards, which are measured by using a fair-value-based measure in accordance with ASC 718.

Chapter 5 of this publication addresses the measurement of goodwill or a bargain purchase gain as well as the items of consideration transferred in a business combination.

In some business combinations, no consideration is transferred and goodwill must be measured by using the fair value of the acquiree. In other business combinations, the acquirer obtains a controlling, but less than a 100 percent, interest in the acquiree or has an equity interest in the acquiree before the date on which it obtains control. Chapter 6 of this publication addresses the measurement of goodwill or a bargain purchase gain in these scenarios.

1.1.8 Measurement Period

Because it may take time for an entity to obtain the information necessary to recognize and measure all the items exchanged in a business combination, the acquirer is allowed a period in which to complete its accounting for the acquisition. That period — referred to as the measurement period — ends as soon as the acquirer (1) receives the information it had been seeking about facts and circumstances that existed as of the acquisition date or (2) learns that it cannot obtain further information. However, the measurement period cannot be more than one year after the acquisition date. During the measurement period, the acquirer recognizes provisional amounts for the items for which the accounting is incomplete. Adjustments to any of these items will affect the amount of goodwill recognized or bargain purchase gain.

ASC 805 originally required that if a measurement-period adjustment was identified, the acquirer retrospectively revised comparative information for prior periods, including making any change in depreciation, amortization, or other income effects as if the accounting for the business combination had been completed as of the acquisition date. However, revising prior periods to reflect measurement-period adjustments added cost and complexity to financial reporting and many believed it did not significantly improve the usefulness of the information provided to users. To address those concerns,
the FASB issued ASU 2015-16 in September 2015. Under the ASU, an acquirer must recognize adjustments to provisional amounts that are identified during the measurement period in the reporting period in which the adjustment amounts are determined rather than retrospectively. The acquirer would include the effect on earnings of changes in depreciation or amortization, or other income effects (if any) as a result of the change to the provisional amounts, calculated as if the accounting had been completed as of the acquisition date. Chapter 6 of this publication addresses issues related to the measurement period.

1.1.9 Determining What Is Part of the Business Combination

An acquirer must assess whether any assets acquired, liabilities assumed, or portion of the consideration transferred is not part of the exchange for the acquiree. Examples of items that are not part of the exchange for the acquiree include payments that effectively settle preexisting relationships between the acquirer and acquiree, payments to compensate employees or former shareholders of the acquiree for future services, and reimbursement of the acquirer's transaction costs. Such items must be accounted for separately from the business combination. Chapter 6 of this publication addresses items that should be accounted for separately from a business combination.

1.1.10 Presentation and Disclosure

The FASB developed an overall disclosure objective for information related to a business combination. In accordance with this objective, an acquirer must disclose enough information for users to evaluate the nature and financial effect of a business combination. ASC 805 also contains detailed requirements related to the disclosures an entity must provide at a minimum to meet that disclosure objective. However, if the disclosures an entity provides under these requirements (along with those provided under other GAAP) do not meet the overall disclosure objective, an acquirer must disclose any additional information necessary. Chapter 7 of this publication addresses presentation and disclosure requirements for business combinations.

1.1.11 Private-Company and Not-for-Profit Entity Accounting Alternatives

In 2012, the Financial Accounting Foundation, which oversees the FASB, established the Private Company Council (PCC), which is tasked with improving accounting standard setting for private companies. The PCC has two principal responsibilities:

1. To determine whether exceptions or modifications to existing nongovernmental U.S. GAAP are necessary to address the needs of users of private-company financial statements. The PCC identifies, deliberates, and votes on any proposed changes, which are subject to endorsement by the FASB and submitted for public comment before being incorporated into GAAP.

2. To advise the FASB regarding how private companies should treat items under active consideration on the FASB's technical agenda.

In December 2014, the FASB issued ASU 2014-18, which gives private companies the option of not recognizing separately from goodwill the following intangible assets: (1) customer-related intangible assets, unless they can be sold or licensed independently from other assets of a business, and (2) noncompetition agreements.
The FASB’s issuance of ASU 2014-02 in January 2014 gives private companies a simplified alternative for the subsequent accounting for goodwill. It allows private companies the option of (1) amortizing goodwill on a straight-line basis over a useful life of 10 years or less than 10 years if the entity is able to demonstrate that a shorter useful life is more appropriate, (2) testing goodwill for impairment only when a triggering event occurs instead of having to perform the test at least annually, and (3) testing goodwill for impairment at either the entity level or the reporting-unit level. The ASU also eliminates step 2 of the goodwill impairment test.

In May 2019, the FASB issued ASU 2019-06, which extends the private-company accounting alternatives for certain identifiable intangible assets and goodwill to not-for-profit entities. Chapter 8 of this publication addresses the private-company and not-for-profit entity accounting alternatives related to business combinations.

1.2 Pushdown Accounting

When an entity obtains control of a business, a new basis of accounting is established in the acquirer’s financial statements for the assets acquired and liabilities assumed. Sometimes the acquiree prepares separate financial statements after its acquisition. Use of the acquirer’s basis of accounting in the preparation of an acquiree’s separate financial statements is called “pushdown accounting.”

In November 2014, the FASB issued ASU 2014-17, which gives an acquiree the option of applying pushdown accounting in its separate financial statements when it undergoes a change in control. Before the issuance of ASU 2014-17, the guidance on pushdown accounting only applied to SEC registrants and was based on bright lines that provided opportunities for structuring and the potential for misapplication. ASU 2014-17, which was codified into the “Pushdown Accounting” subsections of ASC 805-50, now provides both public and nonpublic entities with authoritative guidance on applying pushdown accounting. Appendix A of this publication addresses the application of pushdown accounting.

1.3 Common-Control Transactions

A common-control transaction does not meet the definition of a business combination because there is no change in control over the net assets. The accounting for these transactions is addressed in the “Transactions Between Entities Under Common Control” subsections of ASC 805-50.

In a common-control transaction, the net assets are derecognized by the transferring entity and recognized by the receiving entity at the historical cost of the parent of the entities under common control. Any difference between the proceeds transferred or received and the carrying amounts of the net assets is recognized in equity in the transferring and receiving entities’ separate financial statements and eliminated in consolidation. ASC 805-50 also provides guidance addressing whether the receiving entity should report the net assets received prospectively from the date of the transfer or retrospectively for all periods presented. ASC 805-50 does not specifically address the reporting by the transferring entity; however, the transferring entity usually presents the transfer as a disposal on the date of the transfer in its separate financial statements. Appendix B of this publication addresses common-control transactions.
1.4 Asset Acquisitions

An asset acquisition is an acquisition of an asset, or a group of assets, that does not meet the definition of a business; such an acquisition therefore does not meet the definition of a business combination. The accounting for these transactions is addressed in the “Acquisition of Assets Rather Than a Business” subsections of ASC 805-50. Asset acquisitions are accounted for by using a cost accumulation model (i.e., the cost of the acquisition, including certain transaction costs, is allocated to the assets acquired on the basis of relative fair values, with some exceptions). In contrast, a business combination is accounted for by using a fair value model (i.e., the assets and liabilities are generally recognized at their fair values, and the difference between the consideration paid, excluding transaction costs, and the fair values of the assets and liabilities is recognized as goodwill or, in unusual circumstances, a bargain purchase gain). As a result, there are differences between the accounting for an asset acquisition and the accounting for a business combination. Appendix C of this publication addresses asset acquisitions as well as the differences between the accounting for asset acquisitions and the accounting for business combinations.

1.5 SEC Reporting Considerations for Business Acquisitions

When an acquirer is an SEC registrant and consummates — or it is probable that it will consummate — a significant business acquisition, the SEC may require the filing of certain financial statements for the acquired or to be acquired business (the acquiree) under SEC Regulation S-X, Rule 3-05. For example, if the acquirer files a registration statement or a proxy statement, separate financial statements for the acquiree may be required in addition to the financial statements of the registrant. Including the separate preacquisition financial statements of the acquiree in a filing allows current and prospective investors to evaluate the future impact of the acquiree on the registrant’s consolidated results. Pro forma information may also be required under SEC Regulation S-X, Article 11, for the acquisition or probable acquisition of a business. The following factors govern whether and, if so, for what period financial statements for the acquiree are required:

- Whether the acquired or to be acquired assets and liabilities meet the definition of a business in SEC Regulation S-X, Rule 11-01(d), which differs from the definition of a business in ASC 805.
- Whether consummation of the business acquisition is probable or has recently occurred.
- Significance of the acquired or to be acquired business.

SEC Regulation S-X, Rule 3-14, specifies that when a registrant acquires, or it is probable that it will acquire, a significant amount of real estate operations, the registrant is permitted to file only abbreviated income statements. Since the requirements under SEC Regulation S-X, Rule 3-14, are different, it is important for a registrant to determine whether it is acquiring a real estate operation.

On May 20, 2020, the SEC issued a final rule that amends the financial statement requirements for acquisitions and dispositions of businesses, including real estate operations, and related pro forma financial information. The final rule is effective for fiscal years beginning after December 31, 2020; however, early application is permitted. Appendix D of this Roadmap provides an overview of reporting considerations under the new requirements for SEC registrants that enter into business acquisitions. For considerations related to the requirements before adoption of the final rule, see the June 2020 edition of Deloitte’s A Roadmap to SEC Reporting Considerations for Business Combinations.

For additional information and interpretive guidance on SEC rules regarding business acquisitions and other SEC requirements related to business acquisitions, see Deloitte’s June 2, 2020, Heads Up.
1.6 Comparison of U.S. GAAP and IFRS Standards

ASC 805 is the primary source of guidance in U.S. GAAP on the accounting for business combinations and related matters. IFRS 3 is the primary source of such guidance under IFRS® Standards. Although the standards are largely converged, some differences remain. See Appendix E for a discussion of those differences.
Chapter 2 — Identifying a Business Combination

ASC 805 requires an entity to account for a business combination by using the acquisition method. For an entity to apply the acquisition method, the transaction must meet the definition of a business combination and the net assets acquired must meet the definition of a business in ASC 805. This chapter discusses those definitions and addresses the scope of the business combinations guidance in ASC 805-10, ASC 805-20, and ASC 805-30.

2.1 Definition of a Business Combination

The ASC master glossary defines a business combination as:

A transaction or other event in which an acquirer obtains control of one or more businesses. Transactions sometimes referred to as true mergers or mergers of equals also are business combinations.

A business combination typically occurs when an acquirer purchases the equity interests or net assets of one or more businesses in exchange for cash, equity interests of the acquirer, or other consideration. However, the definition of a business combination is broader and applies to all transactions or events in which an acquirer obtains control of a business. ASC 805-10 includes examples of ways in which an acquirer may obtain control of a business:

<table>
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<tr>
<th>ASC 805-10</th>
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<tr>
<td>25-1 An entity shall determine whether a transaction or other event is a business combination by applying the definition in this Subtopic, 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. An entity shall account for each business combination by applying the acquisition method.</td>
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<tr>
<td>55-2 Paragraph 805-10-25-1 requires an entity to determine whether a transaction or event is a business combination. In a business combination, an acquirer might obtain control of an acquiree in a variety of ways, including any of the following:</td>
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<tr>
<td>a. By transferring cash, cash equivalents, or other assets (including net assets that constitute a business)</td>
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<td>b. By incurring liabilities</td>
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<td>c. By issuing equity interests</td>
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<td>d. By providing more than one type of consideration</td>
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<td>e. Without transferring consideration, including by contract alone (see paragraph 805-10-25-11).</td>
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ASC 805-10 (continued)

55-3 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.

The ASC master glossary indicates that the term “control” has the same meaning as the term “controlling financial interest” in ASC 810-10-15-8. Therefore, an entity applies the guidance in ASC 810-10 to determine whether it has obtained a controlling financial interest in a business. ASC 810-10-15-8 states:

For legal entities other than limited partnerships, the usual condition for a controlling financial interest is ownership of a majority voting interest, and, therefore, as a general rule ownership by one reporting entity, directly or indirectly, of more than 50 percent of the outstanding voting shares of another entity is a condition pointing toward consolidation. The power to control may also exist with a lesser percentage of ownership, for example, by contract, lease, agreement with other stockholders, or by court decree.

In assessing whether it has obtained control of a business under ASC 810-10, an entity begins with an assessment of whether the acquiree is a VIE under the VIE model, which was established for situations in which control may be demonstrated other than by the possession of a majority of the voting rights in a legal entity. Accordingly, the evaluation of whether an entity has a controlling financial interest in a VIE focuses on “the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance” and “the obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE.” Under ASC 810-10-30-2, if the acquired business is determined to be a VIE on the basis of the guidance in ASC 810-10, “[t]he initial consolidation of a VIE that is a business is a business combination and shall be accounted for in accordance with the provisions in Topic 805.”

If a VIE does not meet the definition of a business, the primary beneficiary applies the initial-measurement guidance in ASC 805 to the VIE’s assets and liabilities, except for goodwill. The primary beneficiary is prohibited from recognizing goodwill that otherwise might be measured and instead recognizes a loss. ASC 810-10-30-3 and 30-4 state:

ASC 805-10 (continued)

55-3 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.

The ASC master glossary indicates that the term “control” has the same meaning as the term “controlling financial interest” in ASC 810-10-15-8. Therefore, an entity applies the guidance in ASC 810-10 to determine whether it has obtained a controlling financial interest in a business. ASC 810-10-15-8 states:

For legal entities other than limited partnerships, the usual condition for a controlling financial interest is ownership of a majority voting interest, and, therefore, as a general rule ownership by one reporting entity, directly or indirectly, of more than 50 percent of the outstanding voting shares of another entity is a condition pointing toward consolidation. The power to control may also exist with a lesser percentage of ownership, for example, by contract, lease, agreement with other stockholders, or by court decree.

In assessing whether it has obtained control of a business under ASC 810-10, an entity begins with an assessment of whether the acquiree is a VIE under the VIE model, which was established for situations in which control may be demonstrated other than by the possession of a majority of the voting rights in a legal entity. Accordingly, the evaluation of whether an entity has a controlling financial interest in a VIE focuses on “the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance” and “the obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE.” Under ASC 810-10-30-2, if the acquired business is determined to be a VIE on the basis of the guidance in ASC 810-10, “[t]he initial consolidation of a VIE that is a business is a business combination and shall be accounted for in accordance with the provisions in Topic 805.”

If a VIE does not meet the definition of a business, the primary beneficiary applies the initial-measurement guidance in ASC 805 to the VIE’s assets and liabilities, except for goodwill. The primary beneficiary is prohibited from recognizing goodwill that otherwise might be measured and instead recognizes a loss. ASC 810-10-30-3 and 30-4 state:
The primary beneficiary of a VIE that is not a business shall recognize a gain or loss for the difference between (a) and (b):

a. The sum of:
   1. The fair value of any consideration paid
   2. The fair value of any controlling interests
   3. The reported amount of any previously held interests

b. The net amount of the VIE's identifiable assets and liabilities recognized and measured in accordance with Topic 805.

If the acquiree is not a VIE, an entity proceeds to the voting interest model. Under that model, an entity with ownership of a majority of the voting interests of a legal entity is generally considered to have a controlling financial interest in the entity. However, ASC 810-10-15-8 notes that “control may also exist with a lesser percentage of ownership” in certain situations. In limited situations, an entity may obtain control over another entity that is not a VIE through a contractual arrangement rather than through voting interests (see Section 6.6.3 for more information).

For more information, see Deloitte's *A Roadmap to Consolidation — Identifying a Controlling Financial Interest*.

### 2.2 Transactions Within the Scope of ASC 805-10, ASC 805-20, and ASC 805-30

The guidance in the Business Combinations Topic applies to all transactions or other events that meet the definition of a business combination or an acquisition by a not-for-profit entity.

The guidance in ASC 805-10, ASC 805-20, and ASC 805-30 applies to all transactions or events in which an entity obtains control over one or more businesses. ASC 805-10 specifies that the acquisition method should be used to account for the following types of transactions:

- Roll-up or put-together transactions — see Section 2.2.1.
- Combinations between two or more mutual entities — see Section 2.2.2.
- True mergers or mergers of equals — see Section 2.2.3.
- Acquisitions in which control, but less than 100 percent of the equity interests, is obtained (partial acquisitions) — see Section 6.4.
- Business combinations achieved in stages (step acquisitions) — see Section 6.5.
- Business combinations achieved without the transfer of consideration — see Section 6.6.
2.2.1 Roll-Up or Put-Together Transactions

In some transactions, all the combining entities transfer their net assets or the owners of those entities transfer their equity interests to a newly formed entity. Often, the entities are in the same or similar lines of business. Such transactions are sometimes referred to as “roll-up” or “put-together” transactions. In some cases, one of the owners receives a majority of the voting interests of the combined entity, but in other cases no one individual owner does. Regardless, ASC 805-10-55-3(c) indicates that roll-up or put-together transactions should be accounted for by using the acquisition method.

The FASB discussed its view on roll-up or put-together transactions in paragraph B27 of Statement 141(R), which states:

The Boards concluded that most business combinations, both two-party transactions and those involving three or more entities (multiparty combinations) are acquisitions. The Boards acknowledged that some multiparty combinations (in particular, those that are commonly referred to as roll-up or put-together transactions) might not be acquisitions; however, they noted that the acquisition method has generally been used to account for them. The Boards decided not to change that practice at this time. Consequently, [ASC 805-10, ASC 805-20, and ASC 805-30 require] the acquisition method to be used to account for all business combinations, including those that some might not consider acquisitions.

As a result, in a roll-up or put-together transaction, one entity is identified as the acquirer (see Section 3.1) and the net assets of the other entities are recognized by using the acquisition method.

2.2.2 Combinations Between Two or More Mutual Entities

Business combinations between two or more mutual entities are within the scope of ASC 805. The ASC master glossary defines a mutual entity as:

An entity other than an investor-owned entity that provides dividends, lower costs, or other economic benefits directly and proportionately to its owners, members, or participants. Mutual insurance entities, credit unions, and farm and rural electric cooperatives are examples of mutual entities.

Because a combination of mutual entities involves an exchange, albeit typically of membership interests, ASC 805 makes no concession regarding application of the acquisition method of accounting. Consequently, in a combination between mutual entities, one of the entities must be identified as the acquirer (see Section 3.1) and the acquirer must apply the acquisition method to the acquired assets and assumed liabilities. ASC 805 provides guidance on measuring the consideration transferred in a combination between mutual entities, as addressed in Section 5.10.1.
2.2.3 True Mergers or Mergers of Equals

The term “merger of equals” is sometimes used to describe a transaction in which two entities of approximately equal size combine to form a new company. The definition of a business combination in the ASC master glossary specifies that “[t]ransactions sometimes referred to as true mergers or mergers of equals also are business combinations.” The FASB’s rationale for including mergers of equals within the scope of ASC 805-10, ASC 805-20, and ASC 805-30 was that mergers of equals between for-profit businesses or mutual entities may not be frequent enough in practice to warrant developing a separate accounting model for them. As a result, in a merger between two businesses, one of the entities must be identified as the acquirer, and the acquirer must apply the acquisition method to the acquired assets and assumed liabilities even when, for example, the parties characterize the transaction as a merger of equals, the entities are of approximately equal size, or the initial composition of the governing body and of management are equal or close to equal. However, determining whether a transaction is a merger of equals or a joint venture can be challenging. As discussed below, joint control is not the only defining characteristic of a joint venture. A joint venture is also expected to meet the definition of a “corporate joint venture” in the ASC master glossary. See Section 2.3.1 for information about identifying a joint venture arrangement.

2.2.4 Multiple Arrangements With a Seller That Result in a Business Combination

An acquirer and a seller may agree to transfer a business in more than one transaction for regulatory or other purposes. Sometimes, the parties execute the acquisition as part of a single agreement; other times, the parties enter into multiple separate agreements. In certain cases, each individual acquisition may not meet the definition of a business but would meet it if all the acquisitions were evaluated together. For example, the acquirer and seller may agree to transfer what would constitute a business in the first transaction and agree to transfer only inputs (e.g., customer contracts) in a second transaction. In other cases, the parties may enter into a contract to transfer multiple individual businesses under which each of the individual acquisitions close at different times and in various reporting periods. In such cases, the acquisition agreement may include a single acquisition price for all the acquisitions. Alternatively, each business may be priced separately and, while each individual amount may not represent the fair value of the related business, the total acquisition price will represent the fair value of all the businesses together.

In some instances, it may be appropriate to evaluate the separate transactions as a single acquisition. We believe that when performing this evaluation, an entity should consider the following factors listed in ASC 810-10-40-6 related to identifying when multiple deconsolidation arrangements should be accounted for as a single transaction:

- “They are entered into at the same time or in contemplation of one another.”
- “They 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 they are economically justified when considered together. An example is when one disposal is priced below market, compensated for by a subsequent disposal priced above market.”
All facts and circumstances associated with such arrangements should be considered in the evaluation. When the facts and circumstances indicate that multiple arrangements should be accounted for as a single transaction representing a business combination, an entity may need to use judgment in applying acquisition accounting to each arrangement if closing dates are in different reporting periods. For example, when goodwill is expected to be recognized if all the transactions are accounted for together, a bargain purchase gain should not be recognized, even provisionally, when no bargain purchase gain is expected to result in total.

See Section 6.5 for information about business combinations that are achieved in stages when an acquirer obtains control of an acquiree in which it held a noncontrolling equity interest immediately before the acquisition date.

2.3 Transactions Outside the Scope of ASC 805-10, ASC 805-20, and ASC 805-30

The guidance in ASC 805-10, ASC 805-20, and ASC 805-30 applies to all transactions or events in which an entity obtains control over one or more businesses. However, ASC 805-10-15-4 includes a list of scope exceptions, which are described in further detail below.

### ASC 805-10

15-4 The guidance in the Business Combinations Topic does not apply to any of the following:

- a. The formation of a joint venture
- b. The acquisition of an asset or a group of assets that does not constitute a business or a nonprofit activity
- c. A combination between entities, businesses, or nonprofit activities under common control (see paragraph 805-50-15-6 for examples)
- d. An acquisition by a not-for-profit entity for which the acquisition date is before December 15, 2009 or a merger of not-for-profit entities (NFPs)
- e. A transaction or other event in which an NFP obtains control of a not-for-profit entity but does not consolidate that entity, as described in paragraph 958-810-25-4. The Business Combinations Topic also does not apply if an NFP that obtained control in a transaction or other event in which consolidation was permitted but not required decides in a subsequent annual reporting period to begin consolidating a controlled entity that it initially chose not to consolidate.
- f. Financial assets and financial liabilities of a consolidated variable interest entity that is a collateralized financing entity within the scope of the guidance on collateralized financing entities in Subtopic 810-10.

2.3.1 Joint Venture Formations

The formation of a joint venture is outside the scope of ASC 805-10, ASC 805-20, and ASC 805-30. Paragraph B61 of FASB Statement 141(R) states:

In developing Statement 141, the FASB noted that constituents consider the guidance in paragraph 3(d) of APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, in assessing whether an entity is a joint venture, and it decided not to change that practice in its project on business combinations.

The ASC master glossary defines a corporate joint venture as:

A corporation owned and operated by a small group of entities (the joint venturers) as a separate and specific business or project for the mutual benefit of the members of the group. A government may also be a member of the group. The purpose of a corporate joint venture frequently is to share risks and rewards in developing a new market, product or technology; to combine complementary technological knowledge; or to pool resources in developing production or other facilities. 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. The ownership of a corporate joint venture seldom changes, and its stock is usually not traded publicly. A noncontrolling interest held by public ownership, however, does not preclude a corporation from being a corporate joint venture.

To be considered a joint venture, an entity should also be jointly controlled by its investors.

In identifying whether a transaction meets the definition of a corporate joint venture, an entity must use judgment and consider its particular facts and circumstances. In his remarks at the 2014 AICPA Conference on Current SEC and PCAOB Developments, Christopher Rogers, a professional accounting fellow in the SEC's Office of the Chief Accountant (OCA), reiterated the following long-standing SEC staff view:

In evaluating joint venture formation transactions, the staff continues to believe that joint control is not the only defining characteristic of a joint venture. Rather, each of the characteristics in the definition of a joint venture in Topic 323 should be met for an entity to be a joint venture, including that the “purpose” of the entity is consistent with that of a joint venture. [Footnotes omitted]

In addition, ASC 805-10-S99-8 notes a comment made by an SEC observer at an EITF meeting, stating that:

The SEC staff will object to a conclusion that did not result in the application of Topic 805 to transactions in which businesses are contributed to a newly formed, jointly controlled entity if that entity is not a joint venture. The SEC staff also would object to a conclusion that joint control is the only defining characteristic of a joint venture.

See Deloitte's A Roadmap to Accounting for Equity Method Investments and Joint Ventures for more information about identifying joint ventures and joint venture formation transactions.

2.3.2 Common-Control Transactions

A common-control transaction is similar to a business combination for the entity that receives the net assets or equity interests; however, such a transaction does not meet the definition of a business combination because there is no change in control over the net assets. Therefore, the accounting and reporting for a transaction between entities under common control is outside the scope of the business combinations guidance in ASC 805-10, ASC 805-20, and ASC 805-30 and is addressed in the “Transactions Between Entities Under Common Control” subsections of ASC 805-50. Since there is no change in control over the net assets from the parent's perspective, there is no change in the parent's basis in the net assets. See Appendix B for more information about common-control transactions.

2.3.3 Common-Ownership Transactions

Common ownership exists when two or more entities have the same shareholders but no one shareholder controls all of the entities. Transfers of net assets or equity interests among entities that have common ownership are not common-control transactions. However, they may be accounted for similarly to common-control transactions if the transfer lacks economic substance. See Appendix B for more information about common-ownership transactions.

2.3.4 Asset Acquisitions

For an acquisition to meet the definition of a business combination, the net assets acquired must meet the definition of a business in ASC 805-10 (see Section 2.4). The acquisition of an asset, or a group of assets, that does not meet the definition of a business is called an asset acquisition and is accounted for in accordance with the "Acquisition of Assets Rather Than a Business" subsections of ASC 805-50. See Appendix C for more information about accounting for asset acquisitions.
2.3.5 Combinations of Not-for-Profit Entities

Combinations between not-for-profit entities and acquisitions of for-profit businesses by not-for-profit entities are not within the scope of ASC 805-10, ASC 805-20, and ASC 805-30, although these subtopics apply when a for-profit entity acquires a not-for-profit business.

The ASC master glossary defines a not-for-profit entity as follows:

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.

Combinations between not-for-profit entities or acquisitions of a for-profit business by a not-for-profit entity are accounted for in accordance with ASC 958-805. In contrast to the FASB’s decision regarding mergers of equals between for-profit entities (see Section 2.2.3), ASC 958-805 requires that entities determine whether a combination between not-for-profit entities is a merger or an acquisition. Not-for-profit entities apply the carryover method to account for a merger and the acquisition method to account for an acquisition. However, ASC 805-10, ASC 805-20, and ASC 805-30 apply when a for-profit entity acquires a not-for-profit business.

In May 2019, the FASB issued ASU 2019-06, which extends the private-company accounting alternatives on certain identifiable intangible assets and goodwill to not-for-profit entities. See Chapter 8 of this publication for more information about the accounting alternatives available to not-for-profit entities.

2.3.6 Collateralized Financing Entities

ASU 2014-13 amended ASC 805-10 to exclude from the scope of the business combinations guidance financial assets and financial liabilities of a consolidated VIE that is a collateralized financing entity within the scope of the guidance on collateralized financing entities in ASC 810-10. The ASC master glossary defines a collateralized financing entity as:

A variable interest entity that holds financial assets, issues beneficial interests in those financial assets, and has no more than nominal equity. The beneficial interests have contractual recourse only to the related assets of the collateralized financing entity and are classified as financial liabilities. A collateralized financing entity may hold nonfinancial assets temporarily as a result of default by the debtor on the underlying debt instruments held as assets by the collateralized financing entity or in an effort to restructure the debt instruments held as assets by the collateralized financing entity. A collateralized financing entity also may hold other financial assets and financial liabilities that are incidental to the operations of the collateralized financing entity and have carrying values that approximate fair value (for example, cash, broker receivables, or broker payables).
2.4 Definition of a Business (After Adoption of ASU 2017-01)

In January 2017, the FASB issued ASU 2017-01 to clarify the guidance in ASC 805-10 on evaluating whether a transaction should be accounted for as an acquisition (or disposition) of assets or a business. The FASB issued the ASU in response to stakeholder feedback indicating that the previous definition of a business in ASC 805-10 was being applied too broadly and was difficult and costly to apply. The amendments to ASC 805-10 were intended to make the application of the guidance more consistent and cost-efficient. As expected at the time of ASU 2017-01’s issuance, some transactions that would have been accounted for as business combinations under previous guidance are being accounted for as asset acquisitions under ASU 2017-01. See Appendix C of this Roadmap for more information about accounting for asset acquisitions, including the differences between such accounting and the accounting for business combinations.

Under the clarified definition of a business, entities use the screen as described in ASC 805-10-55-5A through 55-5C, to determine whether an acquired set of assets and activities is not a business. In accordance with ASU 2017-01, if “substantially all of the fair value of the gross assets acquired (or disposed of) is concentrated in a single identifiable asset or a group of similar identifiable assets, the set is not a business.” If such a concentration is not found, the screen is not met and entities must then apply the framework discussed in Section 2.4.3 to determine whether the set is a business.

Distinguishing between the acquisition of a business and the acquisition of an asset or a group of assets is important because there are many differences between the accounting for each. For example, in a business combination, the assets acquired are recognized at fair value and goodwill is recognized, whereas in an asset acquisition, the cost of the acquisition is allocated to the assets acquired on a relative fair value basis and no goodwill is recognized. See Section C.1.1 for a summary of the differences between the accounting for a business combination and the accounting for an asset acquisition.
The following flowchart outlines the application of the FASB’s guidance on the definition of a business:

SEC Considerations
SEC registrants are required to use the definition of a business in SEC Regulation S-X, Rule 11-01(d), when evaluating the requirements of SEC Regulation S-X, Rule 3-05, and SEC Regulation S-X, Article 11. The definition of a business in Rule 11-01(d) is different from both the prior and the clarified definitions of a business in ASC 805-10. See Section D.1 for more information about the definition of a business in Rule 11-01(d) and related reporting requirements for SEC registrants.
2.4.1 Identifying the Activities and Assets of the Acquired Set

To evaluate whether an acquired set of activities and assets meets the definition of a business, an entity must first identify the set (i.e., what is being exchanged). While the identification of the acquired set is relatively straightforward in most acquisitions, judgment may be required in some, as discussed below.

2.4.1.1 Employees of the Seller

In some acquisitions, the acquirer obtains control of a legal entity from the seller, and any employees of that legal entity become employees of the acquirer. In these acquisitions, the acquirer obtains an organized workforce that is expected to be included in the acquired set.

In other acquisitions, the acquirer obtains control of an asset or a group of assets, rather than a legal entity, and it must separately hire the employees of the seller after the acquisition if it seeks to obtain their services. We believe that in such a case, the determination of whether the acquired set includes those employees should be based on an evaluation of all relevant facts and circumstances and that such employees should not be presumptively excluded from the set on the basis of the legal form of the transaction. Employees of the seller are more likely to be included in the acquired set when hired in close proximity to the transaction date and when the seller is involved in facilitating the acquirer’s hiring of the employees, as might be the case if such hiring is a condition of the closing.

2.4.1.2 Contractual Arrangements Between the Acquirer and a Party Other Than the Seller

Contractual arrangements that are separately negotiated between the acquirer and a party other than the seller typically are not considered part of the acquired set even if they are entered into at or around the time of the acquisition or are contingent on the acquisition. In addition, certain contractual arrangements, even if assumed in the acquisition, might be excluded from the acquired set when there is substantial involvement of the acquirer in initiating or modifying the contract that is contingent on the acquisition such that the contract is effectively between the acquirer and a party other than the seller.

2.4.1.3 Revenue Arrangements With the Seller

In some acquisitions, the buyer and seller may enter into revenue arrangements at the time of, or in close proximity to, the acquisition date that will take effect on or after the acquisition date. Paragraph BC54 of ASU 2017-01 clarifies that “[t]he Board decided to specifically exclude those revenue arrangements from the analysis of whether a substantive process has been acquired. That is, the Board decided that a set is not a business just because there is a contract that provides a continuing revenue stream.”

2.4.1.4 Transactions That Are Separate From the Business Combination

As part of its accounting for an acquisition, an acquirer must assess whether the items exchanged include amounts that should be accounted for separately from the business combination. Transactions that are determined to be separate from the business combination should be excluded from the acquired set. See Section 6.2 for more information.
2.4.2 Single or Similar Assets

### ASC 805-10

#### 55-5A
If substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets, the set is not considered a business. Gross assets acquired should exclude cash and cash equivalents, deferred tax assets, and goodwill resulting from the effects of deferred tax liabilities. However, the gross assets acquired should include any consideration transferred (plus the fair value of any noncontrolling interest and previously held interest, if any) in excess of the fair value of net identifiable assets acquired.

Once an entity has identified the acquired set, it then evaluates whether that set is not a business on the basis of the screen in ASC 805-10-55-5A through 55-5C. As noted above, under the screen, “If substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets, the set is not considered a business.” An entity can evaluate whether the screen is met by applying the following steps:

- **Step 1** — Combine the identifiable assets into a single identifiable asset.
- **Step 2** — Combine the assets into similar assets.
- **Step 3** — Measure the fair value of the gross assets acquired.
- **Step 4** — Determine whether substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets.

An entity must apply the recognition and measurement guidance for business combinations in ASC 805-10, ASC 805-20, and ASC 805-30 (including any recognition or measurement exceptions) to perform the screen; however, if the entity determines that the acquired set is not a business, it should recognize and measure the assets (and liabilities) in its financial statements by using the principles in ASC 805-50 (or the guidance in ASC 810-10-30-3 and 30-4 if the entity is a VIE). See Appendix C for more information about accounting for asset acquisitions, including potential differences in the recognition and measurement of acquired assets.

#### 2.4.2.1 Step 1 — Combine the Identifiable Assets Into a Single Identifiable Asset

### ASC 805-10

#### 55-5B
A single identifiable asset includes any individual asset or group of assets that could be recognized and measured as a single identifiable asset in a business combination. However, for purposes of this evaluation, the following should be considered a single asset:

- a. A tangible asset that is attached to and cannot be physically removed and used separately from another tangible asset (or an intangible asset representing the right to use a tangible asset) without incurring significant cost or significant diminution in utility or fair value to either asset (for example, land and building)
- b. In-place lease intangibles, including favorable and unfavorable intangible assets or liabilities, and the related leased assets.
The FASB notes in paragraph BC24 of ASU 2017-01 that “[f]or ease of application, the Board decided that an entity should use the same unit of account when assessing the [screen] that it would use for identifying assets recognized in a business combination even if it results in some tangible assets and intangible assets being combined into a single asset.” The FASB reasoned that the assessment related to the screen should not result in significant incremental costs for acquisitions because entities must determine the fair value of each asset in both asset acquisitions and business combinations.

ASC 805 provides no specific guidance on determining the unit of account for identifiable assets, but it offers the following three examples of acquired assets that may be recognized as a single asset in financial reporting:

- “[A] group of complementary assets such as a trademark (or service mark) and its related trade name, formulas, recipes, and technological expertise.” (See ASC 805-20-55-18.)
- A license to operate a nuclear power plant and the power plant. (See ASC 805-20-55-2(b).)
- An artistic-related copyright “and any related assignments or license agreements.” (See ASC 805-20-55-30.)

In each example, the assets that are combined for financial reporting have similar useful lives. In addition, we believe that to be combined into a single unit of account, the assets should have similar methods of amortization, since this would ensure that they have a similar effect on financial reporting. Determining whether it is appropriate to combine assets into a single unit of account may require considerable judgment, particularly when it comes to combining tangible and intangible assets. See Section 4.10.3 for more information about determining the unit of account.

While entities should generally apply the same unit of account when both performing the evaluation required by the screen and recognizing assets in a business combination, ASC 805-10-55-5B provides two exceptions. The first exception requires entities to combine “[a] tangible asset that is attached to and cannot be physically removed and used separately from another tangible asset (or an intangible asset representing the right to use a tangible asset) without incurring significant cost or significant diminution in utility or fair value to either asset.” In paragraph BC23 of ASU 2017-01, the FASB notes that it permitted this exception because without it, “the [screen] could not be applied practically in certain circumstances, such as in the real estate industry where land and buildings are often transferred together.”

As indicated in ASC 805-10-55-5B(b), the second exception requires entities to combine “[i]n-place lease intangibles, including favorable and unfavorable intangible assets or liabilities, and the related leased assets.” This exception was primarily intended to increase consistency in the accounting for real estate transactions by reducing the likelihood that an acquisition would be accounted for as a business combination simply because a lease was in a sought-after location and had significant in-place value or because a lease had above- or below-market rents.

We do not believe that entities should combine other assets by analogy to these exceptions in ASC 805-10-55-5B. For example, it would not be appropriate to combine a hotel and its related brand name or to combine a wind or solar farm and a related power purchase agreement if the power purchase arrangement does not meet the definition of a lease.
Entities should combine identifiable assets that meet the exceptions (e.g., land and building or in-place lease intangible asset and the related leased assets) only when evaluating the screen; for other purposes, such assets typically should be recognized separately regardless of whether the acquired set is a business or a group of assets. For example, while a building and an in-place lease would be combined in the evaluation required by the screen, they would be recognized separately for financial reporting purposes.

The following table summarizes the examples in ASC 805-10-55-52 through 55-87 (see Section 2.4.4), which illustrate scenarios in which an entity analyzes whether to combine assets into a single identifiable asset:

<table>
<thead>
<tr>
<th>Case</th>
<th>Facts</th>
<th>Can Some or All of the Identifiable Assets Be Combined Into a Single Identifiable Asset?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Case A: Acquisition of Real Estate (Scenario 1 in ASC 805-10-55-52 through 55-54)</td>
<td>Acquisition of a portfolio of single-family homes that each have an in-place lease. Each single-family home includes the land, building, and property improvements.</td>
<td>Yes. The building and property improvements are attached to the land, and the entity cannot remove them without incurring significant cost. The in-place lease is an intangible asset that should be combined with the related real estate asset and considered a single asset.</td>
</tr>
<tr>
<td>Case B: Acquisition of a Drug Candidate (Scenario 1 in ASC 805-10-55-65 and 55-66)</td>
<td>Acquisition of a biotech entity that contains the rights to a phase 3 compound. Included in the in-process research and development (IPR&amp;D) project is the historical know-how, formula protocols, designs, and procedures expected to be needed to complete the related phase of testing.</td>
<td>Yes. The IPR&amp;D is an identifiable asset that would be accounted for as a single asset.</td>
</tr>
<tr>
<td>Case D: Acquisition of a Television Station (ASC 805-10-55-73 through 55-76)</td>
<td>Acquisition of an FCC license, broadcasting equipment, and an office building.</td>
<td>No. The acquired assets cannot be combined into a single asset in accordance with the guidance in ASC 805-10-55-5B(a).</td>
</tr>
<tr>
<td>Case E: Acquisition of a Manufacturing Facility (ASC 805-10-55-77 through 55-81)</td>
<td>Acquisition of idled equipment and facility (land and buildings).</td>
<td>No. The equipment and facility cannot be combined into a single asset in accordance with the guidance in ASC 805-10-55-5B(a).</td>
</tr>
<tr>
<td>Case G: Acquisition of Brands (ASC 805-10-55-85 through 55-87)</td>
<td>Acquisition of intellectual property (the trademark, related trade name, and recipes), customer contracts and relationships, finished goods inventory, supply contracts, and equipment.</td>
<td>Yes. The intellectual property associated with the brand (i.e., the trademark, the related trade name, and recipes) is determined to be a single intangible asset in accordance with the guidance in ASC 805-20-55-18.</td>
</tr>
</tbody>
</table>
### 2.4.2.2 Step 2 — Combine the Assets Into Similar Assets

<table>
<thead>
<tr>
<th>ASC 805-10 - 55-5C</th>
</tr>
</thead>
<tbody>
<tr>
<td>A group of similar assets includes multiple assets identified in accordance with paragraph 805-10-55-5B. When evaluating whether assets are similar, an entity should consider the nature of each single identifiable asset and the risks associated with managing and creating outputs from the assets (that is, the risk characteristics). However, the following should not be considered similar assets:</td>
</tr>
<tr>
<td>a. A tangible asset and an intangible asset</td>
</tr>
<tr>
<td>b. Identifiable intangible assets in different major intangible asset classes (for example, customer-related intangibles, trademarks, and in-process research and development)</td>
</tr>
<tr>
<td>c. A financial asset and a nonfinancial asset</td>
</tr>
<tr>
<td>d. Different major classes of financial assets (for example, accounts receivable and marketable securities)</td>
</tr>
<tr>
<td>e. Different major classes of tangible assets (for example, inventory, manufacturing equipment, and automobiles)</td>
</tr>
<tr>
<td>f. Identifiable assets within the same major asset class that have significantly different risk characteristics.</td>
</tr>
</tbody>
</table>

In accordance with ASC 805-10-55-5C, if the acquired set includes multiple assets, entities should combine the assets that qualify for combination as similar assets. Paragraph BC28 of ASU 2017-01 states, in part:

> If an entity acquires, for example, multiple versions of substantially the same asset type instead of precisely one asset, the Board noted that should not disqualify the acquired items from being considered assets. The Board added that this could help alleviate pressure around what is a single asset because some stakeholders may conclude that they will be required to separate what is typically a single unit of account into multiple units of account (for example, separating a customer list into 1,000 different assets because there are 1,000 different customers).

Although the FASB does not define the term “similar” in ASC 805-10-55-5C, the guidance provides examples of assets that cannot be considered similar. For example, entities cannot combine financial assets with nonfinancial assets or tangible assets with intangible assets. However, assets that are combined under ASC 805-10-55-5B into a single identifiable asset can continue to be combined. For example, if entities combine a building and an in-place lease intangible asset into a single identifiable asset in step 1, they can continue to combine those assets in applying this step even though tangible and intangible assets cannot be combined into similar assets.

In addition, different major classes of the following asset types cannot be combined into similar assets:

- Identifiable intangible assets (e.g., customer-related intangibles, trademarks, and IPR&D).
- Financial assets (e.g., accounts receivable and marketable securities).
- Tangible assets (e.g., inventory, manufacturing equipment, and automobiles).

Entities may need to use judgment when determining whether financial assets, tangible assets, or intangible assets are in the same major class of asset. The ASC master glossary defines an intangible asset class as “[a] group of intangible assets that are similar, either by their nature or by their use in the operations of an entity,” and ASC 350-30-50-1 requires entities to provide disclosures about the amounts assigned to each intangible asset class. We believe that entities should interpret that term consistently when providing the ASC 350-30 disclosures and performing the screen. In addition, while the FASB does not define major classes of tangible assets and financial assets, we believe that an entity should consider the definition of intangible asset class and be consistent in both its balance sheet presentation and its interpretation of major class when performing the screen.
Further, ASC 805-10-55-5C states that entities cannot combine identifiable assets within the same major asset class if the assets have “significantly different risk characteristics.” Paragraph BC31 of ASU 2017-01 states, in part:

The Board clarified that the risks to be evaluated should be linked to the risks associated with the management of the assets and creation of outputs because this assessment may be instructive on whether an integrated set of assets and activities has been acquired. That is, when the risks associated with managing and creating outputs from the assets are significantly different, the set would need more sophisticated processes to manage and create outputs.

Entities in different industries are typically affected by different types of risks. For example, in the real estate industry, entities may consider risk characteristics associated with the type of property (e.g., commercial vs. residential), size (e.g., single tenant vs. multitenant), geographic location (e.g., high-growth areas vs. low-growth areas), and class of customer (e.g., high default-risk tenants vs. low default-risk tenants). By contrast, in the life sciences industry, entities may evaluate risk characteristics associated with the stage of drug development (e.g., compounds in early development stages vs. later stages), class of customer (e.g., compounds that treat one medical condition vs. another medical condition), and market risk (e.g., products for use in the United States vs. outside the United States). Entities should consider all relevant facts and circumstances in making their determination.

The following table summarizes the examples in ASC 805-10-55-52 through 55-92 (see Section 2.4.4), which illustrate scenarios in which an entity analyzes whether assets are similar:

<table>
<thead>
<tr>
<th>Case</th>
<th>Facts</th>
<th>Can Some or All of the Identifiable Assets Be Combined as Similar Assets?</th>
</tr>
</thead>
</table>
| Case A: Acquisition of Real Estate  
(Scenario 1 in ASC 805-10-55-52 through 55-54) | Acquisition of a portfolio of single-family homes that all have in-place leases. Each home has a different floor plan, square footage, lot, and interior design. | Yes. The risks associated with operating the properties and managing and acquiring tenants are not significantly different. |
| (Scenario 2 in ASC 805-10-55-55 through 55-61) | Acquisition of a portfolio of single-family homes and an office park with multiple office buildings. | No. The risks associated with operating the assets and obtaining and managing tenants are significantly different for the single-family homes and the office park. |
| Case B: Acquisition of a Drug Candidate  
(Scenario 2 in ASC 805-10-55-67 through 55-69) | Acquisition of a biotech entity with two IPR&D projects that are in different phases of development and that would treat significantly different medical conditions. | No. The two IPR&D projects are not similar assets because each has significantly different risks associated with creating outputs and with developing and marketing the compound to customers (i.e., the projects are intended to treat significantly different medical conditions, and each project has a significantly different potential customer base and different expected market and regulatory risks). |
<table>
<thead>
<tr>
<th>Case</th>
<th>Facts</th>
<th>Can Some or All of the Identifiable Assets Be Combined as Similar Assets?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Case C: Acquisition of Biotech (ASC 805-10-55-70 through 55-72)</td>
<td>Acquisition of a biotech entity with several IPR&amp;D projects that are in different phases of the FDA approval process and that would treat significantly different diseases.</td>
<td>No. The IPR&amp;D projects are not similar assets because each has significantly different risks associated with managing the assets and creating the outputs (i.e., there are significantly different development risks, because of the different phases of development, and market risks, because of the different customer bases and potential markets for the compounds).</td>
</tr>
<tr>
<td>Case D: Acquisition of a Television Station (ASC 805-10-55-73 through 55-76)</td>
<td>Acquisition of an FCC license, broadcasting equipment, and an office building.</td>
<td>No. The acquired assets are not similar assets because the FCC license cannot be considered similar to the tangible assets and the tangible assets are in different major asset classes.</td>
</tr>
<tr>
<td>Case E: Acquisition of a Manufacturing Facility (ASC 805-10-55-77 through 55-81)</td>
<td>Acquisition of idled equipment and facility (land and buildings).</td>
<td>No. The acquired assets are not similar assets because the manufacturing equipment and facility are in different major classes of tangible assets.</td>
</tr>
<tr>
<td>Case F: License of Distribution Rights (ASC 805-10-55-82 through 55-84)</td>
<td>Acquisition of distribution rights, customer contracts, and an at-market supply agreement.</td>
<td>No. The acquired assets that have fair value assigned to them (e.g., the distribution license and customer contracts) are not considered similar assets because they are in different major classes of identifiable intangible assets.</td>
</tr>
<tr>
<td>Case H: Acquisition of Loan Portfolio</td>
<td>Acquisition of a portfolio of residential mortgage loans.</td>
<td>Yes. The loans represent similar assets because their terms, sizes, and risk ratings are not significantly different and thus the risks associated with managing and creating outputs are not significantly different.</td>
</tr>
<tr>
<td>(Scenario 1 in ASC 805-10-55-88 and 55-89)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(Scenario 2 in ASC 805-10-55-90 through 55-92)</td>
<td>Acquisition of a portfolio of commercial loans.</td>
<td>No. The loans do not represent similar assets because their terms, sizes, and risk ratings are significantly different, and therefore the risks associated with managing them and creating outputs are significantly different.</td>
</tr>
</tbody>
</table>

### 2.4.2.3 Step 3 — Measure the Fair Value of the Gross Assets Acquired

The measurement of the fair value of gross assets acquired, which is used in determining whether substantially all of the fair value is concentrated in a single identifiable asset or group of similar identifiable assets, includes any noncontrolling interests in a partial acquisition and any previously held interests in a step acquisition. Specifically, the measurement will include (1) any consideration transferred in excess of the fair value of the net identifiable assets acquired (i.e., goodwill in a business combination) and (2) any value attributable to an assembled workforce (since it is subsumed into goodwill).
The measurement of gross assets acquired excludes cash and cash equivalents (including restricted cash), deferred tax assets, and goodwill resulting from the effects of deferred tax liabilities. As stated in paragraph BC27 of ASU 2017-01:

The Board concluded that deferred taxes should be excluded from the evaluation of the [screen]. That is, any value associated with deferred tax assets and the effects of deferred tax liabilities on gross assets would be excluded from gross assets acquired. The Board reasoned that the tax form of the transaction that often dictates the amount of deferred taxes in the transaction should not affect the determination of whether the transaction is a business.

In addition, as described in Section 2.4.1.4, entities should exclude any amounts related to transactions that are separate from the acquisition (e.g., arrangements that represent compensation for future services).

With the exception of unfavorable lease liabilities that are combined with the related leased asset under ASC 805-10-55-5B(b), the calculation of gross assets acquired excludes debt and other liabilities. Paragraph BC20 of ASU 2017-01 states that “[t]he Board reached this conclusion to avoid the existence of debt (for example, a building with a mortgage) or other liabilities affecting the analysis of whether the [screen] has been met. That could potentially result in a group of assets that would otherwise be subject to further evaluation under the model bypassing such evaluation solely because a transaction includes liabilities in addition to assets.”

The requirement to exclude liabilities also applies to asset retirement obligations (AROs) related to assets included in the acquired set. For example, assume that Company A acquires Company B, a utility, in a transaction that is accounted for as a business combination. Company A determines that an ARO exists related to B’s facility and estimates the ARO’s fair value to be $25 million. Company A estimates the fair value of the facility to be $100 million, meaning that the value of the facility would be $25 million higher if the costs associated with the ARO were ignored. Accordingly, in determining the single identifiable asset or similar assets and the gross assets acquired, A would use $125 million. See Section 4.8.1 for more information about assets subject to AROs.

ASC 805-10-55-5A states that gross assets should include any consideration transferred in excess of the fair value of net identifiable assets acquired, but it does not address whether the screen should include any deficit (i.e., bargain purchase gains). We believe that bargain purchase gains should be excluded from the screen because their inclusion would distort the calculation in a manner similar to the inclusion of liabilities.

### 2.4.2.4 Step 4 — Determine Whether Substantially All of the Fair Value of the Gross Assets Acquired Is Concentrated in a Single Identifiable Asset or Group of Similar Identifiable Assets

The term “substantially all” is used throughout GAAP (e.g., in ASC 810, ASC 606, and ASC 842) and is generally interpreted to mean 90 percent or more. However, the FASB did not intend that entities treat the term as a bright line; thus, judgment must be applied in circumstances in which the quantitative result of the screen is close to 90 percent. In such cases, entities might consider other evidence to support their evaluation. For example, the following may be indicators that a set is a business:

- The set includes many different types of assets (whereas a set with only a few assets may be more indicative of a group of assets).
- The set includes an organized workforce or other substantive processes.
• The set has outputs.
• The set includes a significant amount of goodwill.
• The set can operate independently on a stand-alone basis.

If the quantitative result is close to 90 percent, the presence of one or more of these indicators might warrant a determination that the screen is not met. In that case, entities should apply the framework to determine whether the set is a business.

Entities may be able to perform the screen qualitatively or bypass it in certain circumstances. See Section 2.4.2.6 for more information.

2.4.2.5 Illustration of the Screen

The example below illustrates how the steps described above are used in the screen.

<table>
<thead>
<tr>
<th>Example 2-1</th>
</tr>
</thead>
</table>

Company A acquires Company B for $5 million in a nontaxable acquisition. Company B is in the real estate industry and owns an apartment complex. As part of the transaction, A assumes a property management contract that was in place between B and a third-party property manager for three years before the acquisition. The pricing of the property management contract is favorable to A in terms of current market rates. Company A measures and recognizes the assets acquired and liabilities assumed at fair value as follows:

<table>
<thead>
<tr>
<th>Amounts Recognized at Fair Value</th>
<th>Tax Basis</th>
<th>Temporary Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>$100,000</td>
<td>$100,000</td>
<td>—</td>
</tr>
<tr>
<td>650,000</td>
<td>600,000</td>
<td>50,000</td>
</tr>
<tr>
<td>5,450,000</td>
<td>5,000,000</td>
<td>450,000</td>
</tr>
<tr>
<td>2,000,000</td>
<td>1,850,000</td>
<td>150,000</td>
</tr>
<tr>
<td>50,000</td>
<td>—</td>
<td>50,000</td>
</tr>
<tr>
<td>80,000</td>
<td>—</td>
<td>80,000</td>
</tr>
<tr>
<td>(400,000)</td>
<td>(400,000)</td>
<td>—</td>
</tr>
<tr>
<td>(3,000,000)</td>
<td>(3,000,000)</td>
<td>—</td>
</tr>
<tr>
<td>(195,000)*</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>$4,735,000</td>
<td>$4,150,000</td>
<td>$780,000</td>
</tr>
<tr>
<td>$265,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* A 25 percent tax rate is assumed in the calculation.
**Example 2-1 (continued)**

**Step 1**
Company A applies step 1 (see Section 2.4.2.1) and determines that the building, land, and in-place lease intangible asset are identifiable assets that qualify for combination into a single identifiable asset as follows:

<table>
<thead>
<tr>
<th>Single Identifiable Asset</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Building</td>
<td>$5,450,000</td>
</tr>
<tr>
<td>Land</td>
<td>2,000,000</td>
</tr>
<tr>
<td>In-place lease intangible asset</td>
<td>50,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$7,500,000</strong></td>
</tr>
</tbody>
</table>

**Step 2**
Company A applies step 2 (see Section 2.4.2.2) and concludes that none of the remaining assets (i.e., cash, furniture or fixtures, or the intangible asset for the favorable property management contract) qualify for combination as similar assets under ASC 805-10-55-5B.

**Step 3**
Company A applies step 3 (see Section 2.4.2.3) and concludes that the gross assets acquired include any consideration transferred in excess of the fair value of the net identifiable assets acquired (i.e., goodwill in a business combination), but it does not include goodwill that results from the effects of deferred tax liabilities, cash and cash equivalents, deferred taxes, or liabilities. Company A calculates the fair value of gross assets acquired as follows:

<table>
<thead>
<tr>
<th>Amounts Recognized at Fair Value</th>
<th>Included in Gross Assets Acquired</th>
<th>Gross Assets Acquired</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$100,000</td>
<td>No</td>
</tr>
<tr>
<td>Furniture and fixtures</td>
<td>650,000</td>
<td>Yes</td>
</tr>
<tr>
<td>Building</td>
<td>5,450,000</td>
<td>Yes</td>
</tr>
<tr>
<td>Land</td>
<td>2,000,000</td>
<td>Yes</td>
</tr>
<tr>
<td>In-place lease intangible asset</td>
<td>50,000</td>
<td>Yes</td>
</tr>
<tr>
<td>Favorable contract intangible asset</td>
<td>80,000</td>
<td>Yes</td>
</tr>
<tr>
<td>Goodwill</td>
<td>265,000</td>
<td>Partially</td>
</tr>
<tr>
<td>Accrued liabilities</td>
<td>(400,000)</td>
<td>No</td>
</tr>
<tr>
<td>Mortgage liability</td>
<td>(3,000,000)</td>
<td>No</td>
</tr>
<tr>
<td>Deferred tax liability</td>
<td>(195,000)</td>
<td>No</td>
</tr>
<tr>
<td><strong>Total gross assets acquired</strong></td>
<td><strong>$8,300,000</strong></td>
<td></td>
</tr>
</tbody>
</table>

* Calculated as:

- Goodwill: $265,000
- Less: Goodwill resulting from deferred tax liabilities: $195,000
- Goodwill excluding the effects of deferred taxes: $70,000
Chapter 2 — Identifying a Business Combination

Example 2-1 (continued)

**Step 4**
Company A applies step 4 (see Section 2.4.2.4) and compares the fair value of the single identifiable asset (or group of similar assets), measured in step 2, to the fair value of the gross assets acquired, measured in step 3.

<table>
<thead>
<tr>
<th>Single identifiable asset or group of similar assets (step 2)</th>
<th>$7,500,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total gross assets acquired (step 3)</td>
<td>$8,300,000</td>
</tr>
<tr>
<td>Percentage</td>
<td>90.4%</td>
</tr>
</tbody>
</table>

While “substantially all” is generally interpreted to mean 90 percent or more in the definition of a business, it is not a bright line. Since 90.4 percent is only slightly above 90 percent, A might consider the qualitative factors in assessing whether the screen has been met.

For example, A might consider the nature of the acquired assets and liabilities, all of which are directly related to the apartment complex. Although A did not acquire any employees, it might consider whether the property management contract it obtained gives it access to an organized workforce, which could be an indicator that A has acquired a substantive process. In this case, A concludes that the contract is not unique or scarce and could be replaced without significantly delaying its ability to continue earning revenues. However, it decides not to replace the property manager because the pricing in the contract is favorable to A compared with the pricing it would be able to obtain on the acquisition date. In addition, A notes that if it had assumed that the acquisition were a business, the amount of goodwill measured would not be a significant amount. Company A believes that the qualitative factors support a determination that the screen is met and that the transaction is an asset acquisition.

2.4.2.6 Assessing the Screen Qualitatively

An entity may sometimes be able to determine qualitatively that the screen has been met. For example, if the acquisition includes a license for a drug candidate and an at-market contract that would have no fair value assigned to it, it may be clear that the screen has been met. By contrast, an entity may be able to qualitatively determine that the screen has not been met if there is clearly significant value in assets that are not similar. Paragraph BC19 of ASU 2017-01 states, in part:

In addition, an entity also could conclude that the set is not a business by assessing the guidance in paragraphs 805-10-55-5D through 55-6 and 805-10-55-8 through 55-9. The Board noted that if the set is not a business, an entity could choose to document its conclusion in the most cost-effective manner depending on its situation. [Emphasis added]

Therefore, entities may bypass the screen and proceed directly to the framework (see Section 2.4.3) as long as the set is determined not to be a business under the framework. However, entities may not bypass the screen and apply the framework to conclude that a set is a business since that determination may contradict the conclusion that would have been made by applying the screen.
2.4.3 Framework for Assessing Whether an Input and a Substantive Process Are Present

ASC 805-10

55-5 To be capable of being conducted and managed for the purposes described in paragraph 805-10-55-3A, an integrated set of activities and assets requires two essential elements — inputs and processes applied to those inputs. A business need not include all the inputs or processes that the seller used in operating that business. However, to be considered a business, the set must include, at a minimum, an input and a substantive process that together significantly contribute to the ability to create output. Paragraphs 805-10-55-5A through 55-5C provide a practical screen to determine when a set would not be considered a business. If the screen is not met, further assessment is necessary to determine whether the set is a business. Paragraphs 805-10-55-5D through 55-6 and 805-10-55-8 through 55-9 provide a framework to assist an entity in evaluating whether the set includes both an input and a substantive process.

55-8 Determining whether a particular set of assets and activities is a business should be based on whether the integrated set is capable of being conducted and managed as a business by a market participant. Thus, in evaluating whether a particular set is a business, it is not relevant whether a seller operated the set as a business or whether the acquirer intends to operate the set as a business.

If the screen is not met, entities must determine whether the acquired set includes, at a minimum, an input and a substantive process that together significantly contribute to the ability to create outputs. ASC 805-10-55 provides a framework for making that judgment.

The assessment of whether a set meets the definition of a business under the framework should be based on whether a market participant would be capable of conducting and managing the set as a business. Neither how the seller operated the set nor how the acquirer intends to operate it is relevant in making the determination. For example, if an acquirer obtains a set with operations that are similar to its own, its plans to integrate the set into its operations and use its own processes to continue the production of outputs are not relevant in the determination of whether a substantive process was acquired.

ASU 2017-01 eliminated the need to assess whether a market participant is capable of replacing any missing elements to continue the production of outputs. Therefore, entities must now focus their analysis on what was acquired and no longer on whether a market participant could potentially replace missing elements.

2.4.3.1 Identify the Elements of a Business

ASC 805-10

55-3A A business is an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants. To be considered a business, an integrated set must meet the requirements in paragraphs 805-10-55-4 through 55-6 and 805-10-55-8 through 55-9.
Chapter 2 — Identifying a Business Combination

ASC 805-10 (continued)

55-4 A business consists of inputs and processes applied to those inputs that have the ability to contribute to the creation of 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 contribute to the creation of, outputs when one or more processes are applied to it. Examples include long-lived assets (including intangible assets or rights to use long-lived assets), intellectual property, the ability to obtain access to necessary materials or rights, and employees.

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

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

55-6 The nature of the elements of a business varies by industry and by the structure of an entity's operations (activities), including the entity's stage of development. Established businesses often have many different types of inputs, processes, and outputs, whereas new businesses often have few inputs and processes and sometimes only a single output (product). Nearly all businesses also have liabilities, but a business need not have liabilities. In addition, some transferred sets of assets and activities that are not a business may have liabilities.

Both a business and an asset or a group of assets possess one or more inputs. As indicated in ASC 805-10-55-4, what distinguishes a business from an asset or a group of assets is that “[a] business consists of inputs and processes applied to those inputs that have the ability to contribute to the creation of outputs.”

According to ASC 805-10-55-4(b), a process is “[a]ny system, standard, protocol, convention, or rule that when applied to an input or inputs, creates or has the ability to contribute to the creation of outputs.” Examples of processes include:

- **Strategic management processes** — for setting the overall strategy and direction of operations.
- **Operational processes** — for obtaining contracts or customers, or developing, fulfilling, or producing outputs.
- **Resource management processes** — for obtaining inventory and managing operational employees.

While processes are usually documented, they do not need to be. For example, employees are an input, but they may form an organized workforce whose knowledge and ability may be considered a process, even if that process is not documented.

Determining whether a substantive process is present in a set can be challenging. ASC 805-10-55 provides guidance for making that judgment in response to the practice issues that existed under the previous definition of a business. According to the revised guidance, only processes that are used in the creation of outputs should be considered substantive under the definition of a business. For example, accounting, billing, payroll, and other administrative systems typically are not used to create outputs.
While acquiring a contract that gives access to an organized workforce may represent the acquisition of a substantive process, ASC 805-10-55-5F states that assumed contracts that provide for a continuation of revenues — such as customer contracts, customer lists, and leases (from the lessor’s perspective) — should not be considered acquired processes and should be excluded from the analysis.

To help reduce the likelihood that a transaction is inappropriately accounted for as a business acquisition, the Board emphasized in paragraph BC35 of ASU 2017-01 that a process must be important to the ability to create outputs. While ASC 805-10-55-5 notes that a “business need not include all the inputs or processes that the seller used in operating that business . . . to be considered a business, the set must include, at a minimum, an input and a substantive process that together significantly contribute to the ability to create output.”

As indicated in ASC 805-10-55-4(c), outputs are “[t]he result of inputs and processes applied to those inputs that provide goods or services to customers, investment income (such as dividends or interest), or other revenues.” ASU 2017-01 narrowed the definition of outputs to align it with the ability to generate goods or services for customers and make it consistent with the description of outputs in ASC 606. However, as discussed in paragraph BC59 of the ASU, “the Board noted that not all entities have revenues within the scope of Topic 606 and therefore, decided to incorporate other types of revenues in the definition. For example, the Board decided to include the reference to investment income in the definition of outputs in the amendments . . . to ensure that the purchase of an investment company can still qualify as a business combination.”

Although outputs are not required for a set to be a business, ASC 805-10-55 provides different criteria for determining whether a set has one or more substantive processes, depending on whether the set has outputs (i.e., a continuation of revenues before and after the acquisition). Because outputs are usually a fundamental element of a business, the Board reasoned that if there are no outputs, the other elements should be more significant. Therefore, the guidance includes more stringent criteria on what is required for a set to have a substantive process when outputs are not present.

ASC 805-10-55 does not specify the amount of outputs an entity should consider when assessing whether to apply the criteria for a set without outputs rather than a set with outputs. We believe that when determining which criteria to apply, an entity may need to use judgment. For example, if an acquired a set has only an insignificant amount of outputs (i.e., revenues), it may be appropriate for an entity to evaluate the criteria for a set without outputs to determine whether a substantive process exists.
2.4.3.2 Sets Without Outputs

ASC 805-10

55-5D When a set does not have outputs (for example, an early stage company that has not generated revenues), the set will have both an input and a substantive process that together significantly contribute to the ability to create outputs only if it includes employees that form an organized workforce and an input that the workforce could develop or convert into output. The organized workforce must have the necessary skills, knowledge, or experience to perform an acquired process (or group of processes) that when applied to another acquired input or inputs is critical to the ability to develop or convert that acquired input or inputs into outputs. An entity should consider the following in evaluating whether the acquired workforce is performing a substantive process:

a. A process (or group of processes) is not critical if, for example, it is considered ancillary or minor in the context of all the processes required to create outputs.

b. Inputs that employees who form an organized workforce could develop (or are developing) or convert into outputs could include the following:
   1. Intellectual property that could be used to develop a good or service
   2. Resources that could be developed to create outputs
   3. Access to necessary materials or rights that enable the creation of future outputs.

Examples of inputs that could be developed include technology, mineral interests, real estate, and in-process research and development.

ASC 805-10-55-5D states that if a set does not have outputs, a substantive process can only be provided by employees that form an organized workforce with “the necessary skills, knowledge, or experience to perform an acquired process (or group of processes) that when applied to another acquired input or inputs is critical to the ability to develop or convert that acquired input or inputs into outputs.” ASC 805-10-55 does not provide guidance on determining whether employees are providing a “critical” process, except to say that “[a] process (or group of processes) is not critical if, for example, it is considered ancillary or minor in the context of all the processes required to create outputs.” Accordingly, entities will need to use judgment in determining whether a process is critical.

While an organized workforce is an input, it is the workforce’s ability to make the set active that must be evaluated as a substantive process. In paragraph BC41 of ASU 2017-01, the Board explained:

If there is no organized workforce to perform an acquired process, the set on its own likely would not be able to actively contribute to the creation of outputs because the acquirer has to provide all of the activities to perform the process. For example, . . . without an organized workforce, an entity could conclude that the acquisition of a blueprint for an airplane includes a substantive process. When the set does not have outputs, . . . the process embedded in that blueprint is not substantive unless there is an organized workforce that could make the set active and contribute to the production of the airplane.
The determination of whether an organized workforce is performing a critical process requires judgment and varies from transaction to transaction and from industry to industry. Entities should evaluate whether the process (or group of processes) is critical in the context of all the processes required to create outputs. If the process (or group of processes) is considered ancillary or minor in that context, it is not critical. The following factors may be indicators that the acquired organized workforce has the necessary skills, knowledge, or experience to perform a critical process (none of the factors below are individually determinative):

- **Composition and size of the workforce** — Generally, the greater the number of employees in an organized workforce, the more likely the process (or group of processes) they perform is critical. However, the composition of the workforce also needs to be considered. That is, a large number of employees that perform ancillary or minor tasks may not have the requisite skills, knowledge, or experience to perform a critical process. By contrast, a small number of employees that have significant skills, knowledge, or experience may perform a process critical to the development of outputs.

- **Ability for the set to operate independently** — A set that includes an organized workforce that was operating independently before the acquisition may be an indicator that the organized workforce is performing a critical process (or group of processes).

- **Significant amount of goodwill** — A set that includes a significant amount of goodwill may be an indicator that the organized workforce has the necessary skills, knowledge, or experience to perform a critical process (or group of processes).

- **Advanced stage of activities** — A set that includes an organized workforce that is in advanced stages of converting acquired inputs into outputs (i.e., generating revenues) may be an indicator that the processes being performed by the employees are critical. For example, if an acquired set is close to generating revenues on a stand-alone basis and the acquirer does not anticipate the need to add a significant number of employees with requisite skills, knowledge, or experience, this may indicate that the organized workforce is performing a critical process (or group of processes).

When an entity obtains access to an organized workforce as a result of an acquired contractual arrangement, the entity cannot consider such workforce to be an acquired substantive process if outputs are not present. The Board indicated in paragraph BC47 of ASU 2017-01 that:

> [W]ithout an employee to manage the performance of the vendor, there are inherent limitations on the processes that can be performed in a development capacity without further decision making or actions from an employee. In contrast, when a vendor is actively contributing to and continuously creating outputs (for example, an asset manager that continuously manages an investment portfolio and generates investment revenues), the Board concluded that the process performed by the service provider is more likely to be substantive and should still be a factor to consider when the set has outputs.

However, the management of service providers could be considered a critical process performed by employees. In paragraph BC48 of ASU 2017-01, the Board noted that “as an example, an entity should come to consistent conclusions when evaluating a set that has 100 employees and a set that has 20 employees with the equivalent of 80 employees replaced by outsourced service providers because the 20 employees would be responsible for the management and performance of the outsourced employees.” If a set without outputs includes both employees and an outsourced workforce, entities must use judgment to determine whether the employees represent an organized workforce that provides a substantive process.
Under ASC 805-10-55-5D(b), for a set without outputs to be a business, it must contain both an organized workforce performing a substantive process and “[i]nputs that employees who form an organized workforce could develop (or are developing) or convert into outputs.” The acquisition of an organized workforce alone is not sufficient to conclude that a set is a business.

The following table summarizes the examples in ASC 805-10-55-65 through 55-81 (see Section 2.4.4), which illustrate scenarios in which an entity analyzes whether a set without outputs is a business:

<table>
<thead>
<tr>
<th>Case</th>
<th>Facts</th>
<th>Does the Set Without Outputs Have an Input and a Substantive Process?</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Case B: Acquisition of a Drug Candidate</strong> (Scenario 2 in ASC 805-10-55-65 through 55-69)</td>
<td>Acquisition of a legal entity that contains the rights to two phase 3 compounds; each is being developed to treat a different medical condition. The set is not yet producing outputs. No employees, other assets, or other activities are transferred.</td>
<td>No. The set includes inputs but not a substantive process, since no employees are acquired as part of the transaction. An organized workforce must be present for a set without outputs to have a substantive process.</td>
</tr>
<tr>
<td><strong>Case C: Acquisition of Biotech</strong> (ASC 805-10-55-70 through 55-72)</td>
<td>Acquisition of a biotech with several IPR&amp;D projects that are in different phases of the FDA approval process and that would treat significantly different diseases. The set includes senior management and scientists who have the necessary skills, knowledge, or experience to perform R&amp;D activities. It is not yet generating revenues.</td>
<td>Yes. The set includes inputs and a substantive process, since senior management and the scientists form an organized workforce that is critical to the ability to develop the inputs into a product that will be provided to customers.</td>
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<tr>
<td><strong>Case D: Acquisition of a Television Station</strong> (ASC 805-10-55-73 through 55-76)</td>
<td>Acquisition of an FCC license, broadcasting equipment, and an office building. No employees will be transferred and the set is not producing outputs.</td>
<td>No. The set includes inputs but not a substantive process, since the set does not include an organized workforce. An organized workforce must be present for a set without outputs to have a substantive process.</td>
</tr>
<tr>
<td><strong>Case E: Acquisition of a Manufacturing Facility</strong> (ASC 805-10-55-77 through 55-81)</td>
<td>Acquisition of an idled manufacturing facility and related equipment but no intellectual property, inventory, customer relationships, or other inputs. To comply with local labor laws, the set must include the furloughed employees.</td>
<td>No. The set includes an organized workforce with the skills to use the equipment but not the necessary intellectual property or other inputs that could be converted into outputs by using the equipment.</td>
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### 2.4.3.3 Sets With Outputs

<table>
<thead>
<tr>
<th>ASC 805-10</th>
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<tbody>
<tr>
<td><strong>55-SE</strong></td>
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<td>a.</td>
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<td>c.</td>
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<td>d.</td>
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<td><strong>55-5F</strong></td>
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Like a set without outputs, a set with outputs is a business if it includes, at a minimum, both an input and a substantive process that together significantly contribute to the ability to create outputs. A set has outputs if there is a continuation of revenue before and after the transaction. While the continuation of revenues alone does not mean that a set is a business, the Board concluded in paragraph BC51 of ASU 2017-01 that a set with outputs is more likely to include an input and substantive process than a set without outputs. Therefore, the criteria for determining whether a substantive process is present are less stringent than those for a set that is not producing outputs. According to ASC 805-10-55-5E, when a set has outputs, a substantive process may be provided by any of the following:

- "[E]mployees that form an organized workforce."
- "[A]n acquired contract that provides access to an organized workforce."
- A process (or group of processes) that, “when applied to an acquired input or inputs significantly contributes to the ability to continue producing outputs and cannot be replaced without significant cost, effort, or delay in the ability to continue producing outputs."
- A process (or group of processes) that, “when applied to an acquired input or inputs significantly contributes to the ability to continue producing outputs and is considered unique or scarce.”

As indicated by that guidance, an organized workforce “must have the necessary skills, knowledge, or experience to perform an acquired process (or group of processes) that when applied to another acquired input or inputs is critical to the ability to develop or convert that acquired input or inputs into outputs.”
The determination of whether an organized workforce is performing a critical process requires judgment and varies from transaction to transaction and from industry to industry. Entities should evaluate whether the process (or group of processes) is critical in the context of all the processes required to create outputs. If that process (or group of processes) is considered ancillary or minor in that context, it is not critical. We generally believe that entities should consider the same factors described in Section 2.4.3.2 to determine whether an organized workforce in a set with outputs has the necessary skills, knowledge, or experience to perform a critical process (or group of processes).

Many industries outsource operating activities that may not be significantly different from those that would be performed by employees (e.g., contract manufacturers or property managers). When a set has outputs, an entity must evaluate acquired contracts to determine whether they represent an acquired substantive process or, possibly, an input. Paragraph BC46 in ASU 2017-01 states:

The Board concluded that the assessment of a contractual arrangement, such as a supply agreement, should be relatively straightforward, meaning those contracts would likely be inputs because the supplier is not applying a process to another input in the set. However, the Board rejected the view that a service provided through a contractual arrangement should never indicate that a substantive process was acquired. The Board observed that there are many industries in which operating activities are outsourced, and the activities performed by a service provider may not be significantly different than the activities that would be performed by employees. The Board acknowledges that in some circumstances, whether an organized workforce accessed through a contractual arrangement performs or provides a process could be subjective and the critical factor to determining whether a set is a business.

Therefore, when a set has outputs, entities must use judgment in determining whether an acquired contract that provides access to an organized workforce also represents a substantive process. Entities should consider the substance of the contract, including:

- The nature of the activities performed by the outsourced workforce.
- The duration and the renewal terms of the contract.
- Whether the outsourced workforce is critical to the ability to continue producing outputs.
- Whether the outsourced workforce could be replaced without significant cost, effort, or delay in the ability to continue producing outputs.

As part of an acquisition, the buyer and seller may agree that the seller will provide services to the buyer after the acquisition. Such an arrangement, commonly referred to as a transition services agreement or a TSA, specifies the period of services and the fee to be paid by the buyer. We believe that a TSA typically does not give the acquirer access to an organized workforce that represents a substantive process because the services provided under a TSA are often limited both in duration and scope.

A substantive process may also be present without an organized workforce when a set has outputs. For example, a set may have one or more automated processes through acquired technology or infrastructure (e.g., automated technology, or a manufacturing or production line). In accordance with ASC 805-10-55-SE, for an automated process to be considered substantive, (1) it must significantly contribute “to the ability to continue producing outputs” when applied to an input or inputs and (2) the acquirer cannot have the ability to replace it “without significant cost, effort, or delay in the ability to continue producing outputs,” or it must be “unique or scarce.”
The following table summarizes the examples in ASC 805-10-55-52 through 55-96 (see Section 2.4.4), which illustrate scenarios in which an entity analyzes whether a set with outputs is a business:

<table>
<thead>
<tr>
<th>Case</th>
<th>Facts</th>
<th>Does the Set With Outputs Have an Input and a Substantive Process?</th>
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<tbody>
<tr>
<td><strong>Case A: Acquisition of Real Estate</strong> (Scenario 2 in ASC 805-10-55-52 through 55-64)</td>
<td>Acquisition of a portfolio of single-family homes, an office park with multiple office buildings, and vendor contracts for outsourced cleaning security and maintenance. The set has continuing revenues through in-place leases.</td>
<td>No. The set has inputs but does not have a substantive process because (1) no employees are acquired, (2) the processes provided by the outsourced contracts are ancillary or minor in the context of all of the processes required in the creation of outputs, and (3) the contracts can be replaced with little cost, effort, or delay and are not unique or scarce.</td>
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<tr>
<td>(Scenario 3 in ASC 805-10-55-52 through 55-64)</td>
<td>Acquisition of a portfolio of single-family homes; an office park with multiple office buildings; employees responsible for leasing, tenant management, and managing operational processes; and vendor contracts for outsourced cleaning security and maintenance. The set has continuing revenues through in-place leases.</td>
<td>Yes. The set has inputs and a substantive process in the form of an organized workforce that performs processes that are critical to the ability to continue producing outputs.</td>
</tr>
<tr>
<td><strong>Case F: License of Distribution Rights</strong> (ASC 805-10-55-82 through 55-84)</td>
<td>Acquisition of distribution rights, customer contracts, and an at-market supply agreement. The set has outputs through a continuation of revenues.</td>
<td>No. The set has inputs (distribution contracts, customer contracts, and supply agreement) but does not include an organized workforce or other process.</td>
</tr>
<tr>
<td><strong>Case G: Acquisition of Brands</strong> (ASC 805-10-55-85 through 55-87)</td>
<td>Acquisition of a right to a brand, including all related intellectual property, customer contracts and relationships, inventory, marketing materials, customer incentive programs, supply contracts, specialized equipment, and documented processes. It does not include employees, any of the manufacturing equipment or processes needed to create the product, or distribution facilities or processes. The set has outputs through a continuation of revenues.</td>
<td>Yes. Even though no employees are acquired, the set includes inputs and a substantive process in the form of unique manufacturing processes.</td>
</tr>
<tr>
<td><strong>Case H: Acquisition of Loan Portfolio</strong> (Scenario 2 in ASC 805-10-55-88 through 55-96)</td>
<td>Acquisition of a portfolio of commercial loans. No employees are acquired, and the set has a continuation of revenues (interest income).</td>
<td>No. The set has inputs but does not have a substantive process because it does not include an organized workforce or other processes.</td>
</tr>
<tr>
<td>(Scenario 3 in ASC 805-10-55-88 through 55-96)</td>
<td>Acquisition of a portfolio of commercial loans and the employees that managed the credit risk of the portfolio and the relationship with the borrowers. The set has a continuation of revenues (interest income).</td>
<td>Yes. The set includes an input and a substantive process in the form of an organized workforce that performs processes that are critical to the ability to continue to produce outputs.</td>
</tr>
</tbody>
</table>
2.4.3.4 Groups of Processes

Individual processes that are used to create outputs may sometimes be considered insignificant on their own but could be substantive as a group because all the processes together could be difficult to replace without significant cost or effort or a delay in operations. In determining whether a substantive process is present, entities should consider whether a group of processes are together significant.

2.4.3.5 Presence of Goodwill

To help entities evaluate whether a set includes a substantive process, the FASB notes in ASC 805-10-55-9 that “the presence of more than an insignificant amount of goodwill may be an indicator that the acquired process is substantive.” That is, the presence of more than an insignificant amount of goodwill could be an indicator that an organized workforce is performing a critical process or that an acquired process in a set is substantive.

Paragraph B313 of the Basis for Conclusions of FASB Statement 141(R) describes components that are conceptually part of goodwill — the fair values of “the going-concern element of the acquiree’s existing business” and “the expected synergies and other benefits from combining the acquirer’s and acquiree’s net assets and businesses.” The guidance also lists elements that are captured in the measurement of goodwill in a business combination but are not conceptually part of goodwill — namely, “[o]vervaluation of the consideration paid by the acquirer stemming from [valuation] errors” and “[o]verpayment or underpayment by the acquirer.” We believe that while the nonrecognition of certain assets and liabilities and the measurement of certain assets or liabilities at amounts other than fair value are not conceptually part of goodwill, those components are captured in the measurement of goodwill. In evaluating goodwill as an indicator of a substantive process, entities should consider the reasons why they have calculated an excess and whether the excess is related to the elements that are conceptually part of goodwill.

Often, part of an excess is the result of an assembled workforce intangible asset that is subsumed into goodwill in a business combination. In such cases, entities should consider whether the employees represent an organized workforce as described in Section 2.4.3.2. That is, in accordance with ASC 805-10-55-5D, entities should assess whether the employees “have the necessary skills, knowledge, or experience to perform an acquired process (or group of processes) that when applied to another acquired input or inputs is critical to the ability to develop or convert that acquired input or inputs into outputs.” The presence of an assembled workforce that has significant fair value may be an indicator that the employees are performing a substantive process. Similarly, an excess may indicate that there is value in an acquired process that would not be captured in an identifiable asset.

2.4.4 Examples Illustrating the Application of the Guidance

The examples in ASC 805-10-55-52 through 55-96 below illustrate the application of the guidance on the definition of a business discussed throughout this chapter.
Case A: Acquisition of Real Estate

Scenario 1

ABC acquires, renovates, leases, sells, and manages real estate properties. ABC acquires a portfolio of 10 single-family homes that each have in-place leases. The only elements included in the acquired set are the 10 single-family homes and the 10 in-place leases. Each single-family home includes the land, building, and property improvements. Each home has a different floor plan, square footage, lot, and interior design. No employees or other assets are acquired.

ABC first considers the threshold guidance in paragraphs 805-10-55-5A through 55-5C. ABC concludes that the land, building, property improvements, and in-place leases at each property can be considered a single asset in accordance with paragraph 805-10-55-5B. That is, the building and property improvements are attached to the land and cannot be removed without incurring significant cost. Additionally, the in-place lease is an intangible asset that should be combined with the related real estate and considered a single asset.

ABC also concludes that the 10 single assets (the combined land, building, in-place lease intangible, and property improvements) are similar. Each home has a different floor plan; however, the nature of the assets (all single-family homes) are similar. ABC also concludes that the risks associated with managing and creating outputs are not significantly different. That is, the risks associated with operating the properties and tenant acquisition and management are not significantly different because the types of homes and class of customers are not significantly different. Similarly, the risks associated with operating in the real estate market of the homes acquired are not significantly different. Consequently, ABC concludes that substantially all of the fair value of the gross assets acquired is concentrated in the group of similar identifiable assets; thus, the set is not a business.

Scenario 2

Assume the same facts as in Scenario 1 except that ABC also acquires an office park with six 10-story office buildings leased to maximum occupancy of which all have significant fair value. ABC also acquires the vendor contracts for outsourced cleaning, security, and maintenance. Seller’s employees that perform leasing (sales, underwriting, and so forth), tenant management, financing, and other strategic management processes are not included in the set. ABC plans to replace the property management and employees with its own internal resources.

ABC concludes that the single-family homes and office park are not similar assets. ABC considers the risks associated with operating the assets, obtaining tenants, and tenant management between the single-family homes and office park to be significantly different because the scale of operations and risks associated with the class of customers are significantly different. Therefore, substantially all of the fair value of the gross assets acquired is not concentrated in a single identifiable asset or group of similar identifiable assets. Thus, ABC must further evaluate whether the set has the minimum requirements to be considered a business.

The set has continuing revenues through the in-place leases and, therefore, has outputs. ABC must consider the criteria in paragraph 805-10-55-5E to determine whether the set includes both an input and a substantive process that together significantly contribute to the ability to create outputs.

ABC concludes that the criteria in paragraph 805-10-55-5E(a) through (b) are not met because the set does not include employees and the processes performed through the cleaning and security contracts (the only processes acquired) will be considered ancillary or minor in the context of all the processes required to create outputs in the real estate industry. That is, while those outsourcing agreements may be considered to provide an organized workforce that performs cleaning and security processes when applied to the building, the processes performed by the cleaning, security, and maintenance personnel are not considered critical in the context of all the processes required to create outputs.
ASC 805-10 (continued)

55-59 ABC also concludes that the criterion in paragraph 805-10-55-5E(c) is not met because the cleaning and security processes could be easily replaced with little cost, effort, or delay in the ability to continue producing outputs. While the cleaning and security processes are necessary for continued operations of the buildings, these contracts can be replaced quickly with little effect on the ability to continue producing outputs.

55-60 ABC concludes that the criterion in paragraph 805-10-55-5E(d) is not met because the cleaning and security contracts are not considered unique or scarce. That is, these types of arrangements are readily accessible in the marketplace.

55-61 Because none of the criteria were met, ABC concludes that the set does not include both an input and substantive processes that together significantly contribute to the ability to create outputs and, therefore, is not considered a business.

Scenario 3

55-62 Assume the same facts as in Scenario 2, except that the set includes the employees responsible for leasing, tenant management, and managing and supervising all operational processes.

55-63 The set has continuing revenues through the in-place leases and, therefore, has outputs. ABC must consider the criteria in paragraph 805-10-55-5E to determine whether the set includes both an input and a substantive process that together significantly contribute to the ability to create outputs.

55-64 ABC determines that the criterion in paragraph 805-10-55-5E(a) is met because the set includes an organized workforce that performs processes that when applied to the acquired inputs in the set (the land, building, and in-place leases) are critical to the ability to continue producing outputs. That is, ABC concludes that the leasing, tenant management, and supervision of the operational processes are critical to the creation of outputs. Because it includes both an input and a substantive process, the set is considered a business.

Case B: Acquisition of a Drug Candidate

Scenario 1

55-65 Pharma Co. purchases from Biotech a legal entity that contains the rights to a Phase 3 (in the clinical research phase) compound being developed to treat diabetes (the in-process research and development project). Included in the in-process research and development project is the historical know-how, formula protocols, designs, and procedures expected to be needed to complete the related phase of testing. The legal entity also holds an at-market clinical research organization contract and an at-market clinical manufacturing organization contract. No employees, other assets, or other activities are transferred.

55-66 Pharma Co. first considers the guidance in paragraphs 805-10-55-5A through 55-5C. Pharma Co. concludes that the in-process research and development project is an identifiable intangible asset that would be accounted for as a single asset in a business combination. Pharma Co. also qualitatively concludes that there is no fair value associated with the clinical research organization contract and the clinical manufacturing organization contract because the services are being provided at market rates and could be provided by multiple vendors in the marketplace. Therefore, all of the consideration in the transaction will be allocated to the in-process research and development project. As such, Pharma Co. concludes that substantially all of the fair value of the gross assets acquired is concentrated in the single in-process research and development asset and the set is not a business.

Scenario 2

55-67 Pharma Co. purchases from Biotech a legal entity that contains the rights to a Phase 3 compound being developed to treat diabetes (Project 1) and a Phase 3 compound being developed to treat Alzheimer's disease (Project 2). Included with each project are the historical know-how, formula protocols, designs, and procedures expected to be needed to complete the related phase of testing. The legal entity also holds at-market clinical research organization contracts and at-market clinical manufacturing organization contracts associated with each project. Assume that Project 1 and Project 2 have equal fair value. No employees, other assets, or other activities are transferred.
Pharma Co. concludes that Project 1 and Project 2 are each separately identifiable intangible assets, both of which would be accounted for as a single asset in a business combination. Pharma Co. then considers whether Project 1 and Project 2 are similar assets. Pharma Co. notes that the nature of the assets is similar in that both Project 1 and Project 2 are in-process research and development assets in the same major asset class. However, Pharma Co. concludes that Project 1 and Project 2 have significantly different risks associated with creating outputs from each asset because each project has different risks associated with developing and marketing the compound to customers. The projects are intended to treat significantly different medical conditions, and each project has a significantly different potential customer base and expected market and regulatory risks associated with the assets. Thus, Pharma Co. concludes that substantially all of the fair value of the gross assets acquired is not concentrated in a single identifiable asset or group of similar identifiable assets and that it must further evaluate whether the set has the minimum requirements to be considered a business.

Because the set does not have outputs, Pharma Co. evaluates the criteria in paragraph 805-10-55-5D to determine whether the set has both an input and a substantive process that together significantly contribute to the ability to create outputs. Pharma Co. concludes that the criteria are not met because the set does not have employees. As such, Pharma Co. concludes that the set is not a business.

Case C: Acquisition of Biotech

Pharma Co. buys all of the outstanding shares of Biotech. Biotech’s operations include research and development activities on several drug compounds that it is developing (in-process research and development projects). The in-process research and development projects are in different phases of the U.S. Food and Drug Administration approval process and would treat significantly different diseases. The set includes senior management and scientists that have the necessary skills, knowledge, or experience to perform research and development activities. In addition, Biotech has long-lived tangible assets such as a corporate headquarters, a research lab, and lab equipment. Biotech does not yet have a marketable product and, therefore, has not generated revenues. Assume that each research and development project has a significant amount of fair value.

Pharma Co. first considers the guidance in paragraphs 805-10-55-5A through 55-5C. The identifiable assets in the set include multiple in-process research and development projects and tangible assets (the corporate headquarters, the research lab, and the lab equipment). Pharma Co. concludes that the in-process research and development projects are not similar assets because the projects have significantly different risks associated with managing the assets and creating the outputs (that is, because there are significantly different development risks in the different phases of development, market risks related to the different customer base, and potential markets for the compounds). In addition, Pharma Co. concludes that there is fair value associated with the acquired workforce because of the proprietary knowledge of and experience with Biotech’s ongoing development projects and the potential for creation of new development projects that the workforce embodies. As such, Pharma Co. concludes that substantially all of the fair value of the gross assets acquired is not concentrated in a single identifiable asset or group of similar identifiable assets and that it must further evaluate whether the set has the minimum requirements to be considered a business.

Because the set does not have outputs, Pharma Co. evaluates the criteria in paragraph 805-10-55-5D to determine whether the set has both an input and a substantive process that together significantly contribute to the ability to create outputs. Pharma Co. concludes that the criteria are met because the scientists make up an organized workforce that has the necessary skills, knowledge, or experience to perform processes that when applied to the in-process research and development inputs is critical to the ability to develop those inputs into a product that can be provided to a customer. Pharma Co. also determines that there is a more-than-insignificant amount of goodwill (including the fair value associated with the workforce), which is another indicator that the workforce is performing a critical process. Thus, the set includes both inputs and substantive processes and is a business.
### Case D: Acquisition of a Television Station

**55-73** Company A is a television broadcaster whose principal business is the ownership and operation of a television station group in the United States through which it broadcasts its proprietary health-care-related programming. Company B owns and operates several television stations in the western United States. Because of a recent merger, Company B must divest itself of a station in Portland, Oregon (KPOR), and agrees to sell the station to Company A.

**55-74** Company A plans to change KPOR’s programming format to its proprietary health-care-related programming. Therefore, Company A will receive only the U.S. Federal Communications Commission license, the broadcasting equipment, and the office building. KPOR will be integrated into Company A’s operations, with most of the station processes centralized at Company A’s corporate headquarters. Company A will not extend offers of employment to any of KPOR’s employees or assume any of KPOR’s contractual relationships.

**55-75** Company A first considers the guidance in paragraphs 805-10-55-5A through 55-5C. The U.S. Federal Communications Commission license is an intangible asset that is recognized and measured separately in a business combination, while the broadcast equipment and building are tangible nonfinancial assets in different major classes. Company A concludes that the broadcast equipment and building are not considered a single asset because the equipment is not attached to the building and can be removed without significant cost or diminution in fair value. Furthermore, none of the assets will be considered similar in accordance with paragraph 805-10-55-5C because the U.S. Federal Communications Commission license cannot be considered similar to tangible assets and the tangible assets are in different major asset classes. Each of the separate identifiable assets has significant fair value. Thus, Company A concludes that substantially all of the fair value of the gross assets acquired is not concentrated in a single identifiable asset or group of similar identifiable assets and that it must further evaluate whether the set has the minimum requirements to be considered a business.

**55-76** The set does not have outputs; therefore, Company A considers the criteria in paragraph 805-10-55-5D to determine whether the set includes both an input and a substantive process that together significantly contribute to the ability to create outputs. The set does not include an organized workforce, so it does not meet the criteria in paragraph 805-10-55-5D. Therefore, the set does not include both an input and a substantive process and is not considered a business.

### Case E: Acquisition of a Manufacturing Facility

**55-77** Widget Co. manufactures complex equipment and has manufacturing facilities throughout the world. Widget Co. decided to idle a facility in a foreign jurisdiction in a reorganization of its manufacturing footprint and furloughed the assembly line employees.

**55-78** Acquirer enters into an agreement to purchase a manufacturing facility and related equipment from Widget Co. To comply with the local labor laws, Acquirer also must assume the furloughed employees.

**55-79** The assets acquired include the equipment and facility (land and building) but no intellectual property, inventory, customer relationships, or any other inputs.

**55-80** Acquirer first considers the guidance in paragraphs 805-10-55-5A through 55-5C. Acquirer concludes that the equipment in the facility can be removed without significant cost or diminution in utility or fair value because the equipment is not attached to the building and can be used in many types of manufacturing facilities. Therefore, the equipment and building are not a single asset. Furthermore, the equipment and facility are not considered similar assets because they are different major classes of tangible assets. Acquirer determines that there is significant fair value in both the equipment and the facility and, thus, concludes that it must further evaluate whether the set has the minimum requirements to be considered a business.
ASC 805-10 (continued)

55-81 The set is not currently producing outputs because there is no continuation of revenue before and after the transaction; therefore, Acquirer considers the criteria in paragraph 805-10-55-5D and whether the set includes both employees that form an organized workforce and an input that the workforce could develop or convert into output. The set includes employees that have the necessary skills, knowledge, or experience to use the equipment; however, without intellectual property or other inputs that could be converted into outputs using the equipment, the set does not include both an organized workforce and an input that will meet the criteria in paragraph 805-10-55-5D. That is, the equipment itself cannot be developed or converted into an output by those employees. Therefore, the set is not a business.

Case F: License of Distribution Rights

55-82 Company A is a distributor of food and beverages. Company A enters into an agreement to sublicense the Latin American distribution rights of Yogurt Brand F to Company B, whereby Company B will distribute Yogurt Brand F in Latin America. As part of the agreement, Company A transfers the existing customer contracts in Latin America to Company B and an at-market supply contract with the producer of Yogurt Brand F. Company A retains all of its employees and distribution capabilities.

55-83 Company B first considers the guidance in paragraphs 805-10-55-5A through 55-5C. The identifiable assets that could be recognized in a business combination include the license to distribute Yogurt Brand F, customer contracts, and the supply agreement. Company B concludes that the license and customer contracts will have fair value assigned to them. Company B concludes that neither asset represents substantially all of the fair value of the gross assets. Company B then considers whether the license and customer contracts are a group of similar intangible assets. Because the license and customer contracts are in different major classes of identifiable intangible assets, they are not considered similar assets. Therefore, substantially all of the fair value of the gross assets acquired is not concentrated in a single identifiable asset or group of similar identifiable assets, and Company B must evaluate whether the set has both an input and a substantive process.

55-84 The set has outputs through the continuation of revenues with customers in Latin America. As such, Company B must evaluate the criteria in paragraph 805-10-55-5E to determine whether the set includes an input and a substantive process that together significantly contribute to the ability to create outputs. Company B considers whether the acquired contracts are providing access to an organized workforce that performs a substantive process. However, because the contracts are not providing a service that applies a process to another acquired input, Company B concludes that the substance of the contracts are only that of acquiring inputs. The set is not a business because:

a. It does not include an organized workforce that could meet the criteria in paragraph 805-10-55-5E(a) through (b).

b. There are no acquired processes that could meet the criteria in paragraph 805-10-55-5E(c) through (d).

c. It does not include both an input and a substantive process.

Case G: Acquisition of Brands

55-85 Company A is a global producer of food and beverages. Company A sells the worldwide rights of Yogurt Brand F, including all related intellectual property, to Company B. Company B also acquires all customer contracts and relationships, finished goods inventory, marketing materials, customer incentive programs, raw material supply contracts, specialized equipment specific to manufacturing Yogurt Brand F, and documented processes and protocols to produce Yogurt Brand F. Company B does not receive employees, manufacturing facilities, all of the manufacturing equipment and processes required to produce the product, and distribution facilities and processes.
Chapter 2 — Identifying a Business Combination

ASC 805-10 (continued)

55-86 Company B first considers the guidance in paragraphs 805-10-55-5A through 55-5C. The gross assets include intellectual property (the trademark, the related trade name, and recipes) associated with Yogurt Brand F (the intellectual property associated with the brand is determined to be a single intangible asset in accordance with the guidance in paragraph 805-20-55-18), customer contracts and related relationships, equipment, finished goods inventory, and the excess of the consideration transferred over the fair value of the net assets acquired. Company B concludes that substantially all of the fair value of the gross assets acquired is not concentrated in a single identifiable asset or group of similar identifiable assets even though, for purposes of the analysis, the intellectual property is considered to be a single identifiable asset. In addition, because there is significant fair value in both tangible assets and intangible assets, Company B concludes that there is not a group of similar assets that meets this threshold.

55-87 The set has outputs through the continuation of revenues, and Company B must consider the criteria in paragraph 805-10-55-5E to determine whether the set includes both inputs and a substantive process that together significantly contribute to the ability to create outputs. The set does not include an organized workforce and, therefore, does not meet the criteria in paragraph 805-10-55-5E(a) through (b). However, the acquired manufacturing processes are unique to Yogurt Brand F, and when those processes are applied to acquired inputs such as the intellectual property, raw material supply contracts, and the equipment, they significantly contribute to the ability to continue producing outputs. As such, the criterion in paragraph 805-10-55-5E(c) is met, and the set includes both inputs and substantive processes. Because the set includes inputs and substantive processes that together significantly contribute to the ability to create outputs, it is considered a business.

Case H: Acquisition of Loan Portfolio

Scenario 1

55-88 Bank A purchases a loan portfolio from Bank Z. The portfolio of loans consists of residential mortgages with terms, size, and risk ratings that are not significantly different. Bank A does not take over the employees of Bank Z that managed the credit risk of the portfolio and the relationship with the borrowers (such as brokers, vendors, and risk managers).

55-89 Bank A first considers the guidance in paragraphs 805-10-55-5A through 55-5C. Bank A concludes that the nature of the assets (residential mortgage loans) is similar. Bank A also concludes that the risks associated with managing and creating outputs are not significantly different because the terms, size, and risk ratings of the loans are not significantly different. Because all of the fair value of the gross assets acquired is in a group of similar identifiable assets, the set is not a business.

Scenario 2

55-90 Assume the same facts as in Scenario 1 except that the portfolio of loans consists of commercial loans with term, size, and risk ratings that are significantly different.

55-91 Bank A first considers the guidance in paragraphs 805-10-55-5A through 55-5C. Bank A must consider whether the loans are similar. Bank A concludes that the nature of the assets (commercial loans) is similar; however, because the term, size, and risk ratings of the loans are significantly different, Bank A concludes that the risks associated with managing and creating outputs are significantly different. Thus, Bank A concludes that substantially all of the fair value of the gross assets acquired is not concentrated in a single identifiable asset or group of similar identifiable assets and that it must further evaluate whether the set has the minimum requirements to be considered a business.

55-92 The set has outputs through the continuation of revenues (interest income). Consequently, Bank A considers the criteria in paragraph 805-10-55-5E to determine whether the set includes both inputs and a substantive process that together significantly contribute to the ability to create outputs. Because the set does not include an organized workforce or acquired processes, the criteria in paragraph 805-10-55-5E are not met and the set is not a business.
Scenario 3

55-93 Assume the same facts as in Scenario 2 except that Bank A takes over the employees of Bank Z that managed the credit risk of the portfolio and the relationship with the borrowers (such as brokers and risk managers). Additionally, consideration transferred is significantly higher than Bank A’s estimate of the fair value of the loan portfolio.

55-94 Bank A first considers the guidance in paragraphs 805-10-55-5A through 55-5C. Bank A concludes that the loan portfolio does not consist of similar identifiable assets. Bank A also concludes that there is significant fair value associated with different groups of financial assets and the acquired workforce. As such, Bank A concludes that substantially all of the fair value of the gross assets acquired is not concentrated in a single identifiable asset or group of similar identifiable assets and that it must further evaluate whether the set has met the minimum requirements to be considered a business.

55-95 The set has outputs through the continuation of revenues (interest income). Consequently, Bank A considers the criteria in paragraph 805-10-55-5E to determine whether the set includes both an input and a substantive process that together significantly contribute to the ability to create outputs.

55-96 Bank A evaluates the criteria in paragraph 805-10-55-5E and concludes that the criterion in paragraph 805-10-55-5E(a) is met because the set includes an organized workforce that performs processes (customer relationship management and credit risk management) critical to the ability to continue producing outputs; therefore, the set is a business.
Chapter 3 — Identifying the Acquirer and Determining the Acquisition Date

If a transaction is determined to be a business combination, it is accounted for by applying the acquisition method. ASC 805-10-05-4 states that the “acquisition method requires all of the following steps”:

1. “Identifying the acquirer” — see Section 3.1 below.
2. “Determining the acquisition date” — see Section 3.2.
3. “Recognizing and measuring the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree” — see Chapter 4.
4. “Recognizing and measuring goodwill or a gain from a bargain purchase” — see Chapter 5.

3.1 Identifying the Acquirer

ASC 805-10

25-4 For each business combination, one of the combining entities shall be identified as the acquirer.

25-5 The guidance in the General Subsections of Subtopic 810-10 related to determining the existence of a controlling financial interest shall be used to identify the acquirer — the entity that obtains control of the acquiree. If a business combination has occurred but applying that guidance does not clearly indicate which of the combining entities is the acquirer, the factors in paragraphs 805-10-55-11 through 55-15 shall be considered in making that determination. However, in a business combination in which a variable interest entity (VIE) is acquired, the primary beneficiary of that entity always is the acquirer. The determination of which party, if any, is the primary beneficiary of a VIE shall be made in accordance with the guidance in the Variable Interest Entities Subsections of Subtopic 810-10, not by applying either the guidance in the General Subsections of that Subtopic, relating to a controlling financial interest, or in paragraphs 805-10-55-11 through 55-15.

55-10 Paragraph 805-10-25-5 provides that the guidance in the General Subsections of Subtopic 810-10 related to determining the existence of a controlling financial interest should be used to identify the acquirer in a business combination, except when a variable interest entity (VIE) is acquired. If a business combination has occurred but applying that guidance does not clearly indicate which of the combining entities is the acquirer, paragraph 805-10-25-5 requires the factors in paragraphs 805-10-55-11 through 55-15 to be considered in making that determination.

ASC 805-10-25-4 requires entities to identify an acquirer in every business combination. The ASC master glossary defines an acquirer as follows:

The entity that obtains control of the acquiree. However, in a business combination in which a variable interest entity (VIE) is acquired, the primary beneficiary of that entity always is the acquirer.
The entity identified as the acquirer for accounting purposes usually is the entity that transfers the consideration (e.g., cash, other assets, or its equity interests) to effect the transaction. However, in some business combinations, the entity that issues its equity interests (the “legal acquirer”) is determined for accounting purposes to be the acquiree (also called the “accounting acquiree”), while the entity whose equity interests are acquired (the “legal acquiree”) is for accounting purposes the acquirer (also called the “accounting acquirer”). Such transactions are commonly called reverse acquisitions. See Section 6.8 for more information.

In all cases, the entity identified as the accounting acquiree must meet the definition of a business (see Section 2.4) for the accounting acquirer to apply the acquisition method.

### 3.1.1 Identifying the Acquirer if the Acquiree Is a VIE

If the legal acquiree in a business combination is a VIE, the primary beneficiary of the VIE is considered the accounting acquirer in accordance with the guidance in ASC 805-10-25-5. Consequently, entities must consider whether the legal acquiree is a VIE on the basis of the guidance in ASC 810-10-15-14. To qualify as a VIE, a legal entity needs to have only one of the following characteristics:

- The legal entity does not have sufficient equity investment at risk (see Section 5.2 of Deloitte’s A Roadmap to Consolidation — Identifying a Controlling Financial Interest).
- The equity investors at risk, as a group, lack the characteristics of a controlling financial interest (see Section 5.3 of Deloitte’s A Roadmap to Consolidation — Identifying a Controlling Financial Interest). In this assessment, there are specific requirements for entities that are limited partnerships or similar legal entities such as limited liability companies with managing members. Some of these entities may be VIEs, depending on what voting rights are provided to limited partners in a limited partnership or to nonmanaging members for certain limited liability corporations (see Section 5.3.1.2 of Deloitte’s A Roadmap to Consolidation — Identifying a Controlling Financial Interest).
- The legal entity is structured with disproportionate voting rights, and substantially all of the activities are conducted on behalf of an investor with disproportionately few voting rights (see Section 5.4 of Deloitte’s A Roadmap to Consolidation — Identifying a Controlling Financial Interest).

If any of these conditions are met, the legal acquiree is a VIE, and the primary beneficiary of the VIE (i.e., the legal acquirer) must be identified as the accounting acquirer.

### 3.1.2 Identifying the Acquirer if the Acquiree Is a Voting Interest Entity

If the acquiree in a business combination is a voting interest entity rather than a VIE, entities should first consider the guidance in the general subsections of ASC 810-10 related to determining the existence of a controlling financial interest to identify the accounting acquirer. In many cases, entities can clearly identify the accounting acquirer by applying that guidance. If they cannot, the identification of the accounting acquirer should be based on an evaluation of “pertinent facts and circumstances.” ASC 805-10-55-11 through 55-15 provide guidance to assist in this evaluation.
3.1.2.1 Business Combinations Effected Primarily by Transferring Cash or Other Assets or by Incurring Liabilities

ASC 805-10

55-11 In a business combination effected primarily by transferring cash or other assets or by incurring liabilities, the acquirer usually is the entity that transfers the cash or other assets or incurring the liabilities.

3.1.2.2 Business Combinations Effected Primarily by Exchanging Equity Interests

ASC 805-10

55-12 In a business combination effected primarily by exchanging equity interests, the acquirer usually is the entity that issues its equity interests. However, in some business combinations, commonly called reverse acquisitions, the issuing entity is the acquiree. Subtopic 805-40 provides guidance on accounting for reverse acquisitions. Other pertinent facts and circumstances also shall be considered in identifying the acquirer in a business combination effected by exchanging equity interests, including the following:

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 the voting rights, an entity shall consider the existence of any unusual or special voting arrangements and options, warrants, or convertible securities.

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.

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.

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.

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.

In a business combination effected primarily by exchanging equity interests, the identification of the accounting acquirer is based on an evaluation of pertinent facts and circumstances, including the following:

- “The relative voting rights in the combined entity after the business combination” (ASC 805-10-55-12(a)) — see Section 3.1.2.2.1.
- “The existence of a large minority voting interest in the combined entity” (ASC 805-10-55-12(b)) — see Section 3.1.2.2.2.
- “The composition of the governing body of the combined entity” (ASC 805-10-55-12(c)) — see Section 3.1.2.2.3.
- “The composition of the senior management of the combined entity” (ASC 805-10-55-12(d)) — see Section 3.1.2.2.4.
- “The terms of the exchange of equity interests” (ASC 805-10-55-12(e)) — see Section 3.1.2.2.5.
- The relative size of the combining entities (ASC 805-10-55-13) — see Section 3.1.2.3.
- Other considerations — see Section 3.1.2.4.
3.1.2.2.1 Relative Voting Rights in the Combined Entity After the Business Combination

**ASC 805-10**

**55-12(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 the voting rights, an entity shall consider the existence of any unusual or special voting arrangements and options, warrants, or convertible securities.

When evaluating relative voting rights in the combined entity after a business combination, entities should consider the following:

- All securities with voting rights — not just voting common shares.
- Any unusual or special voting arrangements.
- Options, warrants, and convertible securities.

Generally, the evaluation of relative voting interests should take into account any in-the-money options, warrants, or convertible securities that are vested and exercisable or convertible into voting interests as of the acquisition date. If any instruments are out-of-the-money but exercisable or convertible into voting shares as of the acquisition date, entities must use judgment in determining how the instruments affect the evaluation of relative voting interests. In making this determination, entities would most likely consider the following:

- The extent to which the instruments are out-of-the-money.
- The volatility of the underlying shares.
- Expectations that the instruments will become in-the-money before their exercisability or conversion features expire.
- The attributes of the instrument holders (e.g., board members, executive management, or a large minority voting interest holder in one of the combining companies).

Instruments that are not vested, exercisable, or convertible until after the acquisition date generally should not be considered in the evaluation of relative voting interests unless they will become exercisable or convertible shortly after the acquisition date. In addition, while some of an acquiree’s options, warrants, or convertible securities may be exchanged for voting securities as of the acquisition date, other similar securities of the acquiree or acquirer may remain outstanding, which could result in the subsequent issuance of voting securities in the combined entity. In such situations, entities should consider the specific facts and circumstances associated with these instruments.

In practice, as the ratio of relative voting rights in the combined entity deviates from 50:50, entities place increasing weight on this factor as an indicator of which combining entity is the accounting acquirer.

3.1.2.2.2 Existence of a Large Minority Voting Interest in the Combined Entity

**ASC 805-10**

**55-12(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.

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When evaluating the effect of minority voting interests in the combined entity on the identification of the accounting acquirer, entities should consider voting interests held both individually and as a part of an organized shareholder group. In practice, as the percentage of voting interests held by a single owner or organized group of owners increases, entities place additional weight on this factor as an indicator of which combining entity is the accounting acquirer, particularly if the voting interest includes additional rights beyond voting (e.g., entitlement to one or more positions on the combined entity’s governing body).

### 3.1.2.2.3 Composition of the Governing Body of the Combined Entity

<table>
<thead>
<tr>
<th>ASC 805-10</th>
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</thead>
<tbody>
<tr>
<td>55-12(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.</td>
</tr>
</tbody>
</table>

While the accounting acquirer usually is the combining entity whose owners have the ability to elect, appoint, or remove a majority of the members of the combined entity’s governing body (i.e., its initial composition), the entity’s ability to affect subsequent corporate governance decisions might be limited by requirements for specified matters to be approved beyond a simple majority.

In addition, if the initial composition of the governing body is subject to change shortly after the business combination, entities should also consider how that composition might change. Changes might occur shortly after an acquisition because of the expected retirement of a member or a recurring or special election in which one or more current members may not be reelected.

If there is an equal number of members and voting rights in the initial composition of the governing body, and matters are subject to majority approval, entities should consider the procedures established for resolving tie votes to determine whether the performance of such procedures would be among the pertinent facts and circumstances evaluated in the identification of the acquirer.

In evaluating the composition of the governing body of the combined entity, entities might also consider the initial composition of its committees, the individuals who will serve as committee chairs, and whether each chair will hold any specific powers. In the absence of a nominating committee, entities might also evaluate the process for identifying future candidates for the governing body, especially if there may be a change in its composition shortly after the business combination.

### 3.1.2.2.4 Composition of the Senior Management of the Combined Entity

<table>
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<th>ASC 805-10</th>
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<tbody>
<tr>
<td>55-12(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.</td>
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</table>

When evaluating the composition of the senior management of the combined entity, entities should consider the executive chairman of the board, the chief executive officer, the chief operating officer, the chief financial officer, and members of the executive committee, if one exists. Entities may also consider other positions such as division heads, if they represent senior management, on the basis of the organizational structure and the nature of the combined entity’s business. Typically, the roles and responsibilities of each position are more important in the evaluation than the relative number of senior management positions taken by the combining entity’s former management.
If the initial composition of senior management is subject to change shortly after the acquisition date, entities should also consider how that composition might change. Changes could be the result of scheduled retirements or planned reorganizations of management roles.

3.1.2.2.5 Terms of the Exchange of Equity Interests

<table>
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<tr>
<th>ASC 805-10</th>
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<tbody>
<tr>
<td>55-12(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.</td>
</tr>
</tbody>
</table>

While the accounting 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, in certain cases it may be difficult to identify whether a premium is paid, because the combining entities’ precombination fair values are not readily determinable.

3.1.2.3 Consideration of the Relative Size of the Combining Entities

<table>
<thead>
<tr>
<th>ASC 805-10</th>
</tr>
</thead>
<tbody>
<tr>
<td>55-13 The acquirer usually is the combining entity whose relative size (measured in, for example, assets, revenues, or earnings) is significantly larger than that of the other combining entity or entities.</td>
</tr>
</tbody>
</table>

When evaluating the relative size of the combining entities, entities should consider the specific asset, revenue, and earning measures determined to be pertinent, which may vary on the basis of the combining entities’ industry. Entities may also identify one or more additional pertinent measures, such as operating cash flows. Further, entities must use judgment to determine which period(s) to evaluate and whether to consider future budgeted amounts (when available).

When comparing the combining entities’ relative size, entities should evaluate the effects of any differences between their accounting policies, capitalization, or histories (i.e., organic growth versus acquisitions) and the existence of any items deemed to be nonrecurring.

3.1.2.4 Other Considerations

If, after consideration of the factors in ASC 805-10-55-12 and 55-13, it is not clear which combining entity is the accounting acquirer, entities sometimes evaluate other evidence such as the following:

- Which combining entity initiated the combination.
- The name to be used for the combined entity.
- The location of the combined entity’s headquarters.

Entities are expected to demonstrate the relevance of any other factors considered in the identification of the acquirer.
Chapter 3 — Identifying the Acquirer and Determining the Acquisition Date

3.1.3 Evaluating Pertinent Facts and Circumstances in Identifying the Acquirer

While an evaluation of the pertinent facts and circumstances often results in the clear identification of one of the combining entities as the accounting acquirer, in some transactions the determination of the acquirer may be less straightforward (i.e., some indicators point to one entity and others point to the other). Since ASC 805 does not specify a hierarchy or the weight to place on each fact and circumstance associated with the assessment, an entity may sometimes need to use judgment. In such cases, the SEC staff typically expects the entity's disclosures to give financial statement users insight into how the accounting acquirer was determined (e.g., a description of the facts and circumstances deemed by the entity to be the most instructive in its identification of the accounting acquirer).

3.1.4 Business Combinations Involving More Than Two Entities

ASC 805-10

55-14 In a business combination involving more than two entities, determining the acquirer shall include a consideration of, among other things, which of the combining entities initiated the combination, as well as the relative size of the combining entities, as discussed in the preceding paragraph.

Even though a business combination is defined as a transaction or other event in which an entity obtains control of one or more businesses, some combinations are specifically within the scope of the business combinations guidance even if no one party obtains control. For example, in some roll-up or put-together transactions, more than two entities combine their businesses but none of the owners of the combining entities individually or as a group retains or receives a majority of the combined entity's voting rights. ASC 805-10 requires that these transactions be accounted for as business combinations, as discussed in Section 2.2. Therefore, in such transactions, the factors in ASC 805-10-55-11 through 55-15 must be used to identify an acquirer.

3.1.5 Use of a New Entity Formed to Effect a Business Combination

ASC 805-10

55-15 A new entity formed to effect a business combination is not necessarily 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 paragraphs 805-10-55-10 through 55-14. In contrast, a new entity that transfers cash or other assets or incurs liabilities as consideration may be the acquirer.
A business combination may be effected by forming a new legal entity (commonly called a “newco”) to issue shares to the combining entities’ shareholders. ASC 805-10-55-15 precludes such a newco from being identified as the acquirer. The newco is disregarded for accounting purposes, and one of the combining entities should be identified as the acquirer. The guidance in ASC 805-10-55-15 was carried forward from FASB Statement 141. In paragraph B100 of the Basis for Conclusions of Statement 141(R), the FASB explains why the IASB agreed with its rationale for such treatment:

The IASB also considered whether treating a new entity formed to issue equity instruments to effect a business combination as the acquirer would place the form of the transaction over its substance, because the new entity may have no economic substance. The formation of such entities is often related to legal, tax, or other business considerations that do not affect the identification of the acquirer. For example, a combination between two entities that is structured so that one entity directs the formation of a new entity to issue equity instruments to the owners of both of the combining entities is, in substance, no different from a transaction in which one of the combining entities directly acquires the other. Therefore, the transaction should be accounted for in the same way as a transaction in which one of the combining entities directly acquires the other. To do otherwise would impair both the comparability and the reliability of the information.

**Example 3-1**

**Newco Only Issues Equity Interests and Is Not the Acquirer**

Company A and Company B enter into an agreement to merge. Both A and B meet the definition of a business in ASC 805-10. Either A or B forms a new legal entity (Newco) to effect the combination. The former shareholders of A and B exchange their equity interests in A and B for equity interests in Newco, and A and B become subsidiaries of Newco. Newco is not a corporate joint venture.

Newco is newly formed to issue equity interests to effect the merger of A and B. Since the transaction was not the formation of a joint venture, under ASC 805-10-55-15, “one of the combining entities that existed before the business combination [A or B] shall be identified as the acquirer by applying the guidance in paragraphs 805-10-55-10 through 55-14.” The transaction described above is economically the same as a transaction in which either A or B directly acquires the other company in exchange for shares in the acquiring company.

In some cases, a newco may be identified as the acquirer if the newco has precombination activities that are significant enough that the newco is determined to be substantive and thus capable of being an acquirer. An entity must often use judgment on the basis of an evaluation of the specific facts and circumstances to determine whether this is the case. A newco that only issues equity interests to effect an acquisition would generally not be considered to be substantive (see Example 3-1). However, a newco may be deemed to be substantive in the following circumstances:

- It has substantive precombination operations or assets.
- It engages in substantial precombination activities such as raising capital to fund an acquisition from third-party debt financing or from third parties in the public market (e.g., a special-purpose acquisition company or SPAC).
- It is actively involved in identifying acquisition targets, negotiating, or promoting acquisitions.
- It had any ownership in the acquiree before the acquisition.

Some also believe that a newco has significant precombination activities if its parent or investors loan or contribute cash to the newco and that cash is used to fund the acquisition. However, others believe that having cash contributed by or loaned from the newco’s parent or investors to fund the acquisition does not constitute a substantive precombination activity and does not make the newco substantive (see Example 3-2).
In addition, some regard a newco that survives the transaction (i.e., a surviving newco) as substantive regardless of the significance of its precombination activities. However, a newco that does not survive the acquisition (i.e., transitory newco) is often not considered substantive (see Example 3-3). While the buyer is frequently the entity that forms the newco, we generally do not believe that it matters which entity forms the newco in evaluating whether it is substantive.

If a newco is identified as the acquirer, the entity or entities that merge into the newco are the acquiree in a business combination, and the acquiree’s assets and liabilities are measured in accordance with the guidance in ASC 805, generally at their acquisition-date fair values.

Example 3-2

**Surviving Newco Is Identified as the Acquirer**

Company A forms a new legal entity, Newco, to effect the acquisition of Company B from an unrelated seller. Company B meets the definition of a business in ASC 805-10. Company A contributes cash to Newco in exchange for 90 percent of Newco’s issued shares. Newco transfers the cash and 10 percent of its issued shares to the seller in exchange for all of B’s outstanding shares. Newco is a surviving legal entity and is a reporting entity after the transaction. Company B becomes a subsidiary of Newco.

**Immediately Before the Acquisition**

```
   Company A
     100%  
   Newco

   Seller
     100%  
   Company B
```

**Immediately After the Acquisition**

```
   Company A
     90%  
   Newco
       100%  
   Company B

   Seller
     10%  
   Newco
```

ASC 805-10-55-15 states that “a new entity that transfers cash or other assets or incurs liabilities as consideration may be the acquirer.” We believe that it would be appropriate to identify Newco as the acquirer in this transaction since it survived the transaction and transferred cash to acquire the equity interests in B. In that case, Newco would apply acquisition accounting and recognize in its separate financial statements a new basis of accounting for B’s assets and liabilities. However, we acknowledge that ASC 805-10-55-15 is not clear and that some may believe that using the cash contributed by a parent or investor as consideration does not constitute a significant precombination activity. In addition, this transaction is economically the same as the transaction described in Example 3-3, in which no new basis is recognized because B does not elect to apply pushdown accounting.
Example 3-2 (continued)

Assume the same facts except that instead of A contributing cash to Newco, Newco obtains debt financing to fund the acquisition of B. Obtaining debt financing is often viewed as a significant precombination activity. In such a case, Newco would be identified as the acquirer.

Example 3-3

Transitory Newco Is Not Identified as the Acquirer

Company A forms a new legal entity, Newco, to effect the acquisition of Company B from an unrelated seller. Company B meets the definition of a business in ASC 805-10. Company A contributes cash to Newco in exchange for all of the issued shares in Newco. Newco transfers the cash to the seller in exchange for 90 percent of B’s outstanding shares. Newco merges with and into Company B. Company B is the surviving legal entity and a reporting entity after the transaction.

Immediately Before the Acquisition

![Diagram of Immediate Before the Acquisition]

Immediately After the Acquisition

Although Newco transferred cash to acquire the majority of B’s outstanding shares, Newco is transitory, is not deemed to be substantive, and is not identified as the acquirer. In other words, Newco is disregarded and A is identified as the acquirer. Company A has obtained control of B and accounts for the transaction as a business combination. This transaction is effectively the same as one in which A acquires 90 percent of B’s shares directly from the seller. Because B elects not to apply pushdown accounting, it does not recognize a new basis of accounting for its assets and liabilities in its separate financial statements. However, we do acknowledge that ASC 805-10-55-15 is not clear and that some may believe that a transitory newco can be substantive in certain cases.

3.2 Determining the Acquisition Date

ASC 805-10

25-6 The acquirer shall identify the acquisition date, which is the date on which it obtains control of the acquiree.
Chapter 3 — Identifying the Acquirer and Determining the Acquisition Date

ASC 805-10 (continued)

25-7 The date on which the acquirer obtains control of the acquiree generally is the date on which the acquirer legally transfers the consideration, acquires the assets, and assumes the liabilities of the acquiree — the closing date. However, the acquirer might obtain control on a date that is either earlier or later than the closing date. For example, the acquisition date precedes the closing date if a written agreement provides that the acquirer obtains control of the acquiree on a date before the closing date. An acquirer shall consider all pertinent facts and circumstances in identifying the acquisition date.

The acquisition date is the date on which control of the business transfers to the acquirer and generally coincides with the date on which the acquirer legally transfers the consideration to the seller, receives the assets, and incurs or assumes the liabilities (i.e., the closing date).

Determining the acquisition date is important because on this date:

- All forms of consideration are measured, including contingent consideration, and the acquirer's equity securities that are issued to the seller.
- The assets acquired, liabilities assumed, and any noncontrolling interests are identified and measured.
- The acquirer begins consolidating the acquiree, if required.

In unusual circumstances, the acquisition date can be before or after the closing date. We believe that the acquisition date can precede the closing date only if a written agreement is in place between the acquirer and the seller and that agreement gives the acquirer control over the acquiree. Such a written agreement must give the acquirer the ability to make all operating and financing decisions related to the acquiree without the seller's approval. That is, the seller should not have any participation in the acquiree's operations, other than having possible protective rights. If the acquisition date occurs before the date on which the consideration is transferred, the acquirer should recognize a liability for the consideration to be transferred to the seller.

If the acquisition requires regulatory or shareholder approval, or shareholder approval is sought by either the acquirer or acquiree, it is generally presumed that control cannot pass to the acquirer until such approval is obtained. In rare circumstances, shareholder approval may be considered perfunctory if management and the board of directors control enough votes to approve the acquisition and a written agreement exists evidencing their intent to approve the transaction. In such cases, the acquisition date may occur before shareholder approval is obtained, provided that control is transferred.

ASC 805 does not contain the “convenience” exception that was present in FASB Statement 141. That exception allowed an acquirer, in certain circumstances, to designate an effective date other than the acquisition date of the business combination (e.g., the end of an accounting period between the dates on which a business combination is initiated and consummated). In the Basis for Conclusions of Statement 141(R), the FASB acknowledges that although there is no longer a convenience-date exception, entities may still designate such a date if its effect on the acquirer's financial statements would be immaterial. Paragraph B110 of Statement 141(R) states the following:

The Boards concluded that the financial statement effects of eliminating that exception were rarely likely to be material. For example, for convenience an entity might wish to designate an acquisition date of the end (or the beginning) of a month, the date on which it closes its books, rather than the actual acquisition date during the month. Unless events between the “convenience” date and the actual acquisition date result in material changes in the amounts recognized, that entity's practice would comply with the requirements of this Statement.
Chapter 4 — Recognizing and Measuring the Identifiable Assets Acquired and Liabilities Assumed

This chapter addresses the recognition and measurement of the identifiable assets acquired and liabilities assumed in a business combination, which is part of step 3 of the acquisition method (see Section 1.1.3). The recognition and measurement of noncontrolling interests, also part of step 3, is addressed in connection with the accounting for partial acquisitions in Section 6.4.

4.1 Recognition and Measurement Principles

<table>
<thead>
<tr>
<th>ASC 805-20</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>25-1</strong> As of the acquisition date, the acquirer shall recognize, 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. However, an entity (the acquirer) within the scope of paragraph 805-20-15-2 may elect to apply the accounting alternative for the recognition of identifiable intangible assets acquired in a business combination as described in paragraphs 805-20-25-29 through 25-33.</td>
</tr>
</tbody>
</table>

**Recognition Conditions**

**25-2** To qualify for recognition as part of applying the acquisition method, the identifiable assets acquired and liabilities assumed must meet the definitions of assets and liabilities in FASB Concepts Statement No. 6, Elements of Financial Statements, at the acquisition date. For example, costs the acquirer expects but is not obligated to incur in the future to effect its plan to exit an activity of an acquiree or to terminate the employment of or relocate an acquiree's employees are not liabilities at the acquisition date. Therefore, the acquirer does not recognize those costs as part of applying the acquisition method. Instead, the acquirer recognizes those costs in its postcombination financial statements in accordance with other applicable generally accepted accounting principles (GAAP).

**25-3** In addition, to qualify for recognition as part of applying the acquisition method, the identifiable assets acquired and liabilities assumed must be part of what the acquirer and the acquiree (or its former owners) exchanged in the business combination transaction rather than the result of separate transactions. The acquirer shall apply the guidance in paragraphs 805-10-25-20 through 25-23: to determine which assets acquired or liabilities assumed are part of the exchange for the acquiree and which, if any, are the result of separate transactions to be accounted for in accordance with their nature and the applicable GAAP.

**25-4** The acquirer's application of the recognition principle and conditions may result in recognizing some assets and liabilities that the acquiree had not previously recognized as assets and liabilities in its financial statements. For example, the acquirer recognizes the acquired identifiable intangible assets, such as a brand name, a patent, or a customer relationship, that the acquiree did not recognize as assets in its financial statements because it developed them internally and charged the related costs to expense.
The acquirer shall measure the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree at their acquisition-date fair values.

The accounting for a business combination is based on two key principles, which ASC 805 calls the recognition principle and the measurement principle. The objective of the principles is to provide guidance that an acquirer can apply when ASC 805 does not contain specific recognition or measurement guidance for a particular asset or liability.

Under the recognition principle in ASC 805-20-25-1, an acquirer must “recognize, separately from goodwill, the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree.” To qualify for recognition as part of a business combination, an item must:

- Meet the definition of an asset or a liability in FASB Concepts Statement 6 on the acquisition date (see ASC 805-20-25-2).
- Be part of the business combination transaction and not the result of separate transactions (see Section 6.2).

Paragraphs 25 and 35, respectively, of Concepts Statement 6 define assets and liabilities as follows:

Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events. [Footnote omitted]

Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events. [Footnotes omitted]

As a result of applying the recognition principle, an acquirer may recognize certain assets and liabilities that were not previously recognized in the acquiree’s financial statements, such as customer-related intangible assets.

Under the measurement principle in ASC 805-20-30-1, an acquirer is required to measure “the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree at their acquisition-date fair values.” Thus, most assets and liabilities and items of consideration are measured at fair value in accordance with the principles of ASC 820. However, there are exceptions to ASC 805’s fair value measurement principle. For example, an acquirer must measure an acquiree’s deferred taxes, employee benefits, share-based payments, and assets held for sale in accordance with other applicable GAAP rather than the general principles discussed in ASC 805. The exceptions to the measurement principle are discussed in Section 4.3. Also see Section 2.3.6 of Deloitte’s A Roadmap to Fair Value Measurements and Disclosures (Including the Fair Value Option) for additional details on the exception to the measurement principle.

4.1.1 Use of a Third-Party Specialist to Measure Fair Value

Some entities elect to engage a third-party specialist to assist management in the valuation of some or all of the assets acquired and liabilities assumed in a business combination, especially if the fair value measurements are unusually complex or management wishes to otherwise supplement its internal valuation expertise. The SEC staff has indicated that under certain conditions, a registrant’s filings do not need to refer to the third-party valuation firm that provided assistance. On November 26, 2008, the
SEC’s Division of Corporation Finance issued revised Compliance and Disclosure Interpretations (C&DI) of Securities Act Sections related to the use of third-party specialists. C&DI Question 141.02 of the Securities Act Sections states:

**Question:** A registrant has engaged a third party expert to assist in determining the fair values of certain assets or liabilities disclosed in the registrant’s Securities Act registration statement. Must the registrant disclose in the registration statement that it used a third party expert for this purpose? In what circumstances must the registrant disclose the name of the third party expert in its registration statement and obtain the third party’s consent to be named?

**Answer:** The registrant has no requirement to make reference to a third party expert simply because the registrant used or relied on the third party expert’s report or valuation or opinion in connection with the preparation of a Securities Act registration statement. The consent requirement in Securities Act Section 7(a) applies only when a report, valuation or opinion of an expert is included or summarized in the registration statement and attributed to the third party and thus becomes “expertised” disclosure for purposes of Securities Act Section 11(a), with resultant Section 11 liability for the expert and a reduction in the due diligence defense burden of proof for other Section 11 defendants with respect to such disclosure, as provided in Securities Act Section 11(b).

If the registrant determines to make reference to a third party expert, the disclosure should make clear whether any related statement included or incorporated in a registration statement is a statement of the third party expert or a statement of the registrant. If the disclosure attributes a statement to a third party expert, the registrant must comply with the requirements of Securities Act Rule 436 with respect to such statement. For example, if a registrant discloses purchase price allocation figures in the notes to its financial statements and discloses that these figures were taken from or prepared based on the report of a third party expert, or provides similar disclosure that attributes the purchase price allocation figures to the third party expert and not the registrant, then the registrant should comply with Rule 436 with respect to the purchase price allocation figures. On the other hand, if the disclosure states that management or the board prepared the purchase price allocations and in doing so considered or relied in part upon a report of a third party expert, or provides similar disclosure that attributes the purchase price allocation figures to the registrant and not the third party expert, then there would be no requirement to comply with Rule 436 with respect to the purchase price allocation figures as the purchase price allocation figures are attributed to the registrant.

Independent of Section 7(a) considerations, a registrant that uses or relies on a third party expert report, valuation or opinion should consider whether the inclusion or summary of that report, valuation or opinion is required in the registration statement to comply with specific disclosure requirements, such as Item 1015 of Regulation M-A, Item 601(b) of Regulation S-K or the general disclosure requirement of Securities Act Rule 408.

According to the SEC, a registrant that does not refer to a valuation firm in its filing must provide disclosures explaining the method and assumptions that were used in the valuation. A registrant that does refer to a valuation firm must provide:

- The valuation firm’s name.
- A consent from the valuation firm as required by of SEC Regulation S-K, Item 601(b)(23).
- The registrant’s analysis of the qualifications of those assisting management in preparing the valuation.

The staff also cautioned that registrants seeking to incorporate their financial statements into their registration statement must amend the financial statements to include the valuation firm’s name and consent, if the statements do not already do so.
Regardless of whether a fair value measurement is prepared entirely by the entity or with the assistance of a third-party specialist, a similar level of evidence is needed to support the measurement; and management is ultimately responsible for the appropriateness of the accounting and reporting of all the fair value measurements — including the valuation techniques, the underlying assumptions, and the completeness and accuracy of the data provided to, and received from, specialists.

4.2 Classifying or Designating the Assets Acquired and Liabilities Assumed

**ASC 805-20**

25-6 At the acquisition date, the acquirer shall classify or designate the identifiable assets acquired and liabilities assumed as necessary to subsequently apply other GAAP. 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.

25-7 In some situations, GAAP provides for different accounting depending on how an entity classifies or designates a particular asset or liability. Examples of classifications or designations that the acquirer shall make on the basis of the pertinent conditions as they exist at the acquisition date include but are not limited to the following:

- Classification of particular investments in securities as trading, available for sale, or held to maturity in accordance with Section 320-10-25
- Designation of a derivative instrument as a hedging instrument in accordance with paragraph 815-10-05-4
- Assessment of whether an embedded derivative should be separated from the host contract in accordance with Section 815-15-25 (which is a matter of classification as this Subtopic uses that term).

Because a business combination results in the initial recognition of the assets acquired and liabilities assumed in the acquirer’s financial statements, the acquiree’s assets and liabilities are recognized even if they did not qualify for recognition before the business combination, and they are generally remeasured at fair value. Similarly, any prior classifications or designations by the acquiree are reconsidered as of the acquisition date. The subsequent accounting for some assets and liabilities differs depending on how they are classified or designated. ASC 805-20-25-7 provides three examples:

- Classification of particular investments in securities as trading, available for sale, or held to maturity in accordance with Section 320-10-25
- Designation of a derivative instrument as a hedging instrument in accordance with paragraph 815-10-05-4
- Assessment of whether an embedded derivative should be separated from the host contract in accordance with Section 815-15-25 (which is a matter of classification as this Subtopic uses that term).

Other examples include classifying newly acquired assets as held for sale or electing the fair value option for eligible items acquired in a business combination. Under ASC 805-20-25-6, an acquirer must classify or designate the acquiree’s assets and liabilities on the basis of all relevant facts as of the acquisition date in the context of the contractual terms, its accounting policies, and other pertinent factors as of that date, with two exceptions that are discussed below.
4.3 Exceptions to Recognition, Measurement, and Designation or Classification of Assets or Liabilities

4.3.1 Exceptions to Recognition and Measurement

ASC 805-20

25-16 This Topic provides limited exceptions to the recognition and measurement principles applicable to business combinations. Paragraphs 805-20-25-17 through 25-28 specify the types of identifiable assets and liabilities that include items for which this Subtopic provides limited exceptions to the recognition principle in paragraph 805-20-25-1. The acquirer shall apply the specified GAAP or the specified requirements rather than that recognition principle to determine when to recognize the assets or liabilities identified in paragraphs 805-20-25-17 through 25-28. That will result in some items being recognized either by applying recognition conditions in addition to those in paragraphs 805-20-25-2 through 25-3 or by applying the requirements of other GAAP, with results that differ from applying the recognition principle and conditions in paragraphs 805-20-25-1 through 25-3.

Pending Content (Transition Guidance: ASC 842-10-65-1)

25-16 This Topic provides limited exceptions to the recognition and measurement principles applicable to business combinations. Paragraphs 805-20-25-17 through 25-28B specify the types of identifiable assets and liabilities that include items for which this Subtopic provides limited exceptions to the recognition principle in paragraph 805-20-25-1. The acquirer shall apply the specified GAAP or the specified requirements rather than that recognition principle to determine when to recognize the assets or liabilities identified in paragraphs 805-20-25-17 through 25-28B. That will result in some items being recognized either by applying recognition conditions in addition to those in paragraphs 805-20-25-2 through 25-3 or by applying the requirements of other GAAP, with results that differ from applying the recognition principle and conditions in paragraphs 805-20-25-1 through 25-3.

25-17 Guidance is presented on all of the following exceptions to the recognition principle:

a. Assets and liabilities arising from contingencies  
b. Income taxes  
c. Employee benefits  
d. Indemnification assets.

Pending Content (Transition Guidance: ASC 842-10-65-1)

25-17 Guidance is presented on all of the following exceptions to the recognition principle:

a. Assets and liabilities arising from contingencies  
b. Income taxes  
c. Employee benefits  
d. Indemnification assets.  
e. Leases.
ASC 805-20 (continued)

30-12 Guidance is presented on all of the following exceptions to the measurement principle:
   a. Income taxes
   b. Employee benefits
   c. Indemnification assets
   d. Reacquired rights
   e. Share-based payment awards
   f. Assets held for sale
   g. Certain assets and liabilities arising from contingencies.

Pending Content (Transition Guidance: ASC 842-10-65-1)

30-12 Guidance is presented on all of the following exceptions to the measurement principle:
   a. Income taxes
   b. Employee benefits
   c. Indemnification assets
   d. Reacquired rights
   e. Share-based payment awards
   f. Assets held for sale
   g. Certain assets and liabilities arising from contingencies
   h. Leases.

Pending Content (Transition Guidance: ASC 326-10-65-1)

30-12 Guidance is presented on all of the following exceptions to the measurement principle:
   a. Income taxes
   b. Employee benefits
   c. Indemnification assets
   d. Reacquired rights
   e. Share-based payment awards
   f. Assets held for sale
   g. Certain assets and liabilities arising from contingencies
   h. Leases
   i. Purchased financial assets with credit deterioration.

As discussed above, ASC 805 includes several exceptions to fair value measurement and recognition. Because most assets acquired and liabilities assumed in an acquisition are subsequently accounted for under the relevant GAAP, the guidance provides exceptions to ensure that those subsequent applications of GAAP do not result in the recognition of a gain or loss when no such economic change occurred. For example, income taxes are an exception to the recognition and measurement principles and are accounted for under ASC 740. If that exception did not exist, an acquirer would be required to recognize and measure income taxes at fair value and the subsequent application of ASC 740 would result in the acquirer’s recognition of deferred taxes at amounts other than fair value or not at all; as a result, the acquirer would recognize a gain or loss even though no economic change had occurred.
4.3.2 Exceptions to Designation or Classification of Assets or Liabilities

**ASC 805-20**

25-8 This Section provides the following two exceptions to the principle in paragraph 805-20-25-6:

a. Classification of a lease contract as either an operating lease or a capital lease in accordance with the guidance in paragraph 840-10-25-27

b. Classification of a contract written by an entity that is in the scope of Subtopic 944-10 as an insurance or reinsurance contract or a deposit contract.

The acquirer shall classify those contracts on the basis of the contractual terms and other factors at the inception of the contract (or, if the terms of the contract have been modified in a manner that would change its classification, at the date of that modification, which might be the acquisition date).

**Pending Content (Transition Guidance: ASC 842-10-65-1)**

25-8 This Section provides the following two exceptions to the principle in paragraph 805-20-25-6:

a. Classification of a lease of an acquiree shall be in accordance with the guidance in paragraph 842-10-55-11

b. Classification of a contract written by an entity that is in the scope of Subtopic 944-10 as an insurance or reinsurance contract or a deposit contract. The acquirer shall classify that contract on the basis of the contractual terms and other factors at the inception of the contract (or, if the terms of the contract have been modified in a manner that would change its classification, at the date of that modification, which might be the acquisition date).

ASC 805 requires most contracts, assets, and liabilities to be classified or designated on the acquisition date. However, there are two exceptions: lease agreements and insurance or reinsurance contracts. ASC 805-20-25-8 notes that if a contract has been modified in a manner that would change its classification, the acquirer should classify it on the basis of the contractual terms and other factors “at the date of that modification, which might be the acquisition date.” That is, if contracts are modified as a result of a business combination, an acquirer should take the modifications into account when classifying or designating the contracts, assets, or liabilities. However, some common changes to contracts do not affect the contracts’ terms. For example, as a result of a business combination, a lease agreement may be modified to change one of the parties to the contract. Such a change is not a substantive modification to the terms of the lease and would not affect its classification.
4.3.3 List of Exceptions to the Recognition, Measurement, Designation, or Classification of Assets or Liabilities

The table below lists the exceptions and highlights the sections in which they are discussed in this publication.

<table>
<thead>
<tr>
<th>Exceptions to General Principles of Recognition, Measurement, and Classification or Designation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Recognition and measurement exceptions</td>
</tr>
<tr>
<td>• Indemnifications assets (see Section 4.3.4 below)</td>
</tr>
<tr>
<td>• Assets held for sale (see Section 4.3.5)</td>
</tr>
<tr>
<td>• Assets and liabilities arising from contingencies (see Section 4.3.6)</td>
</tr>
<tr>
<td>• Reacquired rights (see Section 4.3.7)</td>
</tr>
<tr>
<td>• Income taxes (see Section 4.3.8)</td>
</tr>
<tr>
<td>• Employee benefits (see Section 4.3.9)</td>
</tr>
<tr>
<td>• Purchased financial assets with credit deterioration (see Section 4.3.10)</td>
</tr>
<tr>
<td>• Leases — after adoption of ASC 842 (see Section 4.3.11.1)</td>
</tr>
<tr>
<td>• Leases — before adoption of ASC 842 (see Section 4.3.11.2)</td>
</tr>
<tr>
<td>• Share-based payment awards (see Section 5.6)</td>
</tr>
<tr>
<td>Classification or designation exceptions</td>
</tr>
<tr>
<td>• Leases — after adoption of ASC 842 (see Section 4.3.11.1)</td>
</tr>
<tr>
<td>• Leases — before adoption of ASC 842 (see Section 4.3.11.2)</td>
</tr>
<tr>
<td>• Insurance or reinsurance contracts (see Section 4.3.12)</td>
</tr>
</tbody>
</table>

4.3.4 Indemnification Assets

The seller in a business combination may contractually indemnify the acquirer for uncertainties related to specific assets or liabilities, such as those associated with lawsuits and uncertain tax positions. This type of indemnification represents an asset obtained in the business combination. Indemnification assets are an exception to the recognition and measurement principles.

**Connecting the Dots**

Amounts held in escrow pending resolution of general representation and warranty provisions contained in the acquisition agreement are not indemnification assets. See Section 5.3.1 for information about amounts held in escrow as part of an acquisition agreement.

4.3.4.1 Initial Accounting for Indemnification Assets

<table>
<thead>
<tr>
<th>ASC 805-20</th>
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</thead>
<tbody>
<tr>
<td><strong>Indemnification Assets</strong></td>
</tr>
<tr>
<td>25-27 The seller in a business combination may contractually indemnify the acquirer for the outcome of a contingency or uncertainty related to all or part of a specific asset or liability. For example, the seller may indemnify the acquirer against losses above a specified amount on a liability arising from a particular contingency; in other words, the seller will guarantee that the acquirer's liability will not exceed a specified amount. As a result, the acquirer obtains an indemnification asset. The acquirer shall recognize an indemnification asset at the same time that it recognizes the indemnified item, measured on the same basis as the indemnified item, subject to the need for a valuation allowance for uncollectible amounts. Therefore, if the indemnification relates to an asset or a liability that is recognized at the acquisition date and measured at its acquisition-date fair value, the acquirer shall recognize the indemnification asset at the acquisition date measured at its acquisition-date fair value.</td>
</tr>
</tbody>
</table>
**ASC 805-20 (continued)**

**25-28** In some circumstances, the indemnification may relate to an asset or a liability that is an exception to the recognition or measurement principles. For example, an indemnification may relate to a contingency that is not recognized at the acquisition date because it does not satisfy the criteria for recognition in paragraphs 805-20-25-18A through 25-19 at that date. In those circumstances, the indemnification asset shall be recognized and measured using assumptions consistent with those used to measure the indemnified item, subject to management’s assessment of the collectibility of the indemnification asset and any contractual limitations on the indemnified amount.

**30-18** Paragraph 805-20-25-27 requires that the acquirer recognize an indemnification asset at the same time that it recognizes the indemnified item, measured on the same basis as the indemnified item, subject to the need for a valuation allowance for uncollectible amounts. That paragraph also requires that, if the indemnification relates to an asset or a liability that is recognized at the acquisition date and measured at its acquisition-date fair value, the acquirer recognize the indemnification asset at the acquisition date measured at its acquisition-date fair value. For an indemnification asset measured at fair value, the effects of uncertainty about future cash flows because of collectibility considerations are included in the fair value measure and a separate valuation allowance is not necessary, as noted in paragraph 805-20-30-4.

**30-19** Paragraph 805-20-25-28 states that in some circumstances, the indemnification may relate to an asset or a liability that is an exception to the recognition or measurement principles, and provides an example of an indemnification that may relate to a contingency that is not recognized at the acquisition date because it does not satisfy the criteria for recognition in paragraphs 805-20-25-18A through 25-19 at that date. Alternatively, an indemnification may relate to an asset or a liability, for example, one that results from an uncertain tax position that is measured on a basis other than acquisition-date fair value. (Paragraph 805-20-30-13 identifies the business-combination-related measurement requirements for income taxes.) Paragraph 805-20-25-28 establishes that in those circumstances, the indemnification asset shall be recognized and measured using assumptions consistent with those used to measure the indemnified item, subject to management’s assessment of the collectibility of the indemnification asset and any contractual limitations on the indemnified amount.

The recognition and measurement of an indemnification asset depends on whether the acquirer recognizes the indemnified item as part of the accounting for the business combination and how the acquirer measures the indemnified item. The following are examples of the recognition and measurement of certain types of indemnified items and the resulting indemnification assets:

<table>
<thead>
<tr>
<th>Recognition and Measurement of the Indemnified Item</th>
<th>Recognition and Measurement of the Indemnification Asset</th>
</tr>
</thead>
<tbody>
<tr>
<td>Recognized and measured at its acquisition-date fair value (e.g., a liability arising from a contingency recognized at its fair value as of the acquisition date).</td>
<td>Recognized and measured at its fair value as of the acquisition date, adjusted for any contractual limitations and the credit risk of the indemnifying party. No separate valuation allowance is recognized related to collectibility for indemnification assets measured at fair value.</td>
</tr>
<tr>
<td>Recognized as of the acquisition date but measured at an amount other than fair value (e.g., an uncertain tax position).</td>
<td>Recognized and measured by using assumptions that are consistent with those used to measure the indemnified item, adjusted for any contractual limitations and the credit risk of the indemnifying party. A separate valuation allowance is permitted for indemnification assets measured at other than fair value.</td>
</tr>
</tbody>
</table>
Chapter 4 — Recognizing and Measuring the Identifiable Assets Acquired and Liabilities Assumed

<table>
<thead>
<tr>
<th>Recognition and Measurement of the Indemnified Item</th>
<th>Recognition and Measurement of the Indemnification Asset</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unrecognized as of the acquisition date (e.g., a liability arising from a contingency that does not meet the criteria for recognition as of the acquisition date) and does not qualify for recognition during the measurement period.</td>
<td>Unrecognized as part of the business combination accounting. Subsequent accounting is based on applicable GAAP (see Section 4.3.4.2).</td>
</tr>
<tr>
<td>Recognized as of the acquisition date, but the indemnification only gives the acquirer the ability to recover a portion of the amount (e.g., the amount of recovery is limited to a specific amount or percentage).</td>
<td>Recognized and measured by using assumptions that are consistent with those used to measure the indemnified item, adjusted for the contractual limitations on recovery and the credit risk of the indemnifying party.</td>
</tr>
</tbody>
</table>

For indemnification assets recognized at fair value, no separate valuation allowance is recognized for concerns about collectibility. Entities should take into account collectibility concerns when measuring fair value since such concerns could result in a measurement of the indemnification asset that differs from that of the indemnified item. For indemnification assets measured at other than fair value, entities can establish a separate valuation allowance for collectibility concerns. Such an allowance would only affect presentation.

Example 4-1

**Initial Recognition and Measurement of Indemnification Assets**

On June 15, 20X9, Company A acquires Company B in a transaction accounted for as a business combination. In applying the acquisition method of accounting, A recognizes a $100 liability related to B’s uncertain tax position in accordance with ASC 740. As part of the acquisition, B’s former owners agree to indemnify A for any losses related to the tax position.

Under ASC 805, A should recognize an indemnification asset at the same amount as the liability, $100 (assuming collectibility is not in doubt). This amount most likely does not represent the asset’s fair value because ASC 740 does not require fair value measurement.

Acquisition agreements often include indemnification arrangements, but the parties to the business combination may instead establish such arrangements separately. In such cases, we believe that entities should consider analogizing to the factors in ASC 810-10-40-6 in determining whether to account for the acquisition agreement and the separate indemnification agreement as a single arrangement. Typically, we would expect that the application of those factors would lead an entity to conclude that the indemnification arrangement is part of the business combination agreement, in which case the acquirer would recognize, measure, and subsequently account for the indemnification assets by using the guidance in ASC 805.
4.3.4.2 Subsequent Accounting for Indemnification Assets

<table>
<thead>
<tr>
<th>ASC 805-20</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Indemnification Assets</strong></td>
</tr>
<tr>
<td>35-4 At each subsequent reporting date, the acquirer shall measure an indemnification asset that was recognized in accordance with paragraphs 805-20-25-27 through 25-28 at the acquisition date on the same basis as the indemnified liability or asset, subject to any contractual limitations on its amount, except as noted in paragraph 805-20-35-4B, and, for an indemnification asset that is not subsequently measured at its fair value, management’s assessment of the collectibility of the indemnification asset.</td>
</tr>
<tr>
<td>40-3 The acquirer shall derecognize an indemnification asset recognized in accordance with paragraphs 805-20-25-27 through 25-28 only when it collects the asset, sells it, or otherwise loses the right to it.</td>
</tr>
</tbody>
</table>

When measuring an indemnification asset that was initially recognized as part of the accounting for a business combination, an entity should use assumptions that are consistent with those used to measure the indemnified item after the acquisition date, subject to any contractual limitations and considerations about the indemnifying party's credit risk. If a change in the amount recognized for the indemnification asset is not the result of a qualifying measurement-period adjustment, the entity should recognize the change in earnings. An entity should use judgment in determining whether the changes to the indemnified item and the indemnification asset should be recognized in the same income statement line item so that they effectively offset one another.

**Example 4-2**

**Subsequent Accounting for Indemnification Assets Recognized as of the Acquisition Date**

Company A acquires Company B in a transaction accounted for as a business combination. As of the acquisition date, B has an open claim related to a contract dispute with a former supplier who is asserting damages of $100 million. In connection with the business combination, B's selling shareholders agree to indemnify A for any losses related to this ongoing litigation up to $75 million. In applying the acquisition method of accounting, A recognizes and measures a $50 million liability for this ongoing litigation and an indemnification asset of $50 million because collectibility is not in doubt. After the measurement period for this item closes, a settlement is reached in the amount of $60 million.

Company A should increase its measurement of the liability to $60 million with a corresponding $10 million debit to the income statement. Also, if the additional amount due under the indemnification agreement is determined to be collectible, A should increase the indemnification asset to $60 million with a corresponding $10 million credit to the income statement.

If an indemnification asset only becomes recognizable after the measurement period for the indemnified item is closed and the accounting for the item is complete, the recognition of the asset is subject to other GAAP rather than the guidance in ASC 805. In some cases, it may be appropriate to apply a loss recovery model to the recognition of the indemnification asset. The accounting framework underlying such a model is based on an analogy to the guidance on recognition of potential loss recoveries in ASC 410. Specifically, ASC 410-30-35-8, which provides subsequent measurement guidance related to environmental obligations, states the following, in part:

Potential recoveries may be claimed from a number of different parties or sources, including insurers, potentially responsible parties other than participating potentially responsible parties (see paragraph 410-30-30-2), and governmental or third-party funds. The amount of an environmental remediation liability should be determined independently from any potential claim for recovery, and an asset relating to the recovery shall be recognized only when realization of the claim for recovery is deemed probable. The term probable is used in this Subtopic with the specific technical meaning in paragraph 450-20-25-1 [the future event or events are likely to occur].
Chapter 4 — Recognizing and Measuring the Identifiable Assets Acquired and Liabilities Assumed

The recognition criteria for a loss recovery is different from that for a gain contingency. Provided that its collection is probable, a loss recovery is recognized in the period in which the loss is incurred (or the period in which collection becomes probable). However, a gain contingency is recognized on the earlier of when the gain is realized or is realizable. While not codified, paragraph 16 of EITF Issue 01-10 provides the EITF’s understanding of the distinction between a loss recovery and a gain contingency: a loss recovery represents the recovery of a loss already recognized in the financial statements, whereas a gain contingency represents the recovery of a loss not yet recognized in the financial statements or recovery of an amount that is greater than the loss recognized in the financial statements.

Example 4-3

**Subsequent Accounting for Indemnification Asset Not Recognized as of the Acquisition Date**

On June 15, 20X9, Company A acquires Company B. Before the acquisition, B had ongoing litigation with a former supplier. In connection with the business combination, B’s selling shareholders agree to indemnify A for any losses related to that ongoing litigation. In applying the acquisition method, A concludes that a liability related to the ongoing litigation does not meet the criteria for recognition during the measurement period. Therefore, A does not recognize a liability or an indemnification asset related to the litigation. Eighteen months after the acquisition, A recognizes a liability for $100 million on the basis of a judgment reached in a similar case.

Company A should recognize an indemnification asset for $100 million under a loss recovery model (provided that collectibility of this amount from B’s selling shareholders is not in doubt) since recognition of the indemnification asset represents the recovery of a loss that is already recognized in the financial statements.

ASC 805-20-40-3 states that an acquirer only derecognizes an indemnification asset “when it collects the asset, sells it, or otherwise loses the right to it.” If there were no changes in the values of the recorded liability and associated indemnification asset after the acquisition date, both the asset and liability would be reversed upon derecognition, with no net effect on the income statement.

**4.3.4.3 Subsequent Accounting for an Indemnification Asset Recognized as of the Acquisition Date After a Government-Assisted Acquisition of a Financial Institution**

**ASC 805-20**

**35-4B** An indemnification asset recognized at the acquisition date in accordance with paragraphs 805-20-25-27 through 25-28 as a result of a government-assisted acquisition of a financial institution involving an indemnification agreement shall be subsequently measured on the same basis as the indemnified item. In certain circumstances, the effect of the change in expected cash flows of the indemnification agreement shall be amortized. Any amortization of changes in value shall be limited to the lesser of the contractual term of the indemnification agreement and the remaining life of the indemnified assets. For example, for indemnified assets accounted for under paragraph 310-30-35-10, if the expected cash flows on the indemnified assets increase (and there is no previously recorded valuation allowance), an entity shall account for the associated decrease in the indemnification asset by amortizing the change over the lesser of the contractual term of the indemnification agreement and the remaining life of the indemnified assets. Alternatively, if the expected cash flows on the indemnified assets increase such that a previously recorded valuation allowance is reversed, an entity shall account for the associated decrease in the indemnification asset immediately in earnings. Any remaining decrease in the indemnification asset shall be amortized over the lesser of the contractual term of the indemnification agreement and the remaining life of the indemnified assets.
ASC 805-20 (continued)

### Pending Content (Transition Guidance: ASC 326-10-65-1)

**35-4B** An indemnification asset recognized at the acquisition date in accordance with paragraphs 805-20-25-27 through 25-28 as a result of a government-assisted acquisition of a financial institution involving an indemnification agreement shall be subsequently measured on the same basis as the indemnified item. For example, if the expected cash flows on indemnified assets increase such that a previously recorded valuation allowance is reversed, an entity shall account for the associated decrease in the indemnification assets immediately in earnings.

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### 4.3.5 Assets Held for Sale

**ASC 805-20**

#### Assets Held for Sale

**30-22** The acquirer shall measure an acquired long-lived asset (or disposal group) that is classified as held for sale at the acquisition date in accordance with Subtopic 360-10, at fair value less cost to sell in accordance with paragraphs 360-10-35-38 and 360-10-35-43.

An entity may acquire a business with the intention of selling some of its long-lived assets shortly after the acquisition date. ASC 805-20-30-22 requires an acquirer to “measure an acquired long-lived asset (or disposal group) that is classified as held for sale at the acquisition date in accordance with Subtopic 360-10, at fair value less cost to sell in accordance with paragraphs 360-10-35-38 and 360-10-35-43.” Accordingly, long-lived assets that qualify for held-for-sale classification on the acquisition date are an exception to the measurement principle in ASC 805.

ASC 360-10-35-38 states, in part:

> Costs to sell are the incremental direct costs to transact a sale, that is, the costs that result directly from and are essential to a sale transaction and that would not have been incurred by the entity had the decision to sell not been made. Those costs include broker commissions, legal and title transfer fees, and closing costs that must be incurred before legal title can be transferred.

ASC 360-10-45-12 requires entities to classify a newly acquired long-lived asset or asset group as held for sale as of the acquisition date if it meets both of the following conditions:

- The criterion in ASC 360-10-45-9(d) is satisfied — that is, 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 paragraph 360-10-45-11.”
- “[A]ny other criteria in paragraph 360-10-45-9 that are not met [as of the acquisition] date are probable of being met within a short period following the acquisition (usually within three months).”

Accordingly, as specified in ASC 360-10-45-12, the acquirer must satisfy the one-year criterion in ASC 360-10-45-9(d) as of the acquisition date, but it can satisfy the other criteria in ASC 360-10-45-9 if they
“are probable of being met within a short period following the acquisition (usually within three months).” If the long-lived asset or disposal group cannot be classified as held for sale, the assets and liabilities would be measured in accordance with the requirements in ASC 805, which would generally be fair value.

See Deloitte’s *A Roadmap to Impairments and Disposals of Long-Lived Assets and Discontinued Operations* for more information about the held-for-sale and discontinued-operations reporting criteria for a business or nonprofit activity that meets the held-for-sale classification criteria upon acquisition.

### 4.3.6 Assets and Liabilities Arising From Contingencies

The ASC master glossary defines a contingency as “[a]n existing condition, situation, or set of circumstances involving uncertainty as to possible gain (gain contingency) or loss (loss contingency) to an entity that will ultimately be resolved when one or more future events occur or fail to occur.” Examples of contingencies include litigation, environmental liabilities, or warranty claims.

The guidance in ASC 805-20 on assets and liabilities arising from contingencies applies to assets and liabilities “that would be within the scope of Topic 450 if not acquired or assumed in a business combination” and are “not otherwise subject to specific guidance in this Subtopic (805-20).” For example, indemnification assets may meet the definition of a contingency; however, ASC 805-20 provides specific guidance on accounting for indemnification assets in a business combination. Similarly, income tax uncertainties or temporary differences, including loss carryforwards, are not contingencies because they are accounted for under ASC 740 rather than ASC 450 when they are outside of a business combination.

Contingencies that exist as of the acquisition date result from prior events or circumstances, which is why assets and liabilities arising from contingencies are often referred to as “preacquisition contingencies.” Outside of a business combination, contingencies are accounted for in accordance with the applicable GAAP (e.g., environmental liabilities); however, if no specific GAAP applies to them, they are accounted for as loss contingencies or gain contingencies under ASC 450. Loss contingencies are recognized if they are probable and reasonably estimable, whereas gain contingencies are recognized on the earlier of when they are realized or are realizable.

While contingencies acquired or assumed in a business combination result from past events, they may not have been recognized by the acquiree before the business combination because the recognition criteria are different for contingencies that arise outside of a business combination.
4.3.6.1 **Initial Recognition and Measurement of Assets and Liabilities Arising From Contingencies**

<table>
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<th>ASC 805-20</th>
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### Acquisition Date Fair Value Determinable During Measurement Period

**25-19** If the acquisition-date fair value of the asset or liability arising from a contingency can be determined during the measurement period, that asset or liability shall be recognized at the acquisition date. For example, the acquisition-date fair value of a warranty obligation often can be determined.

### Acquisition Date Fair Value Not Determinable During Measurement Period

**25-20** If the acquisition-date fair value of the asset or liability arising from a contingency cannot be determined during the measurement period, an asset or a liability shall be recognized at the acquisition date if both of the following criteria are met:

a. Information available before the end of the measurement period indicates that it is probable that an asset existed or that 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.

b. The amount of the asset or liability can be reasonably estimated.

**25-20A** The criteria in the preceding paragraph shall be applied using the guidance in Topic 450 for application of similar criteria in paragraph 450-20-25-2.

### Recognition Criteria Not Met During Measurement Period

**25-20B** If the recognition criteria in paragraphs 805-20-25-19 through 25-20A are not met at the acquisition date using information that is available during the measurement period about facts and circumstances that existed as of the acquisition date, the acquirer shall not recognize an asset or liability as of the acquisition date. In periods after the acquisition date, the acquirer shall account for an asset or a liability arising from a contingency that does not meet the recognition criteria at the acquisition date in accordance with other applicable GAAP, including Topic 450, as appropriate.

### Measurement of Assets and Liabilities Arising From Contingencies

**30-9** Paragraphs 805-20-25-18A through 25-20B establish the requirements related to recognition of certain assets and liabilities arising from contingencies. Initial measurement of assets and liabilities meeting the recognition criteria in paragraph 805-20-25-19 shall be at acquisition-date fair value. Guidance on the initial measurement of other assets and liabilities from contingencies not meeting the recognition criteria of that paragraph, but meeting the criteria in paragraph 805-20-25-20 is at paragraph 805-20-30-23.

**30-23** Initial measurement of assets and liabilities meeting the recognition criteria in paragraph 805-20-25-20 shall be at the amount that can be reasonably estimated by applying the guidance in Topic 450 for application of similar criteria in paragraph 450-20-25-2.

ASC 805 requires entities to perform two steps in determining whether an asset or liability arising from a contingency qualifies for recognition in a business combination. The first step is to evaluate whether the “fair value of the asset or liability arising from a contingency can be determined [at the acquisition date or] during the measurement period.” If so, the asset or liability is recognized as of its acquisition-date fair value as part of the accounting for the business combination.

Although ASC 805 does not provide specific guidance on whether the fair value of a contingency is determinable, it does state that “the acquisition-date fair value of a warranty obligation often can be determined.” However, in practice, the acquisition-date fair value of many contingencies, such as contingencies related to litigation, may not be determinable.
If an acquirer cannot determine the acquisition-date fair value of a contingency during the measurement period, it proceeds to the second step and recognizes the contingency at its estimated amount if (1) “it is probable that an asset existed or that a liability had been incurred at the acquisition date” and (2) “[t]he amount of the asset or liability can be reasonably estimated.” These requirements are similar to those in ASC 450 related to loss contingencies. However, in a business combination, both assets and liabilities arising from contingencies have the same recognition criteria, whereas under ASC 450 a gain contingency is not recognized until the earlier of when it is realized or it is realizable.

In some cases, an acquirer may not have identified the contingency either before or on the acquisition date. Although the contingency must have existed as of the acquisition date (i.e., it resulted from prior events), the acquirer is not limited to only recognizing items that were known at the time of acquisition. Contingencies identified during the measurement period that existed as of the acquisition date still qualify for recognition as part of the business combination accounting.

The fair value measurement of a contingent liability takes into account the time value of money. However, for contingent liabilities recognized at their estimated amounts, discounting is permitted, but not required, only if both the timing and amounts of future cash flows are fixed or reliably determinable on the basis of objective and verifiable information. Although ASC 410-30 specifically addresses environmental remediation liabilities, an entity may also find the guidance useful for evaluating whether discounting is appropriate for other contingencies arising from liabilities. ASC 410-30-35-12 states, in part, that the “measurement of the liability, or of a component of the liability, may be discounted to reflect the time value of money if the aggregate amount of the liability or component and the amount and timing of cash payments for the liability or component are fixed or reliably determinable.” However, because the timing and amounts of future cash flows of many contingencies are inherently subjective, it is often difficult for an entity to meet the criteria for discounting (e.g., in the early phases of litigation and environmental remediation efforts). In addition, if the timing and amounts of future cash flows are fixed or reliably determinable, the acquirer would likely be able to measure the contingency at fair value.

**SEC Considerations**

The Interpretative Response to Question 1 in SAB Topic 5.Y states that if a contingent liability is recognized on a discounted basis, the “notes to the financial statements should, at a minimum, include disclosures of the discount rate used, the expected aggregate undiscounted amount, expected payments for each of the five succeeding years and the aggregate amount thereafter, and a reconciliation of the expected aggregate undiscounted amount to amounts recognized in the statements of financial position.”

**4.3.6.2 Subsequent Accounting for Contingencies Recognized as Part of the Business Combination**

<table>
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<th>ASC 805-20</th>
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<tbody>
<tr>
<td><strong>35-3</strong> An acquirer shall develop a systematic and rational basis for subsequently measuring and accounting for assets and liabilities arising from contingencies depending on their nature.</td>
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</table>
ASC 805 does not provide specific subsequent measurement guidance for contingencies recognized in a business combination, except to say that “[a]n acquirer shall develop a systematic and rational basis for subsequently measuring and accounting for assets and liabilities arising from contingencies depending on their nature.” The subsequent accounting depends on whether the contingency was measured at fair value or at its estimated amount.

For contingencies initially recognized at fair value, the acquirer must develop a “systematic and rational” subsequent measurement approach that is consistent with the nature of the asset or liability. In paragraph B20 of the Basis for Conclusions of FSP FAS 141(R)-1, the FASB suggested that the methods used to subsequently account for guarantees initially recognized at fair value under ASC 460-10 (formerly FASB Interpretation 45) could be applied to warranty obligations initially recognized at fair value. We believe that the guidance in ASC 460-10 for the subsequent accounting of guarantees would also be an acceptable approach to accounting for other contingencies recognized at fair value, not just warranty obligations. Another systematic and rational approach would be for entities to subsequently account for contingencies by applying the methods used for AROs under ASC 410. Entities should use judgment in assessing whether the subsequent accounting method they select is consistent with the nature of the asset or liability. Entities should also apply the same method to similar assets and liabilities.

However, we do not believe that the application of ASC 450 to contingencies recognized at fair value would be a systematic or rational approach. This is because it would not be appropriate for an entity to recognize a contingency at fair value on the acquisition date and then immediately recognize a gain or loss upon measuring the contingency at its estimated amount under ASC 450. In addition, subsequently measuring a contingency at fair value is not a systematic or rational approach unless fair value measurement is required by other GAAP.

For contingencies initially recognized in accordance with ASC 805-20-30-23 at the amount that can be reasonably estimated, acquirers should apply other GAAP, including ASC 450, in periods after the acquisition date. However, assets arising from contingencies should not be derecognized after the acquisition date because they do not meet the gain contingency recognition threshold in ASC 450.

Adjustments to the amounts recognized for a contingency should be accounted for as measurement-period adjustments (see Section 6.1) if they are (1) made within the measurement period and (2) based on the facts and circumstances that existed as of the acquisition date. If the adjustments resulted from facts or circumstances that did not exist as of the acquisition date, they should be recognized in the income statement. It can be particularly challenging for entities to determine whether adjustments to contingencies result from changes in fact or are related to facts that existed as of the acquisition date, especially in the case of litigation-related contingencies.

If a contingency does not qualify for recognition as part of the accounting for a business combination, the acquirer should recognize the asset or liability when it meets the recognition criteria in the applicable GAAP, such as ASC 450 for contingencies or ASC 410 for loss recoveries (see discussion in Section 4.3.4.2 for more information). Under ASC 450, gain contingencies are not recognized until the earlier of when they are realized or are realizable. Because an acquirer cannot adjust the acquisition accounting for the recognition of a contingency after the end of the measurement period, contingencies that qualify for recognition outside of the business combination accounting are recognized in the income statement. Also, contingencies for which the obligating event did not exist on the acquisition date, even those that arose before the end of the measurement period, do not qualify as measurement-period adjustments since they are not related to facts and circumstances that existed as of the acquisition date.
Connecting the Dots

After a business combination, disputes may occur between an acquirer and the acquiree's sellers, sometimes resulting in payments between the parties after the acquisition date. Alternatively, an acquirer's shareholders may bring litigation against the acquirer for various reasons, such as a claim that the acquirer overpaid for the acquiree. Litigation arising from a business combination is not an asset or a liability arising from a contingency because it did not exist on or before the acquisition date. See Section 6.2.6 for information about disputes arising from the business combination.

For more information, see Deloitte's A Roadmap to Accounting for Contingencies, Loss Recoveries, and Guarantees.

4.3.7 Reacquired Rights

ASC 805-20-25-14 states that “[a]s part of a business combination, an acquirer may reacquire a right that it had previously granted to the acquiree to use one or more of the acquirer's recognized or unrecognized assets. Examples of such rights include a right to use the acquirer's trade name under a franchise agreement or a right to use the acquirer's technology under a technology licensing agreement.” Such assets are called reacquired rights.

4.3.7.1 Initial Measurement of Reacquired Rights

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<tr>
<td><strong>Reacquired Rights</strong></td>
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<tr>
<td>25-14 As part of a business combination, an acquirer may reacquire a right that it had previously granted to the acquiree to use one or more of the acquirer's recognized or unrecognized assets. Examples of such rights include a right to use the acquirer's trade name under a franchise agreement or a right to use the acquirer's technology under a technology licensing agreement. A reacquired right is an identifiable intangible asset that the acquirer recognizes separately from goodwill. Paragraph 805-20-30-20 provides guidance on measuring a reacquired right, and paragraph 805-20-35-2 provides guidance on the subsequent accounting for a reacquired right.</td>
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<td>25-15 If the terms of the contract giving rise to a reacquired right are favorable or unfavorable relative to the terms of current market transactions for the same or similar items, the acquirer shall recognize a settlement gain or loss. Paragraph 805-10-55-21 provides guidance for measuring that settlement gain or loss.</td>
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<tr>
<td>30-20 The acquirer shall measure the value of a reacquired right recognized as an intangible asset in accordance with paragraph 805-20-25-14 on the basis of the remaining contractual term of the related contract regardless of whether market participants would consider potential contractual renewals in determining its fair value.</td>
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A reacquired right is an identifiable intangible asset that an acquirer recognizes separately from goodwill because it arises from contractual rights. However, reacquired rights are an exception to ASC 805’s measurement principle because ASC 805 requires entities to measure them on the basis of the related contract’s remaining term, regardless of whether market participants would consider potential contract renewals in determining the rights’ fair value. While market participants would generally reflect expected renewals of the term of a contractual right in their fair value estimate of a right traded in the market, the FASB has observed that 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. The Board has therefore concluded that a right reacquired from an acquiree is no longer a contract with a third party and, in substance, has a finite life. Accordingly, reacquired rights are measured only on the basis of the remaining contractual term.
However, complexities can arise when a contract has no stated term or is perpetual. In making reacquired rights an exception to the measurement principle, the FASB intended to limit the value attributed to a reacquired right by restricting the measurement to only the remaining contractual term. In this way, an acquirer could not assume that there would be unlimited renewals (since the reacquired right becomes a contract between the acquirer and itself as a result of the acquisition), classify the reacquired right as indefinite-lived, and measure it consistently with its classification. Accordingly, we would expect it to be unusual for a reacquired right to be classified as indefinite-lived. Before classifying a reacquired right as indefinite-lived and measuring it consistently with its classification, entities should consider consulting with experts, and SEC registrants should consider consulting with the SEC staff on a prefiling basis.

At the 2005 AICPA Conference on Current SEC Developments, then SEC OCA Professional Accounting Fellow Brian Roberson stated the following regarding the valuation of reacquired rights:

> [R]egarding valuation, you need to value the right as if you were buying a right that you did not previously own. A problem is that the rights are oftentimes not transacted on a standalone basis after the initial sale. For example, a restaurant franchise is granted and the franchisee develops a business using the trade name granted by the franchise agreement. Upon reacquisition, the franchisor typically purchases the entire business, which is now an operating restaurant. On the surface, it seems intuitive that a mature franchise right such as in this example would be worth more than a new franchise right, but you have to think about what is driving that value. The restaurant's value may be driven by other assets, such as customer relationship intangibles from catering contracts, appreciated real estate, and a strong workforce, which is a component of goodwill.

While a reacquired right is the result of a preexisting contractual relationship with the acquiree, not all preexisting relationships with an acquiree will result in the recognition of a reacquired right because not all preexisting relationships (e.g., a lawsuit) lead to the reacquisition of a right previously granted to the acquiree. If the terms of the preexisting contractual relationship giving rise to a reacquired right are favorable or unfavorable relative to the terms of current market transactions for the same or similar items, the acquirer must recognize a settlement gain or loss related to the preexisting contractual relationship separately from the accounting for the business combination. ASC 805-10-55-21 provides guidance on measuring that settlement gain or loss (see Section 6.2.2 for more information).

### 4.3.7.2 Subsequent Accounting for Reacquired Rights

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35-2 A reacquired right recognized as an intangible asset in accordance with paragraph 805-20-25-14 shall be amortized over the remaining contractual period of the contract in which the right was granted. An acquirer that subsequently sells a reacquired right to a third party shall include the carrying amount of the intangible asset in determining the gain or loss on the sale.

ASC 805-20-25-14 states that an entity amortizes a reacquired right “over the remaining contractual period of the contract in which the right was granted.” If an acquirer subsequently sells a reacquired right to a third party, the carrying amount of the intangible asset is included in the determination of the gain or loss on the sale. If the acquirer subsequently sells only a portion of the reacquired right to the third party, the acquirer will need to develop a reasonable allocation method for measuring the portion of the intangible asset’s carrying amount that it will include in determining the gain or loss on the sale. Such an allocation method would be necessary if, for example, an acquirer reacquires a franchise right to a specific geographic area and then subsequently subdivides that geographic area and sells only a portion of it to a third party.
4.3.8 Income Taxes

**ASC 805-20**

- **25-21** Section 805-740-25 establishes the recognition guidance for accounting for income taxes in a business combination.

- **30-13** Section 805-740-30 establishes the measurement guidance related to accounting for income taxes in a business combination.

Income taxes are an exception to the recognition and measurement principles in ASC 805. For information about accounting for income taxes in a business combination, see Deloitte’s *A Roadmap to Accounting for Income Taxes*.

4.3.9 Employee Benefits

**ASC 805-20**

- **25-22** The acquirer shall recognize a liability (or asset, if any) related to the acquiree's employee benefit arrangements in accordance with other GAAP. For example, employee benefits in the scope of the guidance identified in paragraphs 805-20-25-23 through 25-26 would be recognized in accordance with that guidance and as specified in those paragraphs.

**Pension and Postretirement Benefits Other Than Pensions**

- **25-23** Guidance on defined benefit pension plans is presented in Subtopic 715-30. If an acquiree sponsors a single-employer defined benefit pension plan, the acquirer shall recognize as part of the business combination an asset or a liability representing the funded status of the plan (see paragraph 715-30-25-1). Paragraph 805-20-30-15 provides guidance on determining that funded status. If an acquiree participates in a multiemployer plan, and it is probable as of the acquisition date that the acquirer will withdraw from that plan, the acquirer shall recognize as part of the business combination a withdrawal liability in accordance with Subtopic 450-20.

- **25-24** The Settlements, Curtailments, and Certain Termination Benefits Subsections of Sections 715-30-25 and 715-30-35 establish the recognition guidance related to accounting for settlements and curtailments of defined benefit pension plans and certain termination benefits.

- **25-25** Guidance on defined benefit other postretirement plans is presented in Subtopic 715-60. If an acquiree sponsors a single-employer defined benefit postretirement plan, the acquirer shall recognize as part of the business combination an asset or a liability representing the funded status of the plan (see paragraph 715-60-25-1). Paragraph 805-20-30-15 provides guidance on determining that funded status. If an acquiree participates in a multiemployer plan and it is probable as of the acquisition date that the acquirer will withdraw from that plan, the acquirer shall recognize as part of the business combination a withdrawal liability in accordance with Subtopic 450-20.
ASC 805-20 (continued)

Other Employee Benefit Arrangements

25-26 See also the recognition-related guidance for the following other employee benefit arrangements:
   a. One-time termination benefits in connection with exit or disposal activities. See Section 420-10-25.
   c. Deferred compensation contracts. See Section 710-10-25.

30-14 The acquirer shall measure a liability (or asset, if any) related to the acquiree's employee benefit arrangements in accordance with other GAAP. For example, employee benefits in the scope of the guidance identified in paragraphs 805-20-30-15 through 30-17 would be measured in accordance with that guidance and as specified in those paragraphs.

Pension and Postretirement Benefits Other Than Pensions

30-15 Guidance on defined benefit pension plans is presented in Subtopic 715-30. Guidance on defined benefit other postretirement plans is presented in Subtopic 715-60. Paragraphs 805-20-25-23 and 805-20-25-25 require an acquirer to recognize as part of a business combination an asset or a liability representing the funded status of a single-employer defined benefit pension or postretirement plan. In determining that funded status, the acquirer shall exclude the effects of expected plan amendments, terminations, or curtailments that at the acquisition date it has no obligation to make. The projected benefit obligation assumed shall reflect any other necessary changes in assumptions based on the acquirer's assessment of relevant future events.

30-16 The Settlements, Curtailments, and Certain Termination Benefits Subsection of Section 715-30-35 establishes the measurement guidance related to accounting for settlements and curtailments of defined benefit pension plans and certain termination benefits.

Other Employee Benefit Arrangements

30-17 See also measurement-related guidance for the following other employee benefit arrangements:
   a. One-time termination benefits in connection with exit or disposal activities. See Section 420-10-30.
   c. Deferred compensation contracts. See Section 710-10-30.

Contractual Termination Benefits and Curtailment Losses

55-50 An entity that has agreed to a business combination may develop a plan to terminate certain employees. The plan will be implemented only if the combination is consummated, but the entity assesses the likelihood of the combination to be probable. In this circumstance, when terminated, the employees will be entitled to termination benefits under a preexisting plan or contractual relationship. The termination of the employees also may affect the entity's assumptions in estimating its obligations for pension benefits, other postretirement benefits, and postemployment benefits; that is, the termination of the employees may trigger curtailment losses or the recording of a contractual termination benefit.

55-51 The liability for the contractual termination benefits and the curtailment losses under employee benefit plans that will be triggered by the consummation of the business combination shall not be recognized when it is probable that the business combination will be consummated; rather it shall be recognized when the business combination is consummated.
Employee benefit arrangements that are within the scope of ASC 710, ASC 712, and ASC 715 are exceptions to ASC 805’s recognition and measurement principles. ASC 805-20-25-22 requires an acquirer to “recognize [and measure] a liability (or asset, if any) related to the acquiree’s employee benefit arrangements in accordance with other GAAP.” ASC 805-20-25-23 through 25-26 also note that the following standards provide recognition and measurement guidance on employee benefits:

- Deferred compensation contracts — see ASC 710-10-25.
- Compensated absences — see ASC 710-10-25.
- Defined benefit pension plans — see ASC 715-30.
- Settlements, curtailments, and certain termination benefits — see ASC 715-30-35 and ASC 715-60-35.
- Other postretirement plans — see ASC 715-60.
- Nonretirement postemployment benefits — see ASC 712-10-25.
- One-time termination benefits related to exit or disposal activities — see ASC 420-10-25.

Employee benefits are an exception to the recognition and measurement principles in ASC 805. The FASB established this broad exception to avoid having to reconsider the requirements under multiple standards, which would have been outside the scope of the business combinations project.

### 4.3.9.1 Pension and Other Postretirement Benefit Plans

If an acquirer will assume as part of a business combination a single-employer defined benefit plan (including a defined benefit pension plan or postretirement benefit plan) sponsored by the acquiree, the acquirer should recognize an asset or a liability on the acquisition date for the funded status of the plan. If, as of the acquisition date, the fair value of the plan assets exceeds the projected benefit obligation, an asset is recognized; however, if the projected benefit obligation exceeds the fair value of the plan assets, a liability is recognized. Previously unrecognized prior service costs, gains or losses, and transition amounts of the acquiree related to the assumed plan, including amounts previously recognized in other comprehensive income, are not carried forward.

Under ASC 805-20-30-15, when measuring the funded status of pension and other postretirement plans, an acquirer must exclude the effects of an entity’s planned but not executed amendments, terminations, and curtailments. Planned or expected amendments, terminations, and curtailments are not considered part of the liability assumed on the acquisition date. Such actions are recognized in the postcombination financial statements in accordance with ASC 715.

Upon an acquisition or a change in control, an acquirer may be obligated to modify an existing plan. The acquirer should assess the modification to determine whether it is part of the business combination or whether it should be accounted for outside of the business combination in accordance with ASC 805-10-55-18. If the modification is determined to be part of the business combination, the acquirer should include the effect of the modification on the existing plan in measuring the plan’s funded status.

The measurement of the projected benefit obligation for pensions or accumulated postretirement benefit obligation for other postretirement benefits and the fair value of the plan assets on the acquisition date should reflect any other necessary changes in discount rates or other assumptions that are based on the acquirer’s assessment of relevant future events.
In addition, ASC 805-20-55-51 addresses the accounting for contractual termination benefits and curtailment losses in an acquiree’s preacquisition financial statements. It states that “[t]he liability for the contractual termination benefits and the curtailment losses under employee benefit plans that will be triggered by the consummation of the business combination shall not be recognized when it is probable that the business combination will be consummated; rather it shall be recognized when the business combination is consummated.”

Example 4-4

Anticipated Plan Amendments in Connection With a Business Combination

Company A intends to acquire Company B in a business combination. Company B currently offers pension benefits to its employees, and as part of the acquisition agreement, A agrees to offer competitive pension benefits to B’s employees for one year after the transaction. Company A is evaluating the possibility of reducing these benefits after one year; but as of the acquisition date, it has not decided how or to what extent the benefits will change. Any change most likely would result in a reduction in the liability representing the plan’s funded status.

ASC 805-20-30-15 states that in “determining that funded status, the acquirer shall exclude the effects of expected plan amendments . . . that at the acquisition date it has no obligation to make.” Because A has no obligation as of the acquisition date to recognize the effects of an expected, but voluntary, amendment, it should not recognize the effect of its expected modification as part of the business combination accounting. If A decides to change B’s employees’ pension benefits after the acquisition date, these changes should be treated as plan amendments in accordance with ASC 715-30-35-10 through 35-17.

Example 4-5

Anticipated Changes to OPEB Plan in Connection With a Business Combination

Company A is acquiring Company B, which currently sponsors an other postemployment benefits (OPEB) plan. The assumptions that B uses to measure the funded status of its plan (e.g., the method to determine the discount rate) differ from those used by A. In addition, certain provisions of B’s plan are different from those of A. After the business combination, A intends to amend B’s plan to make it consistent with its own plans; however, A has no obligation to make amendments on the acquisition date.

ASC 805-20-30-15 states that “the acquirer shall exclude the effects of expected plan amendments, terminations, or curtailments that at the acquisition date it has no obligation to make.” However, in accordance with ASC 805-20-30-15, the plan liabilities that A assumes should “reflect any other necessary changes in assumptions based on the acquirer’s assessment of relevant future events.” That is, to measure B’s plan liabilities, A may use assumptions that are consistent with those used in the measurement of its existing plans, including, for example, the discount rates, health care cost inflation, Medicare reimbursement rates, and expected return on plan assets.

4.3.9.2 Postemployment Benefits

ASC 712 applies to all types of postemployment benefits other than pensions, postretirement benefits, deferred compensation arrangements, and termination benefits, which are addressed in other standards. ASC 712-10-25-5 requires an entity to account for a liability for postemployment benefits in accordance with ASC 450 if those benefits within the scope of ASC 712 do not meet the conditions in ASC 710-10-25-1. In addition, the Background Information and Basis for Conclusions of FASB Statement 112 states that an entity may refer to the guidance in FASB Statement 87 (ASC 715-30) and FASB Statement 106 (ASC 715-60) on measuring a liability for postemployment benefit obligations. While not codified, the guidance in Statement 112’s Background Information and Basis for Conclusions continues to be relevant. Thus, in a manner consistent with the treatment of pensions and OPEBs (see Section 4.3.9.1), an acquirer must exclude the effects of any planned amendments, terminations, or curtailments from the measurement of the assumed obligation in a business combination unless such information
is required as part of the acquisition agreement or as a result of the change in control. Measurement of the assumed obligation should reflect any other necessary changes in discount rates or other assumptions based on the acquirer's assessment of the relevant future event.

4.3.9.3 Multiemployer Plans

Multiemployer plans are accounted for differently than single employer plans, as discussed in ASC 715-80. Liabilities for multiemployer plans generally are recognized only for unpaid contributions as of the acquisition date. ASC 805-20-25-23 states that an acquirer recognizes a withdrawal liability as of the acquisition date in accordance with ASC 450-20 if it is probable that, as of that date, the acquirer will withdraw from a multiemployer plan.

4.3.10 Purchased Financial Assets With Credit Deterioration

ASC 805-20

<table>
<thead>
<tr>
<th>Pending Content (Transition Guidance: ASC 326-10-65-1)</th>
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<tbody>
<tr>
<td><strong>30-4A</strong> For acquired financial assets that are not purchased financial assets with credit deterioration, the acquirer shall record the purchased financial assets at the acquisition-date fair value. Additionally, for these financial assets within the scope of Topic 326, an allowance shall be recorded with a corresponding charge to credit loss expense as of the reporting date.</td>
</tr>
<tr>
<td><strong>30-4B</strong> For assets accounted for as purchased financial assets with credit deterioration (which includes beneficial interests that meet the criteria in paragraph 325-40-30-1A), an acquirer shall recognize an allowance in accordance with Topic 326 with a corresponding increase to the amortized cost basis of the financial asset(s) as of the acquisition date.</td>
</tr>
<tr>
<td><strong>30-26</strong> An acquirer shall recognize purchased financial assets with credit deterioration (including beneficial interests meeting the conditions in paragraph 325-40-30-1A) in accordance with Section 326-20-30 for financial instruments measured at amortized cost or Section 326-30-30 for available-for-sale debt securities. Paragraphs 326-20-55-57 through 55-78 illustrate how the guidance is applied for purchased financial assets with credit deterioration measured at amortized cost. Paragraphs 326-30-55-5 through 55-7 illustrate how the guidance is applied to available-for-sale debt securities. An acquirer shall not accrete into interest income the credit losses embedded in the purchase price for purchased financial assets with credit deterioration.</td>
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</tbody>
</table>

Upon adoption of ASU 2016-13, the accounting for acquired financial assets within the scope of ASC 326 will depend on whether the financial assets are purchased with credit deterioration.

The ASC master glossary defines purchased financial assets with credit deterioration as “acquired individual financial assets (or acquired groups of financial assets with similar risk characteristics) that as of the date of acquisition have experienced a more-than-insignificant deterioration in credit quality since origination, as determined by an acquirer's assessment” (pending content).
Purchased financial assets without credit deterioration will be recognized in accordance with ASC 805-20-30-4 at their acquisition date fair values, with no valuation allowance. For purchased financial assets with credit deterioration, an acquirer will recognize an allowance in accordance with ASC 326, with a corresponding increase to the amortized cost basis of the financial assets. While the net of the amortized cost basis and the allowance represent fair value, purchased financial assets with credit deterioration are an exception to the fair value measurement principle because an acquirer typically does not recognize an allowance for assets recognized at fair value, as described in Section 4.5.

4.3.11 Leases

In February 2016, the FASB issued ASU 2016-02, which amends the Board's guidance on the accounting for leases. The ASU added to U.S. GAAP ASC 842, which, when effective for all entities, will supersede the existing leasing guidance in ASC 840. The sections below address the accounting for leases acquired in a business combination both after and before adoption of ASC 842.

4.3.11.1 Leases — After Adoption of ASC 842

Leases (including contracts that contain a lease) acquired in a business combination may result in the recognition of various assets or liabilities, depending on the classification of the lease and whether the acquiree is the lessee or the lessor under the lease contract. Sections 4.3.11.1.1 through 4.3.11.1.15 below describe the accounting for leases acquired in a business combination after the adoption of ASC 842.

For additional information on the issues discussed in this section, see Deloitte's A Roadmap to Applying the New Leasing Standard.

4.3.11.1.1 Classification

<table>
<thead>
<tr>
<th>ASC 805-20</th>
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</thead>
<tbody>
<tr>
<td><strong>Classifying or Designating Identifiable Assets Acquired and Liabilities Assumed in a Business Combination</strong></td>
</tr>
<tr>
<td>25-6 At the acquisition date, the acquirer shall classify or designate the identifiable assets acquired and liabilities assumed as necessary to subsequently apply other GAAP. 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.</td>
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</tbody>
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<tr>
<th>Pending Content (Transition Guidance: ASC 842-10-65-1)</th>
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<td>25-8 This Section provides the following two exceptions to the principle in paragraph 805-20-25-6:</td>
</tr>
<tr>
<td>a. Classification of a lease of an acquiree shall be in accordance with the guidance in paragraph 842-10-55-11...</td>
</tr>
</tbody>
</table>
As indicated in ASC 842-10-55-11, an acquirer in a business combination should retain the acquiree’s classification of its leases unless “there is a lease modification and that modification is not accounted for as a separate contract.”

The ASC master glossary defines a lease modification as:

A change to the terms and conditions of a contract that results in a change in the scope of or the consideration for a lease (for example, a change to the terms and conditions of the contract that adds or terminates the right to use one or more underlying assets or extends or shortens the contractual lease term). [Emphasis added]

As part of a business combination, a lease might also be changed in ways that do not qualify as a lease modification. For example, a lease may be changed to reflect the new owner of the acquiree. Such a change in the name of one of the parties identified in the contract would not qualify as a lease modification without a change in the scope of or consideration for the lease.

If the terms of a lease are modified as part of a business combination such that there is a lease modification, the acquirer should use the guidance in ASC 842 to determine whether to account for that modification as a separate contract. ASC 842-10-25-8 states that a lease modification should be considered a separate contract (i.e., “separate from the original contract”) if both of the following conditions exist:

a. The modification grants the lessee an additional right of use not included in the original lease (for example, the right to use an additional asset).

b. The lease payments increase commensurate with the standalone price for the additional right of use, adjusted for the circumstances of the particular contract. For example, the standalone price for the lease of one floor of an office building in which the lessee already leases other floors in that building may be different from the standalone price of a similar floor in a different office building, because it was not necessary for a lessor to incur costs that it would have incurred for a new lessee.

Therefore, a lease modification that meets the conditions in ASC 842-10-25-8 effectively results in two separate contracts: (1) the original unmodified contract and (2) a separate contract for the additional right of use. Accordingly, if the lease modification is considered a separate contract, the classification of the original lease is not reconsidered as part of the business combination and the additional right of use added in the lease modification is accounted for, and classified as, a separate “new” lease in accordance with ASC 842 when that lease commences.

However, if the modification does not meet the conditions to be accounted for as a separate contract, the acquirer reconsiders the classification of the lease on the basis of modified terms and conditions that exist as of the acquisition date (i.e., the effective date of the modification) in accordance with ASC 842-10-25-9 and ASC 842-10-25-11 through 25-18.
The following flowchart summarizes the process for classifying an acquiree’s lease contracts:

4.3.11.1.2 Potential Assets or Liabilities Arising From an Acquiree’s Lease

**ASC 805-20**

**Pending Content (Transition Guidance: ASC 842-10-65-1)**

**Leases**

*25-28A* The acquirer shall recognize assets and liabilities arising from leases of an acquiree in accordance with Topic 842 on leases (taking into account the requirements in paragraph 805-20-25-8(a)).

Right-of-use (ROU) assets and lease liabilities arising from an acquiree’s operating or finance leases are exceptions to ASC 805’s recognition and fair value measurement principles. Instead, ROU assets and lease liabilities are recognized and measured in accordance with ASC 842. However, an acquirer should recognize and measure at fair value certain lease-related intangible assets or liabilities previously recognized by the acquiree (e.g., in-place lease intangible assets).
The table below lists the potential assets or liabilities that may be recognized in connection with an acquiree’s leases. Each item is discussed in more detail in the sections noted.

<table>
<thead>
<tr>
<th>Lease Type</th>
<th>Asset or Liability That May Be Recognized</th>
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| Acquiree is the lessee in an operating or finance lease | • ROU asset (see Section 4.3.11.1.3 below)  
• Lease liability (see Section 4.3.11.1.3 below)  
• Leasehold improvements owned by the acquiree (see Section 4.3.11.1.9)  
• Intangible asset for an in-place lease (see Section 4.3.11.1.10) |
| Acquiree is the lessee, and the remaining lease term is 12 months or less | • Accounting policy election to not recognize assets or liabilities for short-term leases, including intangible assets or liabilities for off-market terms or in-place leases (see Section 4.3.11.1.4) |
| Acquiree is the lessor in an operating lease | • Asset (i.e., the property, plant, or equipment) subject to the lease (see Section 4.3.11.1.5)  
• Intangible asset or liability for favorable or unfavorable terms (see Section 4.3.11.1.7), including favorable or unfavorable renewal or termination options (see Section 4.3.11.1.8)  
• Leasehold improvements owned by the acquiree (see Section 4.3.11.1.9)  
• Intangible asset for an in-place lease (see Section 4.3.11.1.10)  
• Intangible asset for customer relationships (see Section 4.3.11.1.11) |
| Acquiree is the lessor in a sales-type or direct financing lease | • Net investment in the lease (see Section 4.3.11.1.6)  
• Intangible asset for an in-place lease (see Section 4.3.11.1.10)  
• Intangible asset for customer relationships (see Section 4.3.11.1.11) |

4.3.11.1.3 Acquiree Is the Lessee in an Operating or Finance Lease

ASC 805-20

Pending Content (Transition Guidance: ASC 842-10-65-1)

25-10A An identifiable intangible asset may be associated with a lease, which may be evidenced by market participants’ willingness to pay a price for the lease even if it is at market terms. For example, a lease of gates at an airport or of retail space in a prime shopping area might provide entry into a market or other future economic benefits that qualify as identifiable intangible assets, such as a customer relationship. In that situation, the acquirer shall recognize the associated identifiable intangible asset(s) in accordance with paragraph 805-20-25-10.

25-11 The acquirer shall recognize assets or liabilities related to an operating lease in which the acquiree is the lessee as required by paragraphs 805-20-25-10A and 805-20-25-28A.


### ASC 805-20 (continued)

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<tr>
<th>Pending Content (Transition Guidance: ASC 842-10-65-1)</th>
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<tbody>
<tr>
<td>25-28A The acquirer shall recognize assets and liabilities arising from leases of an acquiree in accordance with Topic 842 on leases (taking into account the requirements in paragraph 805-20-25-8(a)).</td>
</tr>
</tbody>
</table>

**Measurement of Lease Assets and Lease Liabilities Arising From Leases in Which the Acquiree Is the Lessee**

30-24 For leases in which the acquiree is a lessee, the acquirer shall measure the lease liability at the present value of the remaining lease payments, as if the acquired lease were a new lease of the acquiree at the acquisition date. The acquirer shall measure the right-of-use asset at the same amount as the lease liability as adjusted to reflect favorable or unfavorable terms of the lease when compared with market terms.

For acquired operating or finance leases in which the acquiree is the lessee, the acquirer measures the lease liability and ROU asset in accordance with the principles in ASC 842, and thus their measurement is an exception to ASC 805’s fair value measurement principle. (The acquirer may elect, as an accounting policy, not to recognize assets or liabilities as of the acquisition date for leases that, on the acquisition date, have a remaining lease term of 12 months or less; see Section 4.3.11.1.4.) The FASB considered whether to require an acquirer to apply the general measurement principle in ASC 805 and measure the acquiree’s ROU assets and lease liabilities at fair value as of the acquisition date but decided against it, as described in paragraph BC416 of ASU 2016-02:

>The Board decided that the benefits associated with measuring lease assets and lease liabilities at fair value will not justify the costs because obtaining fair value information — particularly for the right-of-use asset — might be difficult and, thus, costly. The Board also noted that when the acquiree is a lessee, the guidance on the measurement of lease assets and lease liabilities will result in recognizing a net carrying amount for the lease at the date of acquisition that approximates the fair value of the lease at that date.

Accordingly, ASC 805-20-30-24 requires an acquirer to measure “the lease liability at the present value of the remaining lease payments, as if the acquired lease were a new lease of the acquiree at the acquisition date.” The remaining lease payments are those expected to be received over the balance of the lease term and should be determined in accordance with the guidance in ASC 842-10-30-5, except that the commencement date for an acquired lease is the acquisition date. Paragraph BC415 of ASU 2016-02 clarifies that “[m]easuring the acquired lease as if it were a new lease at the date of acquisition includes undertaking a reassessment of all of the following:

- The lease term
- Any lessee options to purchase the underlying asset
- Lease payments (for example, amounts probable of being owed by the lessee under a residual value guarantee)
- The discount rate for the lease.”
We believe that the lease term should be assessed from the acquirer's perspective. The acquirer should take into account any renewal or purchase options it expects to exercise (see Section 4.3.11.1.8) and use the discount rate that is implicit in the lease, if readily determinable; otherwise, the acquirer should use its incremental borrowing rate. In a manner consistent with how an entity would determine the incremental borrowing rate for a new lease, the acquirer should evaluate whether the incremental borrowing rate at the parent level (i.e., acquirer level) or the subsidiary level (i.e., acquiree level) would be appropriate on the basis of the terms and conditions of the lease arrangement. Regardless of this determination, the incremental borrowing rate used should be the rate determined as of the acquisition date. However, the acquirer would not reassess the acquiree's lease classification solely on the basis of differences between the acquirer's and acquiree's assessment of the lease term or likelihood of purchase option exercise by the lessee. In other words, the acquirer will retain the lease classification of the acquiree's leases, regardless of whether the acquirer's and acquiree's conclusions differ regarding lease term or purchase options, as long as the acquisition does not result in a lease modification that is not accounted for as a separate contract. (See Chapters 7 and 8 of Deloitte's A Roadmap to Applying the New Leasing Standard for (1) additional information about the determination of the discount rate and measurement of a new lease under ASC 842 and (2) subsequent accounting considerations for an acquirer that is reasonably certain to exercise a purchase option in an acquired operating lease.)

ASC 805-20-30-24 also requires the acquirer to measure the “right-of-use asset at the same amount as the lease liability as adjusted to reflect favorable or unfavorable terms of the lease when compared with market terms.” Accordingly, an acquirer would not recognize a separate intangible asset or liability if an acquired lease in which the acquiree is a lessee is favorable or unfavorable relative to market terms as of the acquisition date. Thus, the acquirer will first measure the ROU asset in accordance with ASC 842 and then adjust the ROU asset for any off-market terms in accordance with ASC 805.

**Connecting the Dots**

ASC 842-10-55-12 states, in part, that “[l]eases between related parties should be classified in accordance with the lease classification criteria applicable to all other leases on the basis of the legally enforceable terms and conditions of the lease.” Therefore, under ASC 842, entities do not adjust the accounting for related-party leases for off-market terms or conditions. However, an ROU asset acquired in a business combination is adjusted for any off-market terms. We believe that even though it is not explicitly required to do so, an acquirer should, in a manner consistent with the measurement guidance in ASC 805 for all acquired ROU assets, adjust the carrying amount of an ROU asset acquired in a business combination for any off-market terms in a related-party lease. Otherwise, the off-market portion would be captured in goodwill (or possibly a bargain purchase gain) rather than through the amortization of the ROU asset.

In addition to the ROU asset and lease liability, when the acquiree is the lessee, an acquirer should recognize separately:

- Leasehold improvements owned by the acquiree (see Section 4.3.11.1.9).
- An intangible asset for the value associated with an in-place lease even if the lease is at market terms if market participants would place value on an at-the-money contract (see Section 4.3.11.1.10).
4.3.11.1.4 Leases With a Remaining Lease Term of 12 Months or Less in Which the 
Acquiree Is the Lessee

ASC 805-20

Pending Content (Transition Guidance: ASC 842-10-65-1)

25-28B For leases for which the acquiree is a lessee, the acquirer may elect, as an accounting policy 
election by class of underlying asset and applicable to all of the entity's acquisitions, not to recognize 
assets or liabilities at the acquisition date for leases that, at the acquisition date, have a remaining lease 
term of 12 months or less. This includes not recognizing an intangible asset if the terms of an operating 
lease are favorable relative to market terms or a liability if the terms are unfavorable relative to market 
terms.

The ASC master glossary defines a “short-term lease” as “[a] lease that, at the commencement date, 
has a lease term of 12 months or less and does not include an option to purchase the underlying asset 
that the lessee is reasonably certain to exercise.” Lessees may elect an accounting policy (by class of 
underlying asset to which the right of use relates) to not recognize on the balance sheet lease liabilities 
or ROU assets of short-term leases (i.e., the “short-term lease exemption”). Rather, a lessee that makes 
this accounting policy election recognizes (1) fixed lease payments as an expense on a straight-line 
basis over the lease term and (2) variable lease payments that do not depend on an index or rate 
as an expense in the period in which achieving the specified target that triggers the variable lease 
payments becomes probable. See Deloitte’s A Roadmap to Applying the New Leasing Standard for further 
discussion.

ASC 842 amended ASC 805 to allow a similar exemption for leases acquired in a business combination 
on the basis of a remaining lease term of 12 months or less on the acquisition date. ASC 805-20-25-28B 
states, in part:

For leases for which the acquiree is a lessee, the acquirer may elect, as an accounting policy election by class 
of underlying asset and applicable to all of the entity's acquisitions, not to recognize assets or liabilities at the 
acquisition date for leases that, at the acquisition date, have a remaining lease term of 12 months or less.

ASC 805-20-25-28B clarifies that the recognition exemption, when elected, also applies to intangible 
assets or liabilities for favorable or unfavorable terms of acquired operating leases. We also believe that 
this exception may be applied to in-place lease intangible assets.

4.3.11.1.5 Acquiree Is the Lessor in an Operating Lease

ASC 805-20

Assets Subject to Operating Leases in Which the Acquiree Is the Lessor

30-5 The acquirer shall measure the acquisition-date fair value of an asset, such as a building or a patent or 
other intangible asset, that is subject to an operating lease in which the acquiree is the lessor separately from 
the lease contract. In other words, the fair value of the asset shall be the same regardless of whether it is 
subject to an operating lease. In accordance with paragraph 805-20-25-12, the acquirer separately recognizes 
an asset or a liability if the terms of the lease are favorable or unfavorable relative to market terms.
Chapter 4 — Recognizing and Measuring the Identifiable Assets Acquired and Liabilities Assumed

The lessor in an operating lease continues to report the assets subject to the lease on its balance sheet. In a business combination in which the acquiree is a lessor, the assets subject to the lease are recognized by the acquirer and measured at their acquisition-date fair values. The fair value measurement of the assets does not take into consideration the terms of the lease arrangement. That is, ASC 805-20-30-5 clarifies that “the fair value of the asset shall be the same regardless of whether it is subject to an operating lease.”

In addition to the asset subject to the lease, an acquirer may recognize the following separately when the acquiree is the lessor in an operating lease:

- An intangible asset or a liability if the terms of the lease are favorable or unfavorable compared with the market terms of leases of the same or similar items as of the acquisition date (see Section 4.3.11.1.7), including favorable or unfavorable renewal or termination options (see Section 4.3.11.1.8).
- Leasehold improvements owned by the acquiree (see Section 4.3.11.1.9).
- An intangible asset for the value associated with an in-place lease, including a lease that is at current market terms if market participants would place value on an at-the-money contract (see Section 4.3.11.1.10).
- An intangible asset for the value of the existing customer relationship between the acquiree and its lessee (see Section 4.3.11.1.11).

4.3.11.1.6 Acquiree Is the Lessor in a Sales-Type or Direct Financing Lease

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<th>Section 805-20</th>
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<td>Pending Content (Transition Guidance: ASC 842-10-65-1)</td>
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**Measurement of Assets and Liabilities Arising From Leases in Which the Acquiree Is the Lessor**

**30-25** For leases in which the acquiree is a lessor of a sales-type lease or a direct financing lease, the acquirer shall measure its net investment in the lease as the sum of both of the following (which will equal the fair value of the underlying asset at the acquisition date):

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

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

The acquirer shall take into account the terms and conditions of the lease in calculating the acquisition-date fair value of an underlying asset that is subject to a sales-type lease or a direct financing lease by the acquiree-lessor.
ASC 805-20-30-25 requires that when the acquiree is a lessor in a sales-type or direct financing lease, the acquirer must recognize the net investment in the lease — measured as the sum of the lease receivable and the unguaranteed residual asset — which should approximate fair value. The ASC master glossary defines a lease receivable as “[a] lessor’s right to receive lease payments arising from a sales-type lease or a direct financing lease plus any amount that a lessor expects to derive from the underlying asset following the end of the lease term to the extent that it is guaranteed by the lessee or any other third party unrelated to the lessor, measured on a discounted basis.” In the measurement of a lease receivable, it is assumed that the acquirer entered into the lease on the acquisition date under the terms in effect on that date. The measurement should include assessment of the lease term, any lessee options to purchase the underlying asset, lease payments, and the discount rate for the lease as described in paragraph BC415 of ASU 2016-02. See Deloitte’s A Roadmap to Applying the New Leasing Standard for discussion about the measurement of a new lease under ASC 842.

The ASC master glossary defines an unguaranteed residual asset as “[t]he amount that a lessor expects to derive from the underlying asset following the end of the lease term that is not guaranteed by the lessee or any other third party unrelated to the lessor, measured on a discounted basis.” Such an asset is measured as “the difference between the fair value of the underlying asset at the acquisition date and the carrying amount of the lease receivable, as determined in accordance with [ASC 805-20-30-25(a)], at that date.” Because the measurement of the acquisition-date fair value of the underlying asset takes into account the terms and conditions of the existing lease arrangement, including any favorable or unfavorable terms, the acquirer does not recognize a separate intangible asset or liability for such off-market terms.

As described in paragraph BC417 of ASU 2016-02, the Board considered requiring an acquirer to apply the general principle in ASC 805 and measure the acquiree’s lease receivable and unguaranteed residual asset at fair value as of the acquisition date but ultimately decided against such an approach:

The Board considered requiring the measurement of the net investment in the lease and its components — both the lease receivable and the unguaranteed residual asset — at fair value at the date of acquisition. However, the Board noted that there will be costs associated with measuring each of those assets at fair value and that it had decided not to require such a measurement basis for the lease receivable and the unguaranteed residual asset more generally because of those costs. Although the proposed initial measurement of the lease receivable and the unguaranteed residual asset may not represent the fair value of those assets, the sum of the initial measurement of those assets (that is, the net investment in the lease) will equal the fair value of the underlying asset, which is consistent with the principles in Topic 805. Consequently, the Board concluded that the benefits of requiring an acquirer to measure the lease receivable and the unguaranteed residual asset at fair value will not justify the costs.

The net investment in the lease is subsequently accounted for in accordance with ASC 842. See Deloitte’s A Roadmap to Applying the New Leasing Standard for more information on the subsequent accounting for the net investment in a sales-type or direct financing lease.

In addition to the net investment in the lease, an acquirer may recognize the following separately when the acquiree is the lessor in a sales-type or direct financing lease:

- An intangible asset for the value associated with an in-place lease, including a lease that is at current market terms if market participants would place value on an at-the-money contract (see Section 4.3.11.1.10).
- An intangible asset for the value of the existing customer relationship between the acquiree and its lessees (see Section 4.3.11.1.11).
4.3.11.7 Favorable or Unfavorable Terms in Leases

ASC 805-20

Pending Content (Transition Guidance: ASC 842-10-65-1)

25-12 Regardless of whether the acquiree is the lessee or the lessor, the acquirer shall determine whether the terms of each of an acquiree's operating leases are favorable or unfavorable compared with the market terms of leases of the same or similar items at the acquisition date. If the acquiree is a lessee, the acquirer shall recognize an intangible asset if the terms of an operating lease are favorable relative to market terms and a liability if the terms are unfavorable relative to market terms. If the acquiree is a lessee, the acquirer shall adjust the measurement of the acquired right-of-use asset for any favorable or unfavorable terms in accordance with paragraph 805-20-30-24.

One or more of an acquiree's leases may be favorable or unfavorable (i.e., off-market) as of the acquisition date compared with the market terms of leases of the same or similar items. From the perspective of the acquirer, a favorable lease represents an asset, while an unfavorable lease represents a liability (balance sheet credit). The acquirer accounts for each favorable or unfavorable lease as of the acquisition date as follows:

<table>
<thead>
<tr>
<th>Lease Type</th>
<th>Asset or Liability That May Be Recognized</th>
</tr>
</thead>
<tbody>
<tr>
<td>Acquiree is the lessee in an operating or finance lease</td>
<td>The acquirer adjusts the measurement of the ROU asset for any off-market terms (see Section 4.3.11.1.3).</td>
</tr>
<tr>
<td>Acquiree is the lessee and the remaining lease term is 12 months or less</td>
<td>The acquirer may make an accounting policy election not to recognize assets or liabilities for short-term leases, including intangible assets or liabilities for off-market terms or in-place leases (see Section 4.3.11.1.4).</td>
</tr>
<tr>
<td>Acquiree is the lessor in an operating lease</td>
<td>The acquirer recognizes a separate intangible asset or liability for off-market terms (see Section 4.3.11.1.5). Assets and liabilities should be recognized separately and not offset.</td>
</tr>
<tr>
<td>Acquiree is the lessor in a sales-type or direct financing lease</td>
<td>The acquirer adjusts the measurement of the underlying asset for any off-market terms (see Section 4.3.11.1.6), which affects the measurement of the unguaranteed residual asset (in accordance with ASC 805-20-30-25) and thus the measurement of the net investment in the lease.</td>
</tr>
</tbody>
</table>

Connecting the Dots

The above guidance on the recognition of favorable or unfavorable terms in a lease arrangement also applies to sublease transaction scenarios in which the lessee (i.e., intermediate lessor) is not relieved of its primary obligation under the head lease arrangement. For example, if the acquiree is the lessee in a sublease transaction, it would adjust the measurement of its ROU asset for any off-market terms as if it were the lessee in a normal lease arrangement. Likewise, if the acquiree is the intermediate lessor in a sublease transaction, it would account for the off-market terms as if it were the lessor in a normal lease arrangement. Thus, it would either recognize a separate intangible asset or liability or recognize an adjustment to the measurement of the underlying asset, depending on the classification of the sublease as either an operating lease or a sales-type or direct financing lease. See Deloitte's *A Roadmap to Applying the New Leasing Standard* for more information about sublease arrangements.
4.3.11.1.8 Renewal or Termination Options in a Lease

An acquired lease may include a renewal or termination option that the acquirer may factor into the lease term and include in the measurement and recognition of the lease. The ASC master glossary defines lease term as follows:

The noncancellable period for which a lessee has the right to use an underlying asset, together with all of the following:

a. Periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option
b. Periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option
c. Periods covered by an option to extend (or not to terminate) the lease in which exercise of the option is controlled by the lessor.

Accordingly, whether a renewal period is factored into a lease term depends on whether it is reasonably certain that the renewal option will be exercised. Similarly, whether the period after a termination option is factored into the lease term depends on whether it is reasonably certain that the termination option will not be exercised. As discussed in Section 4.3.11.2, if the acquiree (at lease commencement) and the acquirer (on the acquisition date) reach different conclusions about the likelihood of exercising an option to extend or terminate a lease, the classification of the acquired lease does not change unless the lease is modified and the modification is not accounted for as a separate contract. The following table summarizes the acquirer’s accounting for renewal or termination options:

| Acquiree is the lessee in an operating or financing lease | If the lease term includes a period covered by a renewal option (or an option not to terminate), the favorability or unfavorability of the option is considered in the measurement of the ROU asset. |
| Acquiree is the lessor in an operating lease | If the lease term includes a period covered by a renewal option (or an option not to terminate), the acquirer separately recognizes (1) an intangible asset if the terms of an operating lease are favorable relative to market terms or (2) a liability if the terms are unfavorable relative to market terms. That is, the measurement of any favorable lease asset or unfavorable lease liability includes any favorable or unfavorable renewal or termination options. |
| Acquiree is the lessor in a sales-type or direct financing lease | If the lease term includes a period covered by a renewal option (or an option not to terminate), the acquirer does not separately recognize (1) an intangible asset if the terms of the lease are favorable relative to market terms or (2) a liability if the terms are unfavorable relative to market terms. Rather, the favorable or unfavorable terms of the renewal option are considered in the measurement of the lease receivable and unguaranteed residual asset (i.e., the net investment in the lease). |

4.3.11.1.9 Leasehold Improvements

**ASC 805-20**

**Pending Content (Transition Guidance: ASC 842-10-65-1)**

35-6 Leasehold improvements acquired in a business combination shall be amortized over the shorter of the useful life of the assets and the remaining lease term at the date of acquisition. However, if the lease transfers ownership of the underlying asset to the lessee, or the lessee is reasonably certain to exercise an option to purchase the underlying asset, the lessee shall amortize the leasehold improvements to the end of their useful life.
Chapter 4 — Recognizing and Measuring the Identifiable Assets Acquired and Liabilities Assumed

### ASC 842-20

#### Pending Content (Transition Guidance: ASC 842-10-65-1)

**35-13** Leasehold improvements acquired in a business combination or an acquisition by a not-for-profit entity shall be amortized over the shorter of the useful life of the assets and the remaining lease term at the date of acquisition.

Acquired leasehold improvements that are owned by the acquiree are measured at their acquisition-date fair values. ASC 805-20-35-6 requires such improvements, once recognized, to be amortized over the shorter of the remaining lease term or the useful life of those assets, as determined by the acquirer, unless (1) “the lease transfers ownership of the underlying asset to the lessee” or (2) “the lessee is reasonably certain to exercise an option to purchase the underlying asset,” in which case the acquirer is required to amortize the leasehold improvements to the end of their useful life.

The existence of leasehold improvements owned by the acquiree can affect the acquirer’s determination of the lease term (and thus of the acquirer’s measurement of lease assets and lease liabilities). As discussed in Sections 4.3.11.1.3 and 4.3.11.1.6, the acquirer measures the acquired lease as if it were a new lease on the acquisition date, which includes undertaking a reassessment of the lease term (and other inputs). For example, if, as of the acquisition date, the acquiree/lessee has significant leasehold improvements, the acquirer may be likely to exercise a renewal option if failing to do so would result in the loss of those improvements with a remaining useful life.

For additional information about the accounting for leasehold improvements (including about the importance of determining which party owns the improvements), see Deloitte’s *A Roadmap to Applying the New Leasing Standard*.

### 4.3.11.1.10 Intangible Assets for In-Place Lease Value

#### ASC 805-20

#### Pending Content (Transition Guidance: ASC 842-10-65-1)

**25-10A** An identifiable intangible asset may be associated with a lease, which may be evidenced by market participants’ willingness to pay a price for the lease even if it is at market terms. For example, a lease of gates at an airport or of retail space in a prime shopping area might provide entry into a market or other future economic benefits that qualify as identifiable intangible assets, such as a customer relationship. In that situation, the acquirer shall recognize the associated identifiable intangible asset(s) in accordance with paragraph 805-20-25-10.

An in-place lease intangible asset represents the price that a market participant would be willing to pay for an at-market lease. The value associated with an in-place lease reflects, for example, the value associated with avoiding (1) the costs of originating an acquired lease (such as the costs to execute the lease, including marketing costs, sales or leasing commissions, and legal and other related costs) and (2) costs that would be incurred if an asset that was intended to be leased was acquired without a lessee.
An intangible asset for an in-place lease should be recognized separately in the financial statements and not combined with other lease-related assets or liabilities (e.g., not combined with lessee ROU assets, lessor net investments in leases, intangible assets for favorable lease terms, or liabilities for unfavorable lease terms).

4.3.11.1.11 Customer-Relationship Intangible Assets — Acquiree Is the Lessor

Regardless of the classification of a lease as operating, sales-type, or direct financing, if the acquiree is the lessor, the lease contract may provide value to the acquirer as a result of the existing relationship between the acquiree and its lessee (i.e., customer). Accordingly, the acquirer in a business combination may recognize a separate intangible asset for that customer relationship if it is identifiable (i.e., arises from contractual rights or is separable). Because, as noted in ASC 805-20-55-24, the assets' useful lives and the pattern in which their economic benefits are consumed may differ, the acquirer may need to recognize separately the assets and liabilities that are related to a single lessee. See Section 4.10.4.2 for more information about customer-related intangible assets.

The interrelationship of various types of intangible assets associated with the same lessee can pose challenges in the recognition and measurement of a customer-related intangible asset. The values assigned to other assets and liabilities — such as lease receivables, off-market contracts, and in-place lease intangible assets — may also affect the valuation of customer-related intangible assets.

4.3.11.1.12 Prepaid or Accrued Rent

Assets or liabilities for prepaid or accrued rent are not recognized under ASC 805 regardless of whether the acquiree is the lessee or the lessor in a lease. Paragraph BC415 of ASU 2016-02 clarifies that:

The acquiree's right-of-use asset should be measured at the amount of the lease liability, adjusted for any off-market terms (that is, favorable or unfavorable terms) present in the lease. Prepaid or accrued rent should not be recognized [in a business combination] because such amounts do not meet the definition of an asset or a liability in Concepts Statement 6 under the acquisition method of Topic 805, Business Combinations. Instead, the remaining lease payments required under the terms of the lease are considered in evaluating whether the terms of the lease are favorable or unfavorable at the acquisition date.

When an entity enters into a lease, the terms of the lease are presumed to be at market even if the arrangement includes up-front or deferred payments (i.e., the total amount of the payments is presumed to reflect the market rate). However, if a lease with prepaid or deferred payments is acquired in a business combination, the remaining lease payments may be more or less than they would be for a new lease of the property with the same remaining term. As a result, the lease may be above or below market as of the acquisition date. See Section 4.3.11.1.7 for the accounting for off-market terms, which depend on whether the acquiree is the lessee or the lessor and the classification of the lease.

4.3.11.1.13 Variable Lease Payments

The terms of a lease are presumed to be at market even if the lease includes variable payments that are based on the use or performance of the underlying asset (i.e., the total amount of the expected payments is presumed to reflect the market rate). If such a lease is acquired in a business combination, the remaining lease payments may be more or less than the lease payments would be for a new lease of the property with the same remaining term. Consequently, an acquirer may determine that an acquired lease with variable payments is above or below market as of the acquisition date. See Section 4.3.11.1.7 for more information on the accounting for leases with off-market terms, which depends on whether the acquiree is the lessee or the lessor and the classification of the lease.
4.3.11.1.14 Leveraged Leases

ASC 842-50

Pending Content (Transition Guidance: ASC 842-10-65-1)

Leveraged Lease Acquired in a Business Combination or an Acquisition by a Not-for-Profit Entity

25-2 In a business combination or an acquisition by a not-for-profit entity, the acquiring entity shall retain the classification of the acquired entity’s investment as a lessor in a leveraged lease at the date of the combination. The net investment of the acquired leveraged lease shall be disaggregated into its component parts, namely net rentals receivable, estimated residual value, and unearned income including discount to adjust other components to present value.

30-2 In a business combination or an acquisition by a not-for-profit entity, the acquiring entity shall assign an amount to the acquired net investment in the leveraged lease in accordance with the general guidance in Topic 805 on business combinations, based on the remaining future cash flows and giving appropriate recognition to the estimated future tax effects of those cash flows.

35-1 In a business combination or an acquisition by a not-for-profit entity, the acquiring entity shall subsequently account for its acquired investment as a lessor in a leveraged lease in accordance with the guidance in this Subtopic as it would for any other leveraged lease.

On the adoption date of ASC 842, leases that were previously classified as leveraged leases under ASC 840 are subject to the guidance in ASC 842-50, which is generally consistent with the accounting requirements for leveraged leases in ASC 840 and effectively carries forward that guidance. However, if a leveraged lease is modified after the entity adopts ASC 842, it is accounted for as a new lease in accordance with ASC 842 (i.e., classification is reassessed and leveraged lease accounting would no longer be available). Entities are not permitted to account for any new lease arrangements as leveraged leases after the adoption of ASC 842.

If a leveraged lease is acquired in a business combination after the adoption of ASC 842, the acquirer does not reassess the lease’s classification (unless it is modified on or after the date of acquisition) and must apply the recognition, measurement, presentation, and disclosure guidance for leveraged leases in ASC 842-50. If the acquired leveraged lease is modified as part of the business combination, it should be reclassified in accordance with the lease classification guidance in ASC 842. As discussed in Section 4.3.11.1.1, a modification is a change in the scope of or consideration for a lease. Changing the parties identified in a lease contract would not change the classification of a leveraged lease because such a change does not alter the scope of or consideration for the lease.

If the acquiree is a lessor in a leveraged lease that is not modified as part of the business combination, the acquirer measures the net investment on the basis of the remaining net future cash flows and gives appropriate recognition to the estimated future tax effects of such cash flows. The net investment is then broken down into its component parts (i.e., net rentals receivable, estimated residual value, and unearned income, including the discount to adjust the other components to present value), which are recognized as of the acquisition date. After the acquisition, the acquirer accounts for the investment in the leveraged lease in accordance with ASC 842-50.

Example 4 in ASC 842-50-55-27 through 55-33 illustrates the accounting for a leveraged lease acquired in a business combination. Also, see Deloitte’s A Roadmap to Applying the New Leasing Standard for more information about the accounting for leveraged leases.
4.3.11.1.15 Sale-and-Leaseback Transactions

A sale-and-leaseback transaction is a common financing method that involves the transfer of an asset from the owner to a buyer and a leaseback of that asset to the seller. The buyer/lessor in a sale-and-leaseback transaction receives a steady return on its investment in the form of annual rental payments and may receive certain tax advantages. Furthermore, the buyer/lessor obtains the benefits of owning the asset, including any future asset appreciation.

If the initial transfer of the asset is determined to be a sale in accordance with ASC 842-40 and ASC 606, the transaction is accounted for as a sale and leaseback under ASC 842-40. The seller/lessee derecognizes the underlying asset, recognizes any gain or loss on the sale, and accounts for the leaseback as it would any other operating lease. The buyer/lessor recognizes the underlying asset and accounts for the lease as it would any other operating or direct financing lease. If the seller/lessee or buyer/lessor in a sale-and-leaseback transaction is subsequently acquired in a business combination, the acquirer should account for the leaseback as described in Sections 4.3.11.1 through 4.3.11.14.

If the initial transfer does not meet the criteria to be a sale in accordance with ASC 842-40 and ASC 606 (i.e., it is a “failed” sale and leaseback), the seller/lessee and the buyer/lessor account for the transaction as a financing transaction. The seller/lessee continues to report the property on its balance sheet as if it were its owner and recognizes a financial liability (i.e., debt). The buyer/lessor does not recognize the property on its balance sheet and instead recognizes a financial asset (i.e., a loan receivable). If the seller/lessee or buyer/lessor in a failed sale-and-leaseback transaction is subsequently acquired in a business combination, the acquirer should not reassess the transaction. For example, the acquirer may continue to use the acquiree’s accounting for the failed sale-and-leaseback transaction until the transaction meets the requirements in ASC 842-40 and ASC 606 for the transfer to be accounted for as a sale. The assets and liabilities related to the arrangement should be measured at their acquisition-date fair values.

In addition, there may be situations in which a third party acquires an asset directly from the acquiree before or concurrently with the business combination and subsequently leases the asset back to the acquirer after the acquisition. In substance, such arrangements may represent sale-and-leaseback transactions if it is determined that the acquirer or future lessee controls the asset before or concurrently with the acquisition. See Chapter 10 of Deloitte’s A Roadmap to Applying the New Leasing Standard for more information.

4.3.11.1.16 Preexisting Leases Between the Acquirer and Acquiree

An acquirer and an acquiree may have a preexisting lease arrangement that was entered into before negotiations for the business combination began. As described in Section 6.2.2, a preexisting relationship between an acquirer and acquiree is considered effectively settled as part of the business combination even if it is not legally cancelled, because it becomes an intercompany relationship upon the acquisition and is eliminated in consolidation in the postcombination financial statements. Thus, the acquirer does not recognize any lease assets or lease liabilities related to the preexisting lease. In accordance with ASC 805-10-55-21(b), it recognizes a gain or loss on the settlement of the lease in an amount equal to the lesser of (1) “the amount by which the [lease] is favorable or unfavorable from the perspective of the acquirer” relative to market terms or (2) “the amount of any stated settlement provisions in the [lease] available to the counterparty to whom the contract is unfavorable.”
In addition, the acquirer should consider whether it has recognized any assets or liabilities related to the lease that should be derecognized as part of the effective settlement of the arrangement. The carrying amounts of the recognized assets or liabilities, if any, would adjust the amount of the gain or loss recognized for the settlement of the preexisting relationship, as illustrated in Example 3 in ASC 805-10-55-33 (reproduced in Section 6.2.2.3).

4.3.11.2 Leases — Before Adoption of ASC 842

Leases (including contracts that contain a lease) acquired in a business combination may result in the recognition of various assets or liabilities, depending on the classification of the lease and whether the acquiree is the lessee or lessor. Sections 4.3.11.2.1 through 4.3.11.2.13 below describe the accounting for leases acquired in a business combination before the adoption of ASC 842.

4.3.11.2.1 Classification

**ASC 805-20**

*Classifying or Designating Identifiable Assets Acquired and Liabilities Assumed in a Business Combination*

25-6 At the acquisition date, the acquirer shall classify or designate the identifiable assets acquired and liabilities assumed as necessary to subsequently apply other GAAP. 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.

25-8 This Section provides the following two exceptions to the principle in paragraph 805-20-25-6:

a. Classification of a lease contract as either an operating lease or a capital lease in accordance with the guidance in paragraph 840-10-25-27 . . . .

**ASC 840-10**

35-5 The classification of a lease in accordance with the criteria in this Subtopic shall not be changed as a result of a business combination or an acquisition by a not-for-profit entity unless the provisions of the lease are modified. At the acquisition date, an acquirer may contemplate renegotiating and modifying leases of the business or nonprofit activity acquired. Modifications made after the acquisition date, including those that were planned at the time of the combination, are postcombination events that shall be accounted for separately by the acquirer in accordance with the provisions of this Topic. If in connection with a business combination or an acquisition by a not-for-profit entity the provisions of a lease are modified in a way that would require the revised agreement to be considered a new agreement under the preceding paragraph, the new lease shall be classified by the combined entity according to the criteria set forth in this Subtopic, based on conditions as of the date of the modification of the lease. After the recording of the amounts called for by Subtopic 805-20, the leases shall be accounted for in accordance with this Subtopic. Subtopic 840-30 explains the application of this paragraph to a leveraged lease by an entity that acquires a lessor. This Subtopic does not address the subsequent accounting for amounts recorded for favorable or unfavorable operating leases.

As indicated in ASC 805-20-25-6, if a lease is modified as part of a business combination, the acquirer reconsidered the acquiree’s classification of the lease. Otherwise, the acquiree’s classification generally carries over to the acquirer. See Section 4.2 for more information.

If the terms of a lease are modified as part of the business combination and the lease qualifies as a new lease in accordance with ASC 840-10-35-4, the acquirer classifies the lease as of the acquisition date on the basis of the modified lease terms.
Alternatively, a lease might be changed as part of a business combination in ways that do not qualify as a lease modification. For example, a lease may be changed to reflect the new owner of the acquiree. Such a change in the name of one of the parties identified in the contract would not qualify as a lease modification without a change in the scope of or consideration for the lease.

4.3.11.2.2 Potential Assets or Liabilities Related to an Acquiree’s Leases

Under ASC 805, most assets acquired and liabilities assumed are measured and recognized at fair value, including lease-related assets and liabilities that are recognized before the adoption of ASC 842. The table below lists the potential assets or liabilities that may be recognized in connection with an acquiree’s leases. Each item is discussed in more detail in the sections noted.

<table>
<thead>
<tr>
<th>Lease Type</th>
<th>Asset or Liability That May Be Recognized</th>
</tr>
</thead>
<tbody>
<tr>
<td>Acquiree is the lessee in an operating lease</td>
<td>• No recognition of lease asset or lease liability (see Section 4.3.11.2.3 below)</td>
</tr>
<tr>
<td></td>
<td>• Leasehold improvements owned by the lessee (see Section 4.3.11.2.7)</td>
</tr>
<tr>
<td></td>
<td>• Intangible asset or liability for favorable or unfavorable terms (see Section 4.3.11.2.8)</td>
</tr>
<tr>
<td></td>
<td>• Intangible asset for an in-place lease (see Section 4.3.11.2.9)</td>
</tr>
<tr>
<td>Acquiree is the lessee in a capital lease</td>
<td>• Property subject to the lease (see Section 4.3.11.2.4)</td>
</tr>
<tr>
<td></td>
<td>• Capital lease obligation (see Section 4.3.11.2.4)</td>
</tr>
<tr>
<td></td>
<td>• Leasehold improvements owned by the lessee (see Section 4.3.11.2.7)</td>
</tr>
<tr>
<td></td>
<td>• Intangible asset for an in-place lease (see Section 4.3.11.2.9)</td>
</tr>
<tr>
<td>Acquiree is the lessee in an operating lease</td>
<td>• Property subject to the lease (see Section 4.3.11.2.5)</td>
</tr>
<tr>
<td></td>
<td>• Leasehold improvements owned by the lessee (see Section 4.3.11.2.7)</td>
</tr>
<tr>
<td></td>
<td>• Intangible asset or liability for favorable or unfavorable terms (see Section 4.3.11.2.8)</td>
</tr>
<tr>
<td></td>
<td>• Intangible asset for an in-place lease (see Section 4.3.11.2.9)</td>
</tr>
<tr>
<td></td>
<td>• Intangible asset for customer relationships (see Section 4.3.11.2.10)</td>
</tr>
<tr>
<td>Acquiree is the lessor in a sales-type or direct</td>
<td>• Net investment in the lease (see Section 4.3.11.2.6)</td>
</tr>
<tr>
<td>financing lease</td>
<td>• Intangible asset for an in-place lease (see Section 4.3.11.2.9)</td>
</tr>
<tr>
<td></td>
<td>• Intangible asset for customer relationships (see Section 4.3.11.2.10)</td>
</tr>
</tbody>
</table>

4.3.11.2.3 Acquiree Is the Lessee in an Operating Lease

ASC 805-20

Operating Leases

25-11 The acquirer shall recognize no assets or liabilities related to an operating lease in which the acquiree is the lessee except as required by paragraphs 805-20-25-12 through 25-13.

For acquired operating leases in which the acquiree is the lessee, ASC 840 and ASC 805 prohibit recognition of a separate asset for the right to use the underlying asset or a separate liability for the remaining minimum lease payments.
However, an acquirer may recognize other assets or liabilities, such as:

- Any leasehold improvements owned by the acquiree (see Section 4.3.11.2.7).
- An intangible asset or a liability if the terms of the lease (including renewal or purchase options) are favorable or unfavorable relative to current market terms for similar leases (see Section 4.3.11.2.8).
- An intangible asset for the value associated with an in-place lease, including a lease at current market terms if market participants would place value on an at-the-money contract (see Section 4.3.11.2.9).

4.3.11.2.4 Acquiree Is the Lessee in a Capital Lease

An entity may acquire a capital lease in which the acquiree is the lessee. Capital lease assets and lease obligations must be separately recognized and measured at fair value as of the acquisition date.

Before measuring a capital lease asset, the acquirer must determine whether it expects to obtain ownership of the leased property at the end of the lease term. It must consider all facts and circumstances, including the terms of the contract, whether it contains a bargain purchase option, and entity-specific factors. If the acquirer expects to obtain ownership of the property subject to the capital lease, it measures the lease asset at the fair value of the underlying property. If the acquirer does not expect to obtain ownership of the property subject to the capital lease, it measures the lease asset at the fair value of the leasehold interest, which is the fair value of the right to use the property until the end of the lease term.

The acquirer also recognizes a liability at fair value for the remaining minimum lease payments. The assumptions used in measuring the liability should be consistent with those used in measuring the asset (e.g., the same lease term should be used in measuring both the asset and the liability).

In addition, when the acquiree is the lessee in a capital lease, the acquirer may recognize other assets or liabilities, such as:

- Any leasehold improvements owned by the acquiree (see Section 4.3.11.2.7).
- An intangible asset for the value associated with an in-place lease, including a lease at current market terms if market participants would place value on an at-the-money contract (see Section 4.3.11.2.9).

4.3.11.2.5 Acquiree Is the Lessor in an Operating Lease

ASC 805-20

Assets Subject to Operating Leases in Which the Acquiree Is the Lessor

30-5 The acquirer shall measure the acquisition-date fair value of an asset, such as a building or a patent or other intangible asset, that is subject to an operating lease in which the acquiree is the lessor separately from the lease contract. In other words, the fair value of the asset shall be the same regardless of whether it is subject to an operating lease. In accordance with paragraph 805-20-25-12, the acquirer separately recognizes an asset or a liability if the terms of the lease are favorable or unfavorable relative to market terms.
The lessor in an operating lease continues to report the assets subject to the lease on its balance sheet. In a business combination in which the acquiree is a lessor, the assets subject to the lease are recognized by the acquirer and measured at their acquisition-date fair values. The fair value measurement of the assets does not take into consideration the terms or conditions of the lease arrangement. That is, ASC 805-20-30-5 clarifies that “the fair value of the asset shall be the same regardless of whether it is subject to an operating lease.”

In addition to the property subject to the lease, an acquirer may recognize the following separately when the acquiree is the lessor in an operating lease:

- Any leasehold improvements owned by the acquiree (see Section 4.3.11.2.7 below).
- An intangible asset or a liability if the terms of the lease (including renewal or purchase options) are favorable or unfavorable relative to current market terms for similar leases (see Section 4.3.11.2.8).
- An intangible asset for the value associated with an in-place lease, including a lease at current market terms if market participants would place value on an at-the-money contract (see Section 4.3.11.2.9).
- An intangible asset for the value of the existing customer relationship between the acquiree and its lessees (see Section 4.3.11.2.10).

4.3.11.2.6 Acquiree Is the Lessor in a Sales-Type or Direct Financing Leases

When the acquiree is a lessor in a sales-type or direct financing lease, the acquirer recognizes and measures at fair value its net investment in the lease. The lessor’s remaining net investment in the lease includes the residual value, if any, of the leased asset and any renewal or purchase options.

In addition to the net investment in the lease, the acquirer may recognize the following separately when the acquiree is the lessor in a sales-type or direct financing lease:

- An intangible asset for the value associated with an in-place lease, including a lease at current market terms if market participants would place value on an at-the-money contract (see Section 4.3.11.2.9).
- An intangible asset for the value of the existing customer relationship between the acquiree and its lessees (see Section 4.3.11.2.10).

4.3.11.2.7 Leasehold Improvements

| ASC 805-20 35-6 | Leasehold improvements acquired in a business combination shall be amortized over the shorter of the useful life of the assets or a term that includes required lease periods and renewals that are deemed to be reasonably assured (as used in the definition of lease term) at the date of acquisition. |

Acquired leasehold improvements that are owned by the acquiree are measured at their acquisition-date fair values. ASC 805-20-35-6 requires that acquirers amortize leasehold improvements “over the shorter of the useful life of the assets or a term that includes required lease periods and renewals that are deemed to be reasonably assured.” Therefore, to determine the amortization period of leasehold improvements acquired in a business combination, acquirers must evaluate as of the acquisition date both the useful life of those improvements and the required lease periods and renewals that are deemed to be reasonably assured.
When determining the required lease periods and renewals that are deemed to be reasonably assured, entities should consider the definition of lease term in the ASC master glossary, which states that the term should include “all periods, if any, for which failure to renew the lease imposes a penalty on the lessee in such amount that a renewal appears, at lease inception, to be reasonably assured.” Acquirers should assess whether the renewal options are bargain renewal options or whether failure to renew would impose a significant penalty, and, on the basis of that assessment, use judgment to determine whether the renewal options are reasonably assured. If, as of the acquisition date, the acquiree has significant leasehold improvements, the acquirer may assume that it is reasonably assured that the acquiree will exercise its renewal options because the loss of the improvements that would result from the failure to renew the lease would impose a significant penalty.

4.3.11.2.8 Intangible Asset or Liability Related to Favorable or Unfavorable Operating Leases

<table>
<thead>
<tr>
<th>ASC 805-20</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>25-12</strong> Regardless of whether the acquiree is the lessee or the lessor, the acquirer shall determine whether the terms of each of an acquiree's operating leases are favorable or unfavorable compared with the market terms of leases of the same or similar items at the acquisition date. The acquirer shall recognize an intangible asset if the terms of an operating lease are favorable relative to market terms and a liability if the terms are unfavorable relative to market terms.</td>
</tr>
</tbody>
</table>

One or more of an acquiree's lease contracts may be favorable or unfavorable (i.e., off-market) as of the acquisition date relative to current market terms. ASC 805-20-25-12 applies to all operating leases regardless of whether the acquiree was the lessee or the lessor.

From the perspective of the acquirer, a favorable lease represents an asset, while an unfavorable lease represents a liability (balance sheet credit). Some lease contracts may result in the recognition of an intangible asset and others may result in the recognition of a liability. Entities should present intangible assets and liabilities separately on the balance sheet.

The acquirer must consider any renewal options or purchase options in the valuation of an intangible asset or liability as follows:

- If the acquiree is the lessee in an operating lease and the exercise of options is within the acquiree/lessee's control:
  - Renewal or purchase options that are favorable to the acquiree/lessee are generally considered in the valuation of the intangible asset or liability.
  - Renewal or purchase options that are unfavorable to the acquiree/lessee are generally not considered in the valuation of the intangible asset or liability since the acquirer would not be expected to exercise an unfavorable option.

- If the acquiree is the lessor in an operating lease and the exercise of options is within the lessee's control:
  - Renewal or purchase options that are unfavorable to the acquiree/lessor are generally not considered in the valuation of the intangible asset or liability since the lessee would not be expected to exercise an unfavorable option.
  - Renewal or purchase options that are favorable to the acquiree/lessor are generally not considered in the valuation of the intangible asset or liability since the lessee would not be expected to exercise an unfavorable option.
4.3.11.2.9 Intangible Assets for In-Place Lease Value

**ASC 805-20**

| 25-13 | An identifiable intangible asset may be associated with an operating lease, which may be evidenced by market participants’ willingness to pay a price for the lease even if it is at market terms. For example, a lease of gates at an airport or of retail space in a prime shopping area might provide entry into a market or other future economic benefits that qualify as identifiable intangible assets, such as a customer relationship. In that situation, the acquirer shall recognize the associated identifiable intangible asset(s) in accordance with paragraph 805-20-25-10. |

The value of an in-place lease represents the price that a market participant would be willing to pay for an at-market lease. An intangible asset for the value associated with an in-place lease may exist regardless of (1) the lease classification and (2) whether the acquiree is the lessor or the lessee.

A lease that is in place on the acquisition date may provide value to the lessee because it gives the lessee access to property that is unique or scarce and may permit future contract renewals or extensions.

An in-place lease may also provide value to the lessor by allowing it to avoid certain cash outflows to originate the lease (such as marketing, sales commissions, legal costs, and lease incentives) and lost cash flows during an otherwise required lease-up period. Accordingly, measurement of in-place lease intangible assets should reflect both of these benefits to the acquirer (net of service costs to tenants, such as security and maintenance).

4.3.11.2.10 Customer-Related Intangible Assets — Acquiree Is the Lessor

Regardless of the classification of a lease as operating, sales-type, or direct financing, if the acquiree is the lessor, a lease contract may provide value to the acquirer as a result of the existing relationship between the acquiree and its lessee (i.e., customer). Accordingly, the acquirer in a business combination recognizes a separate intangible asset for that customer relationship if it is identifiable (i.e., arises from contractual rights or is separable). Because, as noted in ASC 805-20-55-24, the assets’ useful lives and the pattern in which their economic benefits are consumed may differ, the acquirer may need to recognize separately the assets and liabilities that are related to a single lessee. See Section 4.10.4.2 for more information about customer-related intangible assets.

The interrelationship of various types of intangible assets associated with the same lessee can pose challenges in the recognition and measurement of a customer-related intangible asset. The values assigned to other assets and liabilities — such as lease receivables, off-market contracts, and in-place lease intangible assets — may also affect the valuation of customer-related intangible assets.

4.3.11.2.11 Deferred Rent

Before the acquisition date, an acquiree may have recognized an asset or a liability for deferred rent related to an operating lease. The recognition of deferred rent results from the guidance in ASC 840-20-25-2 that generally requires lessees and lessors to recognize scheduled rent increases on a straight-line basis over the lease term.

In a business combination, the acquirer does not recognize the acquiree’s deferred rent balance because it does not meet the definition of an asset or liability. The impact of any previously recognized asset or liability of the acquiree for deferred rent would be captured in the fair value measurement of an intangible asset or liability for favorable or unfavorable terms (see Section 4.3.11.2.8). After a business combination, the acquirer accounts for any acquired leases in accordance with ASC 840. Accordingly, the
The acquirer recognizes any deferred rent starting from the acquisition date in the postcombination period on the basis of the terms of the assumed lease.

### Example 4-6

**Accounting for Deferred Rent in a Business Combination**

On January 1, 20X6, Company B enters into a four-year operating lease. The payments required under the lease escalate each year. The following table illustrates the calculation of the deferred rent (1) liability, if B is the lessee, or (2) asset, if B is the lessor, at the end of each of years 1 through 4:

<table>
<thead>
<tr>
<th>Rent Payments</th>
<th>Annual Rent Payment</th>
<th>Cumulative Rent Payments</th>
<th>Annual Expense</th>
<th>Cumulative Expense</th>
<th>Liability</th>
<th>Annual Income</th>
<th>Cumulative Income</th>
<th>Asset</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/31/20X6</td>
<td>$200</td>
<td>$200</td>
<td>$350</td>
<td>$350</td>
<td>$(150)</td>
<td>$350</td>
<td>$350</td>
<td>$150</td>
</tr>
<tr>
<td>12/31/20X7</td>
<td>300</td>
<td>500</td>
<td>350</td>
<td>700</td>
<td>(200)</td>
<td>350</td>
<td>700</td>
<td>200</td>
</tr>
<tr>
<td>12/31/20X8</td>
<td>400</td>
<td>900</td>
<td>350</td>
<td>1,050</td>
<td>(150)</td>
<td>350</td>
<td>1,050</td>
<td>150</td>
</tr>
<tr>
<td>12/31/20X9</td>
<td>500</td>
<td>1,400</td>
<td>350</td>
<td>1,400</td>
<td>—</td>
<td>350</td>
<td>1,400</td>
<td>—</td>
</tr>
<tr>
<td>Total rent payments</td>
<td>$1,400</td>
<td>$1,400</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Straight-line rent expense/income: $350 ($1,400/4)

On January 1, 20X8 (i.e., the end of year 2), Company A acquires B and accounts for the acquisition as a business combination. As of the acquisition date, A does not record an asset or a liability for B’s deferred rent, regardless of whether B is the lessee or the lessor. However, starting on the acquisition date, A will account for the acquired lease in accordance with ASC 840 and will begin recognizing deferred rent in the postcombination period. The following table illustrates the calculation of the deferred rent (1) liability, if B is the lessee, or (2) asset, if B is the lessor at the end of years 3 and 4:

<table>
<thead>
<tr>
<th>Rent Payments</th>
<th>Annual Rent Payment</th>
<th>Cumulative Rent Payments</th>
<th>Annual Expense</th>
<th>Cumulative Expense</th>
<th>Liability</th>
<th>Annual Income</th>
<th>Cumulative Income</th>
<th>Asset</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/31/20X6</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>12/31/20X7</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>12/31/20X8</td>
<td>$400</td>
<td>$400</td>
<td>$450*</td>
<td>$450</td>
<td>$(50)</td>
<td>$450*</td>
<td>$450</td>
<td>$50</td>
</tr>
<tr>
<td>12/31/20X9</td>
<td>500</td>
<td>900</td>
<td>450*</td>
<td>900</td>
<td>—</td>
<td>450*</td>
<td>900</td>
<td>—</td>
</tr>
<tr>
<td>Total rent payments</td>
<td>$900</td>
<td>$900</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Straight-line rent expense/income: $450 ($900/2)

* Before the effect of the amortization of any favorable or unfavorable intangible assets related to the lease.
4.3.11.2.12 Sale-Leaseback Transactions

A sale-leaseback transaction is a common financing method that involves the transfer of an asset from the owner to a buyer and a leaseback of that asset to the seller. The buyer/lessor in a sale-leaseback transaction receives a steady return on its investment in the form of annual rental payments and may receive certain tax advantages. Furthermore, the buyer/lessor obtains the benefits of owning the asset, including any future asset appreciation.

If the initial transfer of the asset is determined to be a sale, the transaction is accounted for as a sale-leaseback under ASC 840-40. If the sale-leaseback does not meet the criteria for a sale (i.e., it is a “failed” sale-leaseback), the seller's/lessee's accounting for the transaction depends on the type of underlying asset. If the underlying asset is equipment, the seller/lessee accounts for the transaction as a financing transaction — that is, it continues to recognize the asset on its balance sheet as if it were its owner and recognizes a liability. If the underlying asset is real estate, the seller/lessee accounts for the transaction either as a financing transaction or by using the deposit method, depending on the facts and circumstances.

If the seller/lessee is subsequently acquired in a business combination, the acquirer should not reassess the transaction. For example, the acquirer should continue with the acquiree's accounting for a failed sale-leaseback transaction until the transaction meets the requirements in ASC 840-40 to be accounted for as a sale. The assets and liabilities related to the arrangement should be measured at their acquisition-date fair values.

4.3.11.2.13 Preexisting Leases Between the Acquirer and Acquiree

An acquirer and acquiree may have a preexisting lease arrangement that was entered into before negotiations for the business combination began. As described in Section 6.2.2, a preexisting relationship between an acquirer and acquiree is considered effectively settled as part of the business combination even if it is not legally cancelled because it becomes an intercompany relationship upon the acquisition and is eliminated in consolidation in the postcombination financial statements. Thus, the acquirer does not recognize any lease assets or lease liabilities related to the preexisting lease. In accordance with ASC 805-10-55-21(b), it recognizes a gain or loss on the settlement of the lease in an amount equal to the lesser of (1) “the amount by which the [lease] is favorable or unfavorable from the perspective of the acquiree” relative to market terms or (2) “the amount of any stated settlement provisions in the [lease] available to the counterparty to whom the contract is unfavorable.”

In addition, the acquirer should consider whether it has recognized any assets or liabilities related to the lease that should be derecognized as part of the effective settlement of the arrangement. The carrying amounts of the recognized assets or liabilities, if any, would adjust the amount of the gain or loss recognized for the settlement of the preexisting relationship, as illustrated in Example 3 in ASC 805-10-55-33 (reproduced in Section 6.2.2.3).

4.3.12 Insurance or Reinsurance Contracts

As part of deliberating Statement 141(R) (codified in ASC 805), the FASB established specific guidance on accounting for insurance and reinsurance contracts acquired in a business combination.
4.3.12.1 Classification of Contracts

In a manner consistent with the concept that a business combination results in the initial recognition of an acquiree’s assets and liabilities in the acquirer’s financial statements, most contracts, assets, and liabilities are classified or designated as of the acquisition date as if they were entered into or acquired on that date. ASC 805 provides for two exceptions to that concept, one of which is the classification of contracts as insurance or reinsurance contracts.

ASC 805-20-25-8(b) requires an acquirer to carry forward the classification of an acquired contract as an insurance or a reinsurance contract (rather than a deposit) that the acquiree made at the inception of the contract on the basis of its terms and any related contracts or agreements. If the terms of those contracts or agreements were modified in a way that would change their classification, the acquirer determines the classification of the contract on the basis of its terms and other pertinent factors on the modification date, which may be the acquisition date. When assessing whether a contract qualifies as insurance or reinsurance, an entity must consider related contracts and arrangements because they can significantly affect the amount of risk transferred.

4.3.12.2 Recognition and Measurement of Insurance Contracts

ASC 944-805

30-1 The acquirer shall measure at fair value the assets and liabilities recognized under paragraph 944-805-25-3. However, the acquirer shall recognize that fair value in components as follows:

a. Assets and liabilities measured in accordance with the acquirer’s accounting policies for insurance and reinsurance contracts that it issues or holds. For example, the contractual assets acquired could include a reinsurance recoverable and the liabilities assumed could include a liability to pay future contract claims and claims expenses on the unexpired portion of the acquired contracts and a liability to pay incurred contract claims and claims expenses. However, those assets acquired and liabilities assumed would not include the acquiree’s deferred acquisition costs and unearned premiums that do not represent future cash flows.

b. An intangible asset (or occasionally another liability), representing the difference between the following:
   1. The fair value of the contractual insurance and reinsurance assets acquired and liabilities assumed
   2. The amount described in (a).

30-2 Other related contracts that are not insurance or reinsurance contracts shall be measured at the date of acquisition in accordance with Topic 805.

The assets and liabilities arising from the rights and obligations of insurance and reinsurance contracts acquired in a business combination are recognized on the acquisition date and measured at their acquisition-date fair values. That recognition and measurement might include a reinsurance recoverable, a liability to pay future contractual claims and claim expenses on the unexpired portions of the acquired contracts, and a liability to pay incurred contractual claims and claim expenses. However, those assets acquired and liabilities assumed would not include the acquiree’s insurance and reinsurance contract accounts, such as deferred acquisition costs and unearned premiums that do not represent future cash flows.
Although insurance and reinsurance contracts are measured at fair value, the FASB noted in paragraph B192 of Statement 141(R) that an acquirer should be able to subsequently report the acquired business on the same basis as its written business. However, rights and obligations related to insurance and reinsurance contracts are not measured at fair value under existing GAAP. Thus, in ASC 944-805, the Board provided specific measurement and recognition guidance that requires an acquirer to separate the fair value of the insurance and reinsurance contracts it acquires into (1) insurance and reinsurance GAAP accounting balances, in keeping with the acquirer's accounting policies, and (2) an intangible asset (or, infrequently, another liability) for the difference between the fair value of the insurance and reinsurance contracts and the amount recognized in accordance with the acquirer's existing accounting policies. As a result, the acquirer is permitted to subsequently report the acquired business on the same basis as its written business since the intangible asset is amortized separately. However, while the total value of an insurance contract represents its fair value, the elements of a contract do not (i.e., the rights and obligations related to insurance and reinsurance contracts are measured under existing GAAP, and the intangible asset (or liability) is calculated as a residual).

Other contracts that provide third-party contingent commissions are accounted for in the same manner as other contingencies, and contracts that provide guarantees of the adequacy of claims liabilities are accounted for as indemnifications.

4.3.12.3 Deferred Acquisition Costs and Unearned Premiums

An acquiree’s capitalized deferred acquisition costs and unearned premiums do not meet the definition of assets in FASB Concepts Statement 5 and are not carried forward or recognized by the acquirer in a business combination.

4.3.12.4 Subsequent Accounting for Insurance or Reinsurance Contracts

ASC 805 refers to the subsequent measurement guidance for insurance contracts in ASC 944. Under that guidance, the insurance contract intangible asset (or liability) is measured on a basis consistent with the related insurance or reinsurance liability. Specifically, ASC 944-805-35-1 through 35-3 provide the following guidance:

ASC 944-805

35-1 After the business combination, the acquirer shall measure the intangible asset (or other liability) on a basis consistent with the related insurance or reinsurance liability.

35-2 For example, for most short-duration contracts such as many property and liability insurance contracts, claim liabilities are not discounted under generally accepted accounting principles (GAAP), so amortizing the intangible asset like a discount using an interest method could be an appropriate method.
ASC 944-805 (continued)

35-3 For certain long-duration contracts such as most traditional life insurance contracts, using a basis consistent with the measurement of the liability would be similar to the guidance provided in paragraph 944-30-35-3, which requires that deferred acquisition costs be amortized using methods that include the same assumptions used in estimating the liability for future policy benefits.

Pending Content (Transition Guidance: ASC 944-40-65-2)

35-3 For certain long-duration contracts such as traditional life insurance contracts, using a basis consistent with the measurement of the liability would be similar to the guidance provided in paragraph 944-30-35-3, which requires that deferred acquisition costs be amortized using methods that include assumptions consistent with those used in estimating the liability for future policy benefits including subsequent revisions to those assumptions. Also, paragraph 944-30-35-63 specifies that the present value of future profits is subject to premium deficiency testing in accordance with the provisions of Subtopic 944-60.

4.4 Working Capital

ASC 805 requires the components of working capital (e.g., accounts receivable, accounts payable, and accrued liabilities) to be recorded at their acquisition-date fair values. An acquirer cannot recognize a separate valuation allowance as of the acquisition date for assets initially recognized at fair value (see Section 4.5). Before the FASB incorporated this guidance into ASC 805, an entity generally recorded working capital as the present value of amounts to be received or paid, determined at current interest rates. Because of the short duration in expected cash flows, acquired working capital was often recorded at the acquiree’s carrying value as of the acquisition date.

According to the FASB’s Valuation Resource Group (VRG),¹ because ASC 805 requires working capital items to be measured at fair value, simply carrying over the amounts recorded in the acquiree’s precombination financial statements may not be appropriate. In addition, VRG members have indicated that they do not believe that the exit price notion requires entities to value receivables at the amount they would receive if they sold the receivables to a market participant who engaged in the business of acquiring receivables. The VRG has indicated that the in-exchange price would generally not be the highest and best use of the accounts receivable.

¹ The FASB established the VRG to provide the FASB staff with information on implementation issues about fair value measurements used for financial statement reporting and the alternative viewpoints associated with those implementation issues. The VRG’s conclusions are not authoritative.
4.5 Assets With Uncertain Cash Flows (Valuation Allowances)

**ASC 805-20**

**Assets With Uncertain Cash Flows (Valuation Allowances)**

30-4 The acquirer shall not recognize a separate valuation allowance as of the acquisition date for assets acquired in a business combination that are measured at their acquisition-date fair values because the effects of uncertainty about future cash flows are included in the fair value measure. For example, because this Subtopic requires the acquirer to measure acquired receivables, including loans, at their acquisition-date fair values, the acquirer does not recognize a separate valuation allowance for the contractual cash flows that are deemed to be uncollectible at that date.

**Pending Content (Transition Guidance: ASC 326-10-65-1)**

30-4 The acquirer shall not recognize a separate valuation allowance as of the acquisition date for assets acquired in a business combination that are measured at their acquisition-date fair values because the effects of uncertainty about future cash flows are included in the fair value measure, unless the assets acquired are financial assets for which the acquirer shall refer to the guidance in paragraphs 805-20-30-4A through 30-4B.

Entities do not recognize separate valuation allowances as of the acquisition date for assets that are initially recognized at fair value; uncertainty about collectibility and future cash flows is incorporated into the fair value measurement. For example, no separate valuation allowance is recognized as of the acquisition date for acquired loans and receivables measured at fair value. To comply with disclosure or regulatory requirements, entities may need to track their estimates of uncollectible acquired receivables and loans separately from preexisting receivables and loans. Valuation allowances are permitted for assets not measured at fair value, such as deferred tax assets.

**Changing Lanes**

In June 2016, the FASB issued ASU 2016-13, which, in addition to providing a model for measuring credit losses on financial instruments, also amends ASC 805 to provide guidance on accounting for purchased financial assets with credit deterioration in a business combination. See Section 4.3.10 for more information.

4.6 Financial Instruments

4.6.1 Acquiree’s Equity Investments

An acquiree’s equity investments are measured and recognized at fair value on the acquisition date in accordance with ASC 820. If the equity securities do not have a readily determinable fair value (i.e., are not exchange traded), an acquirer must use other valuation techniques to measure the fair value as of the acquisition date. According to ASC 805-20-25-6, an acquirer must classify the assets acquired and liabilities assumed in a business combination 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” (see Section 4.2). ASC 805 does not provide an exception for financial instruments within the scope of ASC 815 (see Section 4.6.2).

An acquiree may have an investment in an entity that it accounted for by using the equity method of accounting before the business combination. If the investment continues to qualify as an equity method investment after the acquisition, it is recognized at its fair value as if it were newly acquired on the acquisition date. Fair value is measured in accordance with the guidance in ASC 820. The underlying basis differences are also remeasured as of the acquisition date.
4.6.2 Derivatives

An acquiree will often have outstanding financial instruments that meet the definition of a derivative or are designated in a hedging relationship under ASC 815. The acquirer should reevaluate these instruments as of the acquisition date to determine their designation. ASC 805-20-25-7 states that an acquirer should consider the “[d]esignation of a derivative instrument as a hedging instrument” and assess “whether an embedded derivative should be separated from the host contract” in accordance with ASC 815 on the basis of “pertinent conditions as they exist at the acquisition date.” This could include redesignating preexisting hedging relationships and reevaluating certain contracts of the acquiree.

4.7 Inventory

Inventory acquired in a business combination must be measured at its acquisition-date fair value — that is, the price at which market participants would be willing to sell or buy the inventory. Neither ASC 805 nor ASC 820 provides detailed guidance on measuring the fair value of inventory, but carryover of the book basis of the acquiree’s inventories is not permitted. Because there are many acceptable methods for accounting for inventory, an acquirer and acquiree often have different policies for doing so. The method used to account for inventory (e.g., FIFO, LIFO, or average cost) does not affect its fair value measurement. See Section 4.16 for more information about conforming accounting policies.

The objective of measuring the fair value of inventory is to determine the value created by the acquiree before the acquisition date. Conceptually, the acquiree incurs each expense with the expectation of earning a profit. Therefore, the fair value of inventory consists of the raw materials and the direct and indirect expenses that were required to bring the inventory to its current state of completion, plus a reasonable profit margin. Finished goods inventories and work-in-process inventories are usually valued by using a top-down approach, whereas raw materials are generally valued by using a bottom-up approach. The fair value of inventory should be the same regardless of which approach is used.

4.7.1 Finished Goods

The fair value of finished goods inventory is often measured by using a top-down approach, which starts with a market participant’s estimated selling price, adjusted for both (1) the costs of the selling effort and (2) an approximately normal profit for the selling effort. The acquirer’s results of operations after the business combination should reflect the costs and profits of the selling effort after the acquisition.

Because neither ASC 805 nor ASC 820 provides detailed guidance on measuring the fair value of inventory, stakeholders have questioned whether an acquirer is permitted to recognize any profit on finished goods inventory acquired in a business combination under ASC 820’s exit price notion and highest-and-best-use concept. When asked to discuss the issue, the FASB’s VRG indicated that the fair value of inventory is probably close to its net realizable value, which allows an acquirer to realize a profit on the selling effort. The VRG noted that this view is supported by ASC 820-10-55-21(f), which provides the following guidance on valuing 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 (that is, 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.
The costs of the selling effort must be incremental and directly related to the inventory and must be based on assumptions that other market participants would make. Direct costs are those that would not have been incurred if the finished goods inventory had not been produced — for example, transportation, packaging, and direct marketing costs, as well as sales commissions based on the sale of the inventory. The costs of the selling effort should not include indirect and general expenses not attributable to the production of the inventory.

An approximately normal profit for the selling effort should be based on the assumptions of a market participant. The acquirer should not receive credit for any portion of the selling effort completed by the acquiree before the acquisition; that effort should be part of the fair value of the acquired inventory.

### 4.7.2 Work in Process

An acquirer generally measures the fair value of acquired work-in-process inventory similarly to the way it measures the fair value of finished goods inventory, except that the measure also includes estimates for completing the production process. To determine the fair value of work in process, an entity generally uses a market participant’s estimated selling price for the finished product, adjusted for (1) the costs of both the selling effort and the effort to complete the manufacturing process and (2) an approximately normal profit for both the selling and manufacturing efforts.

An approximately normal profit for the work-in-process inventory will be greater than the profit for the acquired finished goods inventory since the profit will include the portion related to the manufacturing effort to complete the product.

The costs to complete the manufacturing process should include all inventoriable costs. ASC 330-10-30-2 through 30-8 provide general guidance on determining which costs should and should not be included in inventory.

### 4.7.3 Raw Materials

Raw materials must be measured at fair value as of the acquisition date from the perspective of a market participant; an acquiree’s cost cannot be presumed to be an item’s fair value. Entities typically apply a bottom-up approach, which uses a market method for valuation if observable market prices are available or a cost approach if they are not. The fair value of raw materials inventory will often be similar to its replacement cost. In accordance with ASC 820-10-35-5, it is assumed in the measurement of a raw material’s fair value that the transaction to sell the raw material occurs in the principal market or, in the absence of a principal market, the most advantageous market.

### 4.7.4 Supply Inventory

Supplies used in the manufacturing process are measured at fair value as of the acquisition date, in a similar manner to raw materials inventory.

### 4.7.5 LIFO Inventories

Inventory should be measured at fair value as of the acquisition date. Neither the acquirer’s future method of accounting nor the acquiree’s past method is relevant in the fair value determination. An acquirer is not permitted to carry over the book basis of the acquiree’s inventories, including inventories that will be carried under the LIFO method of accounting even if the acquirer is able to carry over the acquiree’s prior LIFO basis for income tax purposes.
SAB Topic 5.L (SAB 58) states that registrants should refer to the AICPA Issues Paper *Identification and Discussion of Certain Financial Accounting and Reporting Issues Concerning LIFO Inventories* for guidance on determining what constitutes acceptable LIFO accounting practices. The Issues Paper states that if acquired inventory is treated as a separate business unit or a new LIFO pool, the acquired inventory should be considered the LIFO base inventory. If, however, the acquired inventory is combined into an existing pool, it should be considered part of the current year's purchases. Paragraph 2-15 of the Issues Paper notes that the order of acquisition approach (first purchase price) to pricing current purchases is the most compatible with the LIFO objective; however, any of the three approaches noted in paragraph 2-10 may be used: “(a) the order of acquisition price (first purchase price), (b) the most recent acquisition price (latest purchase price), [or] (c) the average purchase price.”

### 4.8 Property, Plant, and Equipment

PP&E that is acquired in a business combination and classified as held and used by the acquirer should be measured at fair value. The acquiree’s accumulated depreciation is not carried over into the acquirer’s financial statements; rather, the acquirer’s financial statements should reflect only the accumulated depreciation since the acquisition date.

**Connecting the Dots**

If PP&E is acquired in a business combination and the acquirer intends to sell it shortly after the acquisition, the PPE may qualify for held-for-sale classification as of the acquisition date. Such PP&E is measured at fair value less costs to sell in accordance with ASC 360 and is therefore an exception to ASC 805’s measurement principle. PP&E that the acquirer intends to abandon, however, must be recognized and measured at fair value by using market participant assumptions. See Section 4.3.5 for more information about classifying assets as held for sale as of the acquisition date and Section 4.9 for information about assets that the acquirer intends to use in a manner other than their highest and best use.

#### 4.8.1 PP&E Subject to Asset Retirement Obligations

ASC 410-20 provides guidance on accounting for AROs and, as indicated in ASC 410-20-15-2(a), its scope includes “[l]egal obligations associated with the retirement of a tangible long-lived asset that result from the acquisition, construction, or development and (or) the normal operation of a long-lived asset, including any legal obligations that require disposal of a replaced part that is a component of a tangible long-lived asset.” For a long-lived asset acquired and a related ARO assumed in a business combination, an entity should measure and record both of the following:

- The ARO on the basis of the fair value of the liability by using the credit-adjusted risk-free rate as of the acquisition date.
- The associated long-lived asset at fair value without considering any future cash outflows associated with the asset retirement activities and without making an adjustment to add the amount of the ARO.

While quoted market prices, if available, provide the most reliable and best evidence of an ARO’s fair value, often they do not exist and fair value is determined by using an income approach. ASC 410-20-30-1 states, in part, that “[a]n expected present value technique will usually be the only appropriate technique with which to estimate the fair value of a liability for an asset retirement obligation.”
In a manner consistent with the above framework, if an income approach is used to measure the fair value of the PP&E to which the ARO is related, the cash outflows associated with the obligation may not be incorporated into the measure. However, if the measure does incorporate such cash outflows, the fair value of the ARO should be added back to the value of the PP&E to remove that effect from the measurement of the PP&E. Either approach should result in a consistent PP&E measure exclusive of any future cash outflows associated with the asset retirement activities.

Further, if a quoted market price is used to obtain the fair value of the PP&E to which the ARO is related, and the market price incorporates costs that will be incurred to retire the asset, an entity should add back the fair value of the ARO to appropriately measure the fair value of the asset.

Example 4-7

Initial Recognition of an ARO in a Business Combination

Company A acquires Company B in a transaction accounted for as a business combination. Company B is a utility, and A determines that an ARO related to the facility exists and estimates its fair value to be $25 million. Company A estimates the fair value of the facility to be $100 million (by using either (1) an income approach that includes the expected cash outflows for the ARO in the cash flow model or (2) an approach based on a quoted market price that incorporates the ARO into the measure of fair value). Thus, the value of the facility would be $25 million higher if the costs associated with the ARO were ignored.

Company A should recognize an asset of $125 million for the facility and a liability of $25 million for the ARO.

After the acquisition date, the ARO should be subsequently measured in accordance with ASC 410-20-35.

4.8.2 Mineral Rights and Mining Assets

The ASC master glossary defines mineral rights as “[t]he legal right to explore, extract, and retain at least a portion of the benefits from mineral deposits.” While some mineral rights may have characteristics of both tangible and intangible assets, ASC 805-20-55-37 states that “mineral rights are tangible assets.”

Mining assets include mineral rights. ASC 805 requires entities to recognize mining assets at fair value as of the acquisition date. Entities should use the guidance in ASC 930-805-30-1 and 30-2 when measuring the fair value of mining assets. The guidance states that in estimating the fair value of mining assets, an acquirer should take into account both of the following:

- The “value beyond proven and probable reserves” (VBPP) “to the extent that a market participant would include [VBPP] in determining the fair value of the asset.”
- The “effects of anticipated fluctuations in the future market price of minerals . . . in a manner that is consistent with the expectations of marketplace participants.”

Estimates of anticipated fluctuations in market prices should be based on all available information, including current prices, historical averages, and forward pricing curves.
4.9 Assets That the Acquirer Does Not Intend to Use, or Intends to Use in a Manner Other Than Their Highest and Best Use

ASC 805-20

Assets That the Acquirer Intends Not to Use or to Use in a Way Other Than Their Highest and Best Use

30-6 To protect its competitive position, or for other reasons, the acquirer may intend not to use an acquired nonfinancial asset actively, or it may not intend to use the asset according to its highest and best use. For example, that might be the case for an acquired research and development intangible asset that the acquirer plans to use defensively by preventing others from using it. Nevertheless, the acquirer shall measure the fair value of the nonfinancial asset in accordance with Subtopic 820-10 assuming its highest and best use by market participants in accordance with the appropriate valuation premise, both initially and for purposes of subsequent impairment testing.

Unless a specific recognition or measurement exception applies, all tangible and intangible assets must be recognized and measured at fair value by using the guidance in ASC 820, even if the acquirer does not intend to use the asset or intends to use it in a manner other than its highest and best use. Such assets are often intangible, rather than tangible, assets, but the requirement to measure them at fair value is the same. See Section 4.10.4.8 for information about defensive intangible assets.

4.10 Intangible Assets

ASC 805-20

25-10 The acquirer shall recognize separately from goodwill the identifiable intangible assets acquired in a business combination. An intangible asset is identifiable if it meets either the separability criterion or the contractual-legal criterion described in the definition of identifiable. Additional guidance on applying that definition is provided in paragraphs 805-20-25-14 through 25-15, 805-20-55-2 through 55-45, and Example 1 (see paragraph 805-20-55-52). For guidance on the recognition and subsequent measurement of a defensive intangible asset, see Subtopic 350-30.

The ASC master glossary defines intangible assets as “[a]ssets (not including financial assets) that lack physical substance. (The term intangible assets is used to refer to intangible assets other than goodwill).” An acquirer must recognize, separately from goodwill, the identifiable intangible assets acquired in a business combination. An intangible asset is identifiable if it meets either the separability criterion or the contractual-legal criterion.

Changing Lanes

The FASB has an active project on its agenda to revisit the accounting for certain identifiable intangible assets and the subsequent accounting for goodwill broadly for all entities. The staff plans to (1) explore adding amortization to the goodwill impairment model, including the amortization method and period; (2) explore other changes to the goodwill impairment model; (3) consider the accounting for identifiable intangible assets; and (4) address matters related to presentation, disclosure, and transition. Practitioners should monitor this project for any developments that might change the current accounting.
4.10.1 Initial Recognition of Intangible Assets

An intangible asset is identifiable and therefore recognized separately from goodwill if it meets either of the following criteria:

- The intangible asset arises from contractual or other legal rights (i.e., the "contractual-legal criterion"), regardless of whether those rights are transferable or separable from the acquiree or from other rights and obligations.
- The intangible asset is separable (i.e., the "separability criterion"). According to ASC 805-20-55-3, an asset that meets this criterion “is capable of being separated or divided from the acquiree and sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract, identifiable asset, or liability.” An intangible asset is separable regardless of whether the acquirer intends to transfer it.

Both of these criteria are explained in more detail in the following sections.

4.10.1.1 The Contractual-Legal Criterion

<table>
<thead>
<tr>
<th>ASC 805-20</th>
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<tbody>
<tr>
<td>55-2 Paragraph 805-20-25-10 establishes that an intangible asset is identifiable if it meets either the separability criterion or the contractual-legal criterion described in the definition of identifiable. An intangible asset that meets the contractual-legal criterion is identifiable even if the asset is not transferable or separable from the acquiree or from other rights and obligations. . . .</td>
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</tbody>
</table>

Many intangible assets arise from rights conveyed by contract, statute, or similar means. As stated in paragraph B156 of the Background Information and Basis for Conclusions of FASB Statement 141, “franchises are granted to automobile dealers, fast-food outlets, and professional sports teams. Trademarks and service marks may be registered with the government. Contracts are often negotiated with customers or suppliers. Technological innovations are often protected by patent.” Therefore, the fact that an intangible asset arises from contractual or other legal rights distinguishes it from goodwill. Such an intangible asset must be recognized separately from goodwill even if the acquirer is legally or contractually restricted from selling, transferring, or otherwise exchanging it. Restrictions on selling or otherwise transferring an intangible asset arising from contractual rights do not affect its recognition; however, such restrictions may affect its fair value measurement.
ASC 805-20-55-2 provides the following examples of intangible assets arising from contractual or other legal rights:

<table>
<thead>
<tr>
<th><strong>ASC 805-20</strong></th>
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<tbody>
<tr>
<td><strong>55-2 . . .</strong></td>
</tr>
<tr>
<td>a. An acquiree leases a manufacturing facility to a lessee under an operating lease that has terms that are favorable relative to market terms. The lease terms explicitly prohibit transfer of the lease (through either sale or sublease). The amount by which the lease terms are favorable compared with the pricing of current market transactions for the same or similar items is an intangible asset that meets the contractual-legal criterion for recognition separately from goodwill, even though the acquirer cannot sell or otherwise transfer the lease contract. See also paragraphs 805-20-25-12 through 25-13.</td>
</tr>
<tr>
<td>b. An acquiree owns and operates a nuclear power plant. The license to operate that power plant is an intangible asset that meets the contractual-legal criterion for recognition separately from goodwill, even if the acquirer cannot sell or transfer it separately from the acquired power plant. An acquirer may recognize the fair value of the operating license and the fair value of the power plant as a single asset for financial reporting purposes if the useful lives of those assets are similar.</td>
</tr>
<tr>
<td>c. An acquiree owns a technology patent. It has licensed that patent to others for their exclusive use outside the domestic market, receiving a specified percentage of future foreign revenue in exchange. Both the technology patent and the related license agreement meet the contractual-legal criterion for recognition separately from goodwill even if selling or exchanging the patent and the related license agreement separately from one another would not be practical.</td>
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<thead>
<tr>
<th><strong>Pending Content (Transition Guidance: ASC 842-10-65-1)</strong></th>
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<tbody>
<tr>
<td><strong>55-2 . . .</strong></td>
</tr>
<tr>
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</table>

Some intangible assets that meet the contractual-legal criterion may also meet the separability criterion, but only one criterion must be met for an intangible asset to be identifiable. Similarly, an intangible asset that meets the separability criterion is identifiable even if it does not arise from a contractual or legal right.
4.10.1.2 The Separability Criterion

**ASC 805-20**

55-3 The separability criterion means that an acquired intangible asset is capable of being separated or divided from the acquiree and sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract, identifiable asset, or liability. An intangible asset that the acquirer would be able to sell, license, or otherwise exchange for something else of value meets the separability criterion even if the acquirer does not intend to sell, license, or otherwise exchange it.

55-4 An acquired intangible asset meets the separability criterion if there is evidence of exchange transactions for that type of asset or an asset of a similar type, even if those transactions are infrequent and regardless of whether the acquirer is involved in them. For example, customer and subscriber lists are frequently licensed and thus meet the separability criterion. Even if an acquiree believes its customer lists have characteristics different from other customer lists, the fact that customer lists are frequently licensed generally means that the acquired customer list meets the separability criterion. However, a customer list acquired in a business combination would not meet the separability criterion if the terms of confidentiality or other agreements prohibit an entity from selling, leasing, or otherwise exchanging information about its customers.

In contrast to goodwill, which cannot be separated from an entity, some intangible assets do not arise from contractual or other legal rights but are capable of being separated from the acquiree and exchanged for something else of value. Therefore, identifiable assets can also be distinguished from goodwill on the basis of separability.

An acquired intangible asset meets the separability criterion if there is evidence of exchange transactions for the asset or similar assets, even if such exchanges occur infrequently and the acquirer has not participated and does not intend to participate in such exchanges. It is the acquirer's ability to separate the asset from the combined entity that makes an intangible asset separable. ASC 805-20-55-4 provides the following example of customer-related intangible assets that meet the separability criterion:

> Customer and subscriber lists are frequently licensed and thus meet the separability criterion. Even if an acquiree believes its customer lists have characteristics different from other customer lists, the fact that customer lists are frequently licensed generally means that the acquired customer list meets the separability criterion. However, a customer list acquired in a business combination would not meet the separability criterion if the terms of confidentiality or other agreements prohibit an entity from selling, leasing, or otherwise exchanging information about its customers.

Therefore, even if an intangible asset that is related to a contract, identifiable asset, or liability cannot be separated individually from that contract, identifiable asset, or liability, it will still meet the separability criterion if it can be transferred together with that related contract, identifiable asset, or liability. ASC 805-20-55-5 provides examples of intangible assets that, while not individually separable, are separable when combined with other assets or liabilities.
Chapter 4 — Recognizing and Measuring the Identifiable Assets Acquired and Liabilities Assumed

ASC 805-20

55-5 An intangible asset that is not individually separable from the acquiree or combined entity meets the separability criterion if it is separable in combination with a related contract, identifiable asset, or liability. For example:

a. Market participants exchange deposit liabilities and related depositor relationship intangible assets in observable exchange transactions. Therefore, the acquirer should recognize the depositor relationship intangible asset separately from goodwill.

b. An acquiree owns a registered trademark and documented but unpatented technical expertise used to manufacture the trademarked product. To transfer ownership of a trademark, the owner is also required to transfer everything else necessary for the new owner to produce a product or service indistinguishable from that produced by the former owner. Because the unpatented technical expertise must be separated from the acquiree or combined entity and sold if the related trademark is sold, it meets the separability criterion.

Unlike the contractual-legal criterion, restrictions on the sale, transfer, or exchange of an intangible asset may preclude the asset from meeting the separability criterion. If agreements, laws, or statutes prohibit the sale, transfer, license, rent, or exchange of an intangible asset, that asset does not meet the separability criterion, although it could still meet the contractual-legal criterion.

4.10.1.3 Intangible Assets That Are Not Identifiable as of the Acquisition Date

ASC 805-20

55-7 The acquirer also subsumes into goodwill any value attributed to items that do not qualify as assets at the acquisition date. For example, the acquirer might attribute value to potential contracts the acquiree is negotiating with prospective new customers at the acquisition date. Because those potential contracts are not themselves assets at the acquisition date, the acquirer does not recognize them separately from goodwill. The acquirer should not subsequently reclassify the value of those contracts from goodwill for events that occur after the acquisition date. However, the acquirer should assess the facts and circumstances surrounding events occurring shortly after the acquisition to determine whether a separately recognizable intangible asset existed at the acquisition date.

An acquirer might identify certain intangible assets acquired in a business combination that may have value but do not meet either the separability or contractual-legal criterion. Thus, such assets are subsumed into goodwill.

FASB Statement 141 includes the following examples of intangible assets that are not identifiable (while ASC 805 did not carry forward all of these examples, they continue to be relevant):

- Potential contracts that an acquiree is negotiating with prospective new customers as of the acquisition date, which is specifically addressed in ASC 805-20-55-7.
- Customer base or unidentifiable customers — a group of customers that are not known or identifiable to the entity (e.g., customers of a fast-food franchise).
- Assembled workforce, which is specifically addressed in ASC 805-20-55-6.
- Customer service capacity.
- A presence in geographic markets or in certain locations.
- Status as a nonunion, or strong labor relations.
- Training that is ongoing.
• Recruitment programs.
• Outstanding credit ratings.
• Access to capital markets.
• Favorable governmental relationships.

ASC 805-20-55-7 acknowledges that while potential contracts do not meet the criteria for separate recognition as of the acquisition date and cannot be subsequently reclassified from goodwill for events that occur after the acquisition date, the acquirer should “assess the facts and circumstances surrounding events occurring shortly after the acquisition to determine whether a separately recognizable intangible asset existed at the acquisition date.”

In a business combination, an intangible asset must be identifiable according to the specific criteria in ASC 805 to be recognized, but in an asset acquisition, it must only meet the asset recognition criteria in FASB Concepts Statement 5 to be recognized in accordance with ASC 350-30-25-4. (See Section C.3.4 for more information.)

4.10.1.3.1 Assembled Workforce

**ASC 805-20**

**Assembled Workforce and Other Items That Are Not Identifiable**

55-6 The acquirer subsumes into goodwill the value of an acquired intangible asset that is not identifiable as of the acquisition date. For example, an acquirer may attribute value to the existence of an assembled workforce, which is an existing collection of employees that permits the acquirer to continue to operate an acquired business from the acquisition date. An assembled workforce does not represent the intellectual capital of the skilled workforce — the (often specialized) knowledge and experience that employees of an acquiree bring to their jobs. Because the assembled workforce is not an identifiable asset to be recognized separately from goodwill, any value attributed to it is subsumed into goodwill.

An assembled workforce is an example of an intangible asset that is not identifiable and therefore not separately recognizable in a business combination. In paragraph B178 of the Basis for Conclusions of Statement 141(R), the FASB explains why an assembled workforce is not an identifiable intangible asset to be recognized separately from goodwill in a business combination:

Because an assembled workforce is a collection of employees rather than an individual employee, it does not arise from contractual or legal rights. Although individual employees might have employment contracts with the employer, the collection of employees, as a whole, does not have such a contract. In addition, an assembled workforce is not separable, either as individual employees or together with a related contract, identifiable asset, or liability. An assembled workforce cannot be sold, transferred, licensed, rented, or otherwise exchanged without causing disruption to the acquirer’s business. In contrast, an entity could continue to operate after transferring an identifiable asset.

By contrast, an assembled workforce meets the recognition criteria if it is acquired in an asset acquisition, as discussed Section C.3.4.
4.10.2 Initial Measurement of Intangible Assets

ASC 805-20

The identifiability criteria determine whether an intangible asset is recognized separately from goodwill. However, the criteria neither provide guidance for measuring the fair value of an intangible asset nor restrict the assumptions used in measuring the fair value of an intangible asset. For example, the acquirer would take into account the assumptions that market participants would use when pricing the intangible asset, such as expectations of future contract renewals, in measuring fair value. It is not necessary for the renewals themselves to meet the identifiability criteria. (However, see paragraph 805-20-30-20, which establishes an exception to the fair value measurement principle for reacquired rights recognized in a business combination.)

Intangible assets acquired in a business combination are measured at their acquisition-date fair values in accordance with the guidance in ASC 820 unless the intangible asset qualifies for an exception to ASC 805’s fair value measurement principle (e.g., a reacquired right).

SEC Considerations

The SEC staff frequently asks registrants how they have assigned amounts to assets acquired and liabilities assumed in business combinations. In particular, the staff asks registrants that have recorded a significant amount of goodwill why they have not attributed value to identifiable intangible assets. The staff also compares the disclosures provided in press releases, the business section, and MD&A to the disclosures in the financial statements. For example, the SEC staff may ask why a registrant did not recognize a customer-related intangible asset if its MD&A discloses that it acquired customers in a business combination. In addition, the SEC staff may ask detailed questions about (1) how a registrant determined that intangible assets would have finite or indefinite useful lives, (2) the useful lives of identified intangible assets determined to have finite useful lives, and (3) material revisions to the initial accounting for a business combination, including what significant assumptions have changed to support a revision to the value of intangible assets.

4.10.2.1 Use of the Residual Method to Value Intangible Assets

In the past, some entities used what was called the “residual method” for assigning fair value to certain intangible assets that, it was believed, could not be separately and directly valued. However, in EITF Topic D-108, the SEC staff indicated that this method is not acceptable. Topic D-108 states, in part:

The SEC staff is aware of instances in which registrants have asserted that certain intangible assets that arise from legal or contractual rights cannot be separately and directly valued (hereinafter referred to as a “direct value method”) because the nature of the particular asset makes it fundamentally indistinguishable from goodwill in a business combination (for example, cellular/spectrum licenses, cable franchise agreements, and so forth). . . .

The SEC staff notes that a fundamental distinction between other recognized intangible assets and goodwill is that goodwill is both defined and measured as an excess or residual asset, while other recognized intangible assets are required to be measured at fair value. The SEC staff does not believe that the application of the residual method to the valuation of intangible assets can be assumed to produce amounts representing the fair values of those assets. . . . Furthermore, the SEC staff notes that the same types of assets being valued using the residual method by some entities are being valued using a direct value method by other entities. Accordingly, the SEC staff believes the residual method should no longer be used to value intangible assets other than goodwill.
4.10.3 Combining Intangible Assets Into a Single Unit of Account

ASC 805 does not provide any specific guidance on identifying the unit of account for tangible or intangible assets, but it offers the following three examples of acquired assets that may be combined for financial reporting:

- “[A] group of complementary assets such as a trademark (or service mark) and its related trade name, formulas, recipes, and technological expertise.” (See ASC 805-20-55-18.)
- A license to operate a nuclear power plant and a power plant. (See ASC 805-20-55-2(b).)
- An artistic-related copyright “and any related assignments or license agreements.” (See ASC 805-20-55-30.)

In each example, the individual assets cited have similar useful lives — a factor that supports combining them for financial reporting. In addition, we believe that to ensure that their effect on financial reporting is similar, only assets that have similar methods of amortization should be combined. Likewise, ASC 805-20-55-24 states that “[a] customer contract and the related customer relationship may represent two distinct intangible assets” because “[b]oth the useful lives and the pattern in which the economic benefits of the two assets are consumed may differ.” Determining whether it is appropriate to combine intangible assets into a single unit of account requires considerable judgment. See Section 4.10.4.2.8 for more information about the unit of account for customer-related intangible assets.

4.10.4 Examples of Identifiable Intangible Assets

The implementation guidance in ASC 805-20-55 lists intangible assets that are frequently recognized in business combinations. In correspondence to the FASB staff dated August 16, 2001, then SEC Chief Accountant Lynn Turner notes the following:

Appendix A of SFAS No. 141 indicates that the list of identifiable intangible assets is illustrative. The SEC staff believes there is a rebuttable presumption that any intangible asset identified in the listing will be valued in a purchase business combination. In its review of filings, the staff may look to such documentation as the sales agreement, memorandums, presentations by the target to the buyer, minutes of the Board of Directors Meetings, etc. for discussions and evidence of assets, including intangibles, being purchased.

While the SEC staff’s comments referred to FASB Statement 141, the list of intangible assets it describes was carried forward to ASC 805, and therefore the views expressed remain applicable.

The list of examples in ASC 805-20 is not all-inclusive. Entities should also consider the following when searching for the presence of acquired intangible assets:

- Other acquisitions by the acquirer in the same line of business.
- Other acquisitions by companies in the same industry.
- Historical financial statements of the acquired entity for disclosure, discussion, or both, of any previously recognized or unrecognized intangibles.

ASC 805-20-55-12 indicates that the identifiable intangible assets discussed in ASC 805-20 are divided into two groups that are designated as follows (emphasis added):

- “Intangible assets designated with the symbol # are those that arise from contractual or other legal rights.”
- “Those designated with the symbol * do not arise from contractual or other legal rights but are separable.”
The guidance also notes that “[i]ntangible assets designated with the symbol # might also be separable, but separability is not a necessary condition for an asset to meet the contractual-legal criterion.”

The sections below discuss both types of identifiable intangible assets.

4.10.4.1 Marketing-Related Intangible Assets

Marketing-related intangible assets are “primarily used in the marketing or promotion of products or services.” They are typically registered or protected through legal rights and, therefore, generally meet the contractual-legal criterion for recognition separately as intangible assets. ASC 805-20-55-14 provides the following examples of marketing-related intangible assets:

- Trademarks, trade names, service marks, collective marks, certification marks #
- Trade dress (unique color, shape, package design) #
- Newspaper mastheads #
- Internet domain names #
- Noncompetition agreements. #

4.10.4.1.1 Trademarks, Trade Names, Service Marks, Collective Marks, and Certification Marks

ASC 805-20

Trademarks, Trade Names, Service Marks, Collective Marks, Certification Marks #

55-16 Trademarks are words, names, symbols, or other devices used in trade to indicate the source of a product and to distinguish it from the products of others. A service mark identifies and distinguishes the source of a service rather than a product. Collective marks identify the goods or services of members of a group. Certification marks certify the geographical origin or other characteristics of a good or service.

55-17 Trademarks, trade names, service marks, collective marks, and certification marks may be protected legally through registration with governmental agencies, continuous use in commerce, or by other means. If it is protected legally through registration or other means, a trademark or other mark acquired in a business combination is an intangible asset that meets the contractual-legal criterion. Otherwise, a trademark or other mark acquired in a business combination can be recognized separately from goodwill if the separability criterion is met, which normally it would be.

55-18 The terms brand and brand name, often used as synonyms for trademarks and other marks, are general marketing terms that typically refer to a group of complementary assets such as a trademark (or service mark) and its related trade name, formulas, recipes, and technological expertise. This Subtopic does not preclude an entity from recognizing, as a single asset separately from goodwill, a group of complementary intangible assets commonly referred to as a brand if the assets that make up that group have similar useful lives.

4.10.4.1.2 Internet Domain Names

ASC 805-20

Internet Domain Names #

55-19 An Internet domain name is a unique alphanumeric name that is used to identify a particular numeric Internet address. Registration of a domain name creates an association between that name and a designated computer on the Internet for the period of the registration. Those registrations are renewable. A registered domain name acquired in a business combination meets the contractual-legal criterion.
4.10.4.1.3 Noncompetition Agreements

Noncompetition or “noncompete” agreements are legal agreements that prohibit or restrict one party from competing against another party, typically in a defined market for a specified period. Noncompete agreements of the acquiree that were in place before the business combination would meet the contractual-legal criterion because such agreements arise from legal or contractual rights. The terms, conditions, and enforceability of noncompete agreements affect the fair value of such agreements (e.g., in certain jurisdictions, noncompete agreements may be unenforceable as a matter of law and therefore have little value) but not their recognition. Amounts assigned to noncompete agreements are generally subject to amortization; however, determining the period of amortization is a matter of judgment, and all terms of the agreement, including restrictions on its enforceability, should be considered.

The acquirer and the acquiree may also enter into noncompete agreements at the time of the business combination. There are differing views regarding whether such agreements should be accounted for as part of the business combination or whether they represent transactions that are separate from the acquisition (see Section 6.2). These differing views are discussed in paragraph BC19 of ASU 2014-18, which is based on a consensus of the PCC. It states, in part:

While many reporting entities and public accountants consider noncompetition agreements to be part of most business combinations, to other reporting entities and public accountants, most noncompetition agreements represent transactions separate from a business combination. Noncompetition agreements are not specifically discussed in the guidance on determining what is part of a business combination transaction. To date, however, the diversity in practice has not resulted in significantly different financial reporting outcomes. As a result, the PCC and the Board decided not to provide additional guidance to clarify whether noncompetition agreements are part of a business combination.

Connecting the Dots

If the acquirer is a private company or not-for-profit entity, it may elect to apply the accounting alternative for the recognition of noncompetition agreements acquired in a business combination, which is discussed in Chapter 8.

4.10.4.2 Customer-Related Intangible Assets

Customer-related intangible assets include, but are not limited to, customer contracts and related customer relationships, noncontractual customer relationships, customer lists, order and production backlogs, and customer loyalty programs. Entities may find it challenging to recognize and measure these assets because in many cases, an acquiree’s relationship with a customer can encompass various types of intangible assets (e.g., a customer contract and related relationship, a customer list, and a backlog), which may be interrelated. The values assigned to other intangible assets, such as brand names and trademarks, may also affect the valuation of customer-related intangible assets. Further, as noted in ASC 805-25-55-24, because the useful lives and pattern in which the assets’ economic benefits are consumed may differ, entities may need to recognize separately the intangible assets related to a single customer relationship. ASC 805-20-55-20 provides the following examples of customer-related intangible assets:

a. Customer lists *
b. Order or production backlog #
c. Customer contracts and related customer relationships #
d. Noncontractual customer relationships. *
4.10.4.2.1 Valuation Techniques and Assumptions Used in Measuring Customer-Related Intangible Assets

Because of the absence of market transactions involving identical or comparable assets, it is often difficult to use the market approach to measure the fair value of a customer-relationship intangible asset. Likewise, the cost approach may not be appropriate. Therefore, in most cases, customer-related intangible assets are measured by using an income approach.

At the 2003 AICPA Conference on Current SEC Developments, then SEC OCA Professional Accounting Fellow Chad Kokenge stated the following in prepared remarks:

[T]he [cost] approach only focuses on the entity's specific costs that are necessary to “establish” the relationship. Such an approach would not be sensitive to the volume of business that might be generated by the customer, other relationship aspects, such as referral capability, or other factors that may be important to how a marketplace participant might assess the asset. If these factors are significant, we believe the use of such an approach would generally be inconsistent with the . . . definition of fair value.

In addition, in a statement at the 2006 AICPA Conference on Current SEC and PCAOB Developments, then SEC OCA Professional Accounting Fellow Joseph Ucuzoglu also addressed the valuation of customer-relationship intangible assets in a business combination:

Some have suggested that the SEC staff always requires the use of an income approach to value customer relationship intangible assets. The staff has even heard some suggest that, as long as a registrant characterizes its valuation method as an income approach, the specific assumptions used or results obtained will not be challenged by the staff, because one has complied with a perceived bright line requirement to use an income approach. Let me assure you, these statements are simply false. While an income approach often provides the most appropriate valuation of acquired customer relationship intangible assets, circumstances may certainly indicate that a different method provides a better estimate of fair value. On the flipside, even when a registrant concludes that an income approach is the most appropriate valuation methodology, the staff may nevertheless question the result obtained when the underlying assumptions, such as contributory asset charges, do not appear reasonable in light of the circumstances.

When determining the appropriate valuation of a customer relationship intangible asset, I believe that the first step in the process should be to obtain a thorough understanding of the value drivers in the acquired entity. That is, why is it that customers continually return to purchase products or services from the acquired entity? In some cases, the nature of the relationship may be such that customers are naturally “sticky,” and tend to stay with the same vendor over time without frequently reconsidering their purchasing decisions. In that circumstance, it would appear that a significant portion of the ongoing cash flows that the acquired entity will generate can be attributed to the strength of its customer relationships.

At the other end of the spectrum, relationships may be a less significant value driver in an environment where customers frequently reassess their purchasing decisions and can easily switch to another vendor with a lower price or a superior product. In that environment, if customers continually return to buy products from the acquired entity, perhaps they do so in large part due to factors other than the relationship, such as a well-known tradename, strong brands, and proprietary technologies. As a result, the value of the customer relationship intangible asset may be less than would be the case in a circumstance where the relationship is stronger. However, the staff would generally expect that the amount attributed to other intangible assets would be commensurately higher, reflecting the increasingly important role of those assets in generating cash flows.

4.10.4.2.2 Customer Lists

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**Customer Lists**

A customer list consists of information about customers, such as their names and contact information. A customer list also may be in the form of a database that includes other information about the customers, such as their order histories and demographic information. A customer list generally does not arise from contractual or other legal rights. However, customer lists are frequently leased or exchanged. Therefore, a customer list acquired in a business combination normally meets the separability criterion.
There is often an active market for customer information, referred to as customer lists, which an entity may receive regarding the acquiree’s customers. Such information is generally deemed to be separable if there are no terms of confidentiality or restrictions on selling, leasing, or otherwise exchanging it, even if the entity has no intention of doing so.

However, if the terms of confidentiality or restrictions on the sale or transfer of customer lists prohibit a company from selling, leasing, or otherwise exchanging a noncontractual customer list, the separability criterion would not be met and an intangible asset would not be recognized apart from goodwill. While most entities will possess some information about their customers, thereby establishing the presence of a customer-list intangible asset, the specific information possessed and the resulting value of this asset will vary.

The following decision tree is intended to help an entity evaluate the criteria related to the recognition apart from goodwill of a customer-list intangible asset:

### 4.10.4.2.3 Order or Production Backlog

**ASC 805-20**

**Order or Production Backlog #**

55-22 An order or production backlog arises from contracts such as purchase or sales orders. An order or production backlog acquired in a business combination meets the contractual-legal criterion even if the purchase or sales orders are cancelable.
An order or production backlog acquired in a business combination meets the contractual-legal criterion even if the purchase or sales orders are cancelable. However, the fact that a contract is cancelable may affect the fair value measurement of the associated intangible asset.

4.10.4.2.4 Customer Contracts and Customer Relationships

Customer Contracts and the Related Customer Relationships #

55-23 If an entity establishes relationships with its customers through contracts, those customer relationships arise from contractual rights. Therefore, customer contracts and the related customer relationships acquired in a business combination meet the contractual-legal criterion, even if confidentiality or other contractual terms prohibit the sale or transfer of a contract separately from the acquiree.

55-24 A customer contract and the related customer relationship may represent two distinct intangible assets. Both the useful lives and the pattern in which the economic benefits of the two assets are consumed may differ.

55-25 A customer relationship exists between an entity and its customer if the entity has information about the customer and has regular contact with the customer, and the customer has the ability to make direct contact with the entity. Customer relationships meet the contractual-legal criterion if an entity has a practice of establishing contracts with its customers, regardless of whether a contract exists at the acquisition date. Customer relationships also may arise through means other than contracts, such as through regular contact by sales or service representatives. As noted in paragraph 805-20-55-22, an order or a production backlog arises from contracts such as purchase or sales orders and therefore is considered a contractual right. Consequently, if an entity has relationships with its customers through these types of contracts, the customer relationships also arise from contractual rights and therefore meet the contractual-legal criterion.

Noncontractual Customer Relationships *

55-27 A customer relationship acquired in a business combination that does not arise from a contract may nevertheless be identifiable because the relationship is separable. Exchange transactions for the same asset or a similar asset that indicate that other entities have sold or otherwise transferred a particular type of noncontractual customer relationship would provide evidence that the noncontractual customer relationship is separable. For example, relationships with depositors are frequently exchanged with the related deposits and therefore meet the criteria for recognition as an intangible asset separately from goodwill.

Customer relationships (both contractual and noncontractual) are recognized separately from goodwill only if they exist as of the acquisition date. If the acquiree routinely signs contracts with its customers (e.g., sales and purchase orders), the acquirer would recognize separate intangible assets for the following:

- Customer contracts that exist as of the acquisition date.
- Customer relationships that exist as of the acquisition date, regardless of whether a contract exists on that date.

Although ASC 805 does not define the term “contractual,” it indicates that both of the above items would satisfy the contractual-legal criterion. Therefore, the absence of enforceable rights by the parties to a particular arrangement does not preclude recognition. The SEC staff has historically agreed with this view.

In addition, while a noncontractual customer relationship may not be separable by itself, it may be separable along with another identifiable asset, liability, or contract — such as a sales representative’s contract or a brand, trademark, or product line — even if management has no intention of separating it. In that case, the customer relationship would meet the separability criterion. ASC 805-20-55-25
provides the following three criteria that may indicate that a relationship exists between an entity and its customer:

- The acquired entity maintains current customer information.
- The acquired entity contacts its customers regularly.
- Customers can directly contact the acquired entity.

ASC 805 nullified EITF Issue 02-17 but carried forward the EITF’s prior decisions about customer contracts and related customer relationships. Issue 02-17 offered the following illustration, which is still considered relevant under the guidance in ASC 805:

Company X acquires Company Y in a business combination on December 31, 20X2. Company Y does business with its customers solely through purchase and sales orders. At December 31, 20X2, Company Y has a backlog of customer purchase orders in-house 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 December 31, 20X2, Company Y does not have any open purchase orders, or other contracts, with those customers.

**Evaluation:** The purchase orders from 60 percent of Company Y’s customers (whether cancelable or not) meet the contractual-legal criterion and, therefore, must be recorded at fair value apart from goodwill. Additionally, since Company Y has established its relationship with 60 percent of its customers through a contract, those customer relationships meet the contractual-legal criterion and must also be recorded at fair value apart from goodwill.

Because Company Y has a practice of establishing contracts with the remaining 40 percent of its customers, those customer relationships also arise through contractual rights and, therefore, meet the contractual-legal criterion. Company X must record the customer relationship for the remaining 40 percent of Company Y’s customers at fair value apart from goodwill, even though Company Y does not have contracts with those customers at December 31, 20X2.

**Connecting the Dots**

If the acquirer is a private company or not-for-profit entity, it may elect to apply the accounting alternative for the recognition of certain customer-related intangible assets acquired in a business combination, which are discussed in Chapter 8.

The following cases from ASC 805-20-55-53 through 55-57 illustrate the recognition of customer-contract and customer-relationship intangible assets acquired in a business combination:

<table>
<thead>
<tr>
<th>ASC 805-20</th>
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<tbody>
<tr>
<td><strong>55-53</strong> In each of the Cases, the Acquirer acquires Target in a business combination on December 31, 20X5.</td>
</tr>
<tr>
<td><strong>Case A: Five-Year Supply Agreement</strong></td>
</tr>
<tr>
<td><strong>55-54</strong> Target has a five-year agreement to supply goods to Customer. Both Target and Acquirer believe that Customer will renew the agreement at the end of the current contract. The agreement is not separable. The agreement, whether cancelable or not, meets the contractual-legal criterion. Additionally, because Target establishes its relationship with Customer through a contract, not only the agreement itself but also Target’s customer relationship with Customer meet the contractual-legal criterion.</td>
</tr>
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</table>
Case B: One Customer, Contract in One of Two Lines of Business

Target manufactures goods in two distinct lines of business: sporting goods and electronics. Customer purchases both sporting goods and electronics from Target. Target has a contract with Customer to be its exclusive provider of sporting goods but has no contract for the supply of electronics to Customer. Both Target and Acquirer believe that only one overall customer relationship exists between Target and Customer. The contract to be Customer's exclusive supplier of sporting goods, whether cancelable or not, meets the contractual-legal criterion. Additionally, because Target establishes its relationship with Customer through a contract, the customer relationship with Customer meets the contractual-legal criterion. Because Target has only one customer relationship with Customer, the fair value of that relationship incorporates assumptions about Target's relationship with Customer related to both sporting goods and electronics. However, if Acquirer determines that the customer relationships with Customer for sporting goods and for electronics are separate from each other, Acquirer would assess whether the customer relationship for electronics meets the separability criterion for identification as an intangible asset.

Case C: Purchase and Sales Orders

Target does business with its customers solely through purchase and sales orders. At December 31, 20X5, Target has a backlog of customer purchase orders from 60 percent of its customers, all of whom are recurring customers. The other 40 percent of Target's customers also are recurring customers. However, as of December 31, 20X5, Target has no open purchase orders or other contracts with those customers. Regardless of whether they are cancelable or not, the purchase orders from 60 percent of Target's customers meet the contractual-legal criterion. Additionally, because Target has established its relationship with 60 percent of its customers through contracts, not only the purchase orders but also Target's customer relationships meet the contractual-legal criterion. Because Target has a practice of establishing contracts with the remaining 40 percent of its customers, its relationship with those customers also arises through contractual rights and therefore meets the contractual-legal criterion even though Target does not have contracts with those customers at December 31, 20X5.

Case D: Cancelable Contracts

Target has a portfolio of one-year motor insurance contracts that are cancelable by policyholders. Because Target establishes its relationships with policyholders through insurance contracts, the customer relationship with policyholders meets the contractual-legal criterion. The guidance in Subtopic 350-30 applies to the customer relationship intangible asset.

4.10.4.2.5 Customer Loyalty Programs

Customer loyalty programs generally allow customers to earn current or future discounts, free products or services, or other benefits on the basis of cumulative purchases from the operator of the program. Many airlines, casinos, hotels, and retailers offer such programs. Typically, a program's enrollment process is designed to be easy for customers to complete, with the participants agreeing to the terms and conditions of the program at the time of enrollment. Participants in such programs usually have no obligation to complete future purchases of products or services, and operators of such programs generally reserve the right to modify or cancel the program at any time.

Despite the absence of enforceable rights between the parties regarding future purchases or the fulfillment of accrued benefits, such loyalty program arrangements are deemed to meet the contractual-legal criterion because the parties have agreed to certain terms and conditions or had a previous contractual relationship, or both. Any liability accruals, or revenue deferrals, by the operator would also indicate that the arrangement is “contractual.” In addition to evaluating the recognition and measurement of an acquired customer-related intangible asset, an acquirer must separately evaluate the recognition and measurement of assumed liabilities related to the acquiree's customer loyalty program as of the acquisition date.
4.10.4.2.6 Overlapping Customers

An acquirer and acquiree may have relationships with the same customers, sometimes referred to as overlapping customers. If the acquired customer relationship is identifiable, the acquirer should recognize an intangible asset. When estimating the fair value of the acquired relationship, the acquirer must use assumptions that market participants would make about their ability to generate incremental cash flows from these relationships.

In prepared remarks at the 2005 AICPA Conference on SEC and PCAOB Developments, then SEC OCA Professional Accounting Fellow Pamela Schlosser offered the following example, which discussed a scenario in which overlapping customers would provide value to the acquirer:

Company A, which sells apparel products to retail customers, acquires Company B, which sells toy products to those same retail customers. The question is: at what amount the customer relationships of Company B should be recognized, considering the fact that Company A already had relationships with those very same customers, albeit for different product sales?

Some have argued that in this situation, no value should be attributed to these intangible assets since Company A already sold its products to Company B’s customer base, and thus already had pre-established relationships with them. However, we have found this argument difficult to accept. Because of the acquisition, Company A now has the ability to sell new products (that is, toy products) to its retail customers that it was unable to sell prior to the acquisition of Company B. And even if the two companies sold competing products to the same retail customers, for instance both sold toy products, the fact that Company A has increased its “shelf space” at each of its customers’ retail locations would be indicative of value to those relationships.

In the SEC staff’s view, an acquired customer relationship that overlaps an existing customer relationship has value because it gives the acquirer the ability to generate incremental cash flows; for example, an acquirer can sell new products to the customer or increase its “shelf space” with the customer. That value may also be reflected in the recognition of other intangible assets, such as trade names, that drive customer loyalty. The SEC staff also indicated that the most appropriate approach to valuing the intangible asset would generally be an income approach based on the benefits of incremental sales to those customers.

4.10.4.2.7 Customer Base

A customer base is a group of customers, also referred to as walk-up customers, that are not known or identifiable to the company. For example, customers who make purchases from newsstands or fast food restaurants may be loyal, repeat customers, but often specific demographic data on those customers is not be maintained in such a way that the separability criterion would be met. However, if information about the customers is obtained, a customer base may give rise to a customer list or customer loyalty program. For example, even just basic contact information about a customer, such as name and address or telephone number, may constitute a customer list.

4.10.4.2.8 Unit of Account for Customer-Related Intangible Assets

Customer-related intangible assets can pose challenging unit of account issues that require the use of judgment. One issue is that if an acquiree’s relationship with a single customer gives rise to multiple customer-related intangible assets (e.g., customer relationships, customer contracts, customer lists, or backlog), questions may arise about whether different customer-related intangible assets pertaining to the same customer should be recognized separately or as a single unit of account. As noted in Section 4.10.3, we believe that to be combined for financial reporting, assets should have similar useful lives and methods of amortization.
Another unit of account issue can occur if numerous customer-related intangible assets with different customers are acquired. In practice, customer-related intangible assets with different customers but with similar characteristics are frequently aggregated into pools for recognition and measurement. Entities must apply judgment in determining which characteristics make the customers similar.

Subsequent useful life determinations and methods of amortization might differ among pools. ASC 350-30 provides additional guidance on subsequently measuring and accounting for assets acquired in a business combination (see Section 4.10.5).

### 4.10.4.3 Artistic-Related Intangible Assets

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<td><strong>55-30</strong></td>
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ASC 805-20-55-29 provides the following examples of artistic-related intangible assets:

- a. Plays, operas, ballets #
- b. Books, magazines, newspapers, other literary works #
- c. Musical works such as compositions, song lyrics, advertising jingles #
- d. Pictures, photographs #
- e. Video and audiovisual material, including motion pictures or films, music videos, television programs. #

### 4.10.4.4 Contract-Based Intangible Assets

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<td><strong>55-31</strong></td>
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As stated in ASC 805-20-55-31, “[c]ontract-based intangible assets represent the value of rights that arise from contractual arrangements.” Contracts with terms that are favorable relative to market terms give rise to contract-based intangible assets, and contracts with terms that are unfavorable relative to market terms give rise to a liability assumed in the business combination (see additional discussion in Section 4.10.4.4.5).
ASC 805-20-55-31 (pending content) also provides the following examples of contract-based intangible assets:

a. Licensing, royalty, standstill agreements #
b. Advertising, construction, management, service or supply contracts #
c. Operating lease agreements of a lessor #
d. Construction permits #
e. Franchise agreements #
f. Operating and broadcast rights #
g. Servicing contracts such as mortgage servicing contracts #
h. Employment contracts #
i. Use rights such as drilling, water, air, timber cutting, and route authorities. #

4.10.4.4.1 Franchise Agreements

A franchise agreement is a contractual arrangement through which a franchisor grants a franchisee the right to operate a franchised outlet for a specified period. The purpose of the agreement is to distribute a product or service, or an entire business concept, within a particular market area. A franchise agreement of the acquiree that has terms that are favorable relative to market terms gives rise to contract-based intangible assets, whereas an agreement that has terms that are unfavorable relative to market terms gives rise to a liability assumed in the business combination. In addition, there may be other intangible assets that an acquirer should recognize (e.g., customer lists or customer contracts and related customer-relationship intangible assets).

4.10.4.4.2 Servicing Contracts Such as Mortgage Servicing Contracts

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<th>ASC 805-20</th>
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<tbody>
<tr>
<td><strong>Servicing Contracts Such as Mortgage Servicing Contracts #</strong></td>
</tr>
<tr>
<td><strong>55-33</strong> Contracts to service financial assets are one type of contract-based intangible asset. Although servicing is inherent in all financial assets, it becomes a distinct asset or liability by either of the following:</td>
</tr>
<tr>
<td>a. If the transfer of the servicer’s financial assets met the requirements for sale accounting</td>
</tr>
<tr>
<td>b. Through the separate acquisition or assumption of a servicing obligation that does not relate to financial assets of the combined entity.</td>
</tr>
<tr>
<td><strong>55-34</strong> Topic 860 provides guidance on accounting for servicing contracts.</td>
</tr>
<tr>
<td><strong>55-35</strong> If mortgage loans, credit card receivables, or other financial assets are acquired in a business combination with the servicing obligation, the inherent servicing rights are not a separate intangible asset because the fair value of those servicing rights is included in the measurement of the fair value of the acquired financial asset.</td>
</tr>
</tbody>
</table>
The ASC master glossary defines a servicing asset as “[a] contract to service financial assets under which the benefits of servicing are expected to more than adequately compensate the servicer for performing the servicing. A servicing contract is either: [(a)] [u]ndertaken in conjunction with selling or securitizing the financial assets being serviced [or (b)] [p]urchased or assumed separately.” Further, ASC 860-50-05-3 states that contracts to service financial assets may include the following:

a. Collecting principal, interest, and escrow payments from borrowers
b. Paying taxes and insurance from escrowed funds
c. Monitoring delinquencies
d. Executing foreclosure if necessary
e. Temporarily investing funds pending distribution
f. Remitting fees to guarantors, trustees, and others providing services
g. Accounting for and remitting principal and interest payments to the holders of beneficial interests or participating interests in the financial assets.

Although servicing is inherent in all financial assets, it is not recognized as a separate intangible asset unless (1) the underlying financial assets (e.g., receivables) are sold or securitized and the servicing contract is retained by the seller or (2) the servicing contract is separately purchased or assumed.

### 4.10.4.4.3 Employment Contracts

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<tbody>
<tr>
<td><strong>Employment Contracts #</strong></td>
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<tr>
<td><strong>55-36</strong> Employment contracts that are beneficial contracts from the perspective of the employer because the pricing of those contracts is favorable relative to market terms are one type of contract-based intangible asset.</td>
</tr>
</tbody>
</table>

Employment contracts, including collective bargaining agreements, meet the contractual-legal criterion for recognition apart from goodwill as intangible assets (or, in some circumstances, liabilities). When valuing an employment contract, an entity should consider whether there are any favorable or unfavorable contract elements and any inherent fair value related to the price that a market participant would pay for an at-market employment contract. In practice, little value is often attributed to at-market employment contracts because employees often give relatively short notice of their intention to leave their job and the employment contracts are often not enforced. In addition, while an employment contract may be perceived to be above or below market from the employer’s perspective (i.e., the pricing of the contract is favorable or unfavorable relative to market terms), an entity may find it challenging to measure such an asset or liability because of the difficulty of substantiating market compensation for specific employees. Therefore, it is unusual for an acquirer to recognize an asset or liability for an off-market employment contract. The value of an employment contract should be recognized separately from the value of a noncompete agreement (see Section 4.10.4.1.3).
4.10.4.4 Use Rights

**ASC 805-20**

*Use Rights #*

55-37 Use rights such as drilling, water, air, timber cutting, and route authorities are contract-based intangible assets to be accounted for separately from goodwill. Particular use rights may have characteristics of tangible, rather than intangible, assets. For example, mineral rights are tangible assets. An acquirer should account for use rights based on their nature.

Use rights are contract-based intangible assets. Certain use rights are tangible, rather than intangible, assets. An acquirer should account for use rights on the basis of their nature. For example, mineral rights, which are legal rights to explore, extract, and retain all or a portion of mineral deposits, are tangible assets (see Section 4.8.2).

4.10.4.4.5 Executory Contracts

An executory contract is a contract that remains wholly unperformed or for which there remains something to be done by either or both parties to the contract. Examples of executory contracts include purchase and supply contracts, franchise agreements, service contracts, and licensing arrangements. Because executory contracts arise from contractual rights, they are identifiable intangible assets. While an executory contract acquired or assumed in a business combination is required to be recognized at its fair value unless it is subject to an exception (e.g., a reacquired right), most executory contracts do not have significant fair value unless they are favorable (or unfavorable) compared with the market terms for the same or similar items as of the acquisition date or they have inherent fair value related to the price that a market participant would to pay for an in-place, at-market contract.

4.10.4.5 Technology-Based Intangible Assets

Technology-based intangible assets generally represent innovations on products or services but can also include collections of information held electronically. Many innovations and technological advances are protected by contractual or other legal rights, such as patents and copyrights, and therefore meet the contractual-legal criterion. ASC 805-20-55-38 provides the following examples of technology-based intangible assets:

a. Patented technology #

b. Computer software and mask works #

c. Unpatented technology *

d. Databases, including title plants *

e. Trade secrets, such as secret formulas, processes, recipes. #

4.10.4.5.1 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. If it can be sold with a related asset, the unpatented technology would meet the separability criterion. However, the fact that the technology is unpatented may affect its fair value measurement.
4.10.4.5.2 Computer Software and Mask Works

**ASC 805-20**

*Computer Software and Mask Works #*

55-40 Computer software and program formats acquired in a business combination that are protected legally, such as by patent or copyright, meet the contractual-legal criterion for identification as intangible assets.

55-41 Mask works are software permanently stored on a read-only memory chip as a series of stencils or integrated circuitry. Mask works may have legal protection. Mask works with legal protection that are acquired in a business combination meet the contractual-legal criterion for identification as intangible assets.

ASC 805-20-55-40 states that “[c]omputer software and program formats acquired in a business combination that are protected legally, such as by patent or copyright, meet the contractual-legal criterion for identification as intangible assets.” However, even software and program formats not protected by patent or copyright may meet the separability criterion if they can be separated or divided from the acquiree (individually or combined with a related identifiable asset, liability, or contract) and sold, transferred, licensed, rented, or exchanged.

4.10.4.5.3 Databases, Including Title Plants

**ASC 805-20**

*Databases, Including Title Plants*

55-42 Databases are collections of information, often stored in electronic form, such as on computer disks or files. A database that includes original works of authorship may be entitled to copyright protection. A database acquired in a business combination that is protected by copyright meets the contractual-legal criterion. However, a database typically includes information created as a consequence of an entity’s normal operations, such as customer lists, or specialized information, such as scientific data or credit information. Databases that are not protected by copyright can be, and often are, exchanged, licensed, or leased to others in their entirety or in part. Therefore, even if the future economic benefits from a database do not arise from legal rights, a database acquired in a business combination meets the separability criterion.

55-43 Title plants constitute a historical record of all matters affecting title to parcels of land in a particular geographical area. Title plant assets are bought and sold, either in whole or in part, in exchange transactions or are licensed. Therefore, title plant assets acquired in a business combination meet the separability criterion.

While a database acquired in a business combination that is protected by copyright would meet the contractual-legal criterion, databases that are not protected by copyright can be, and often are, exchanged, licensed, or leased to others in their entirety or in part. Such databases acquired in a business combination meet the separability criterion even if they do not arise from contractual rights unless there is a restriction on their transfer or exchange.

ASC 805-20-55-43 defines title plant as “[a] historical record of all matters affecting title to parcels of land in a particular geographical area.” The number of years covered by a title plant varies depending on regulatory requirements and the minimum information period considered necessary to issue title insurance policies efficiently. Because title plant assets are bought and sold (either in whole or in part) in exchange transactions or are licensed, they meet the separability criterion unless there is a restriction on their transfer or exchange.
4.10.4.5.4 Trade Secrets Such as Secret Formulas, Processes, and Recipes

ASC 805-20

Trade Secrets Such as Secret Formulas, Processes, Recipes #

55-44 A trade secret is "information, including a formula, pattern, recipe, compilation, program, device, method, technique, or process that (1) derives independent economic value, actual or potential, from not being generally known and (2) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy," according to The New Role of Intellectual Property in Commercial Transactions (Simensky and Breyer 1998).

55-45 If the future economic benefits from a trade secret acquired in a business combination are legally protected, that asset meets the contractual-legal criterion. Otherwise, trade secrets acquired in a business combination are identifiable only if the separability criterion is met, which is likely to be the case.

Antipiracy laws or regulations frequently exist to protect trade secrets and other intellectual property. Even a trade secret that is not protected by laws or regulations would generally be recognized as an intangible asset apart from goodwill if the separability criterion was met, which is likely to be the case. However, the value of such a trade secret might be adversely affected by the lack of legal or regulatory protection.

4.10.4.6 Examples of Intangible Assets by Industry

While some intangible assets, such as customer relationships and trade names, are common in various industries, others are specific to particular industries. The table below provides examples of intangible assets that may exist in certain industries. Intangible assets should be identified on the basis of the facts and circumstances of each transaction.

<table>
<thead>
<tr>
<th>Intangible Assets Associated With Certain Industries</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Asset Management</strong></td>
</tr>
<tr>
<td>• Account relationships</td>
</tr>
<tr>
<td>• Broker relationships</td>
</tr>
<tr>
<td>• Fund manager contracts</td>
</tr>
<tr>
<td>• Investment management contracts</td>
</tr>
<tr>
<td><strong>Banking</strong></td>
</tr>
<tr>
<td>• Brokerage relationships</td>
</tr>
<tr>
<td>• Core deposit intangibles</td>
</tr>
<tr>
<td>• Distribution channels</td>
</tr>
<tr>
<td>• Mortgage servicing rights</td>
</tr>
<tr>
<td><strong>Credit Card Issuers</strong></td>
</tr>
<tr>
<td>• Agent bank agreements</td>
</tr>
<tr>
<td>• Cardholder relationships</td>
</tr>
<tr>
<td>• Merchant relationships</td>
</tr>
<tr>
<td>• Recourse rights</td>
</tr>
<tr>
<td>• Servicing rights</td>
</tr>
<tr>
<td><strong>Consumer Products</strong></td>
</tr>
<tr>
<td>• Distribution agreements</td>
</tr>
<tr>
<td>• Employee contracts (sales representatives)</td>
</tr>
<tr>
<td>• Exclusivity agreements</td>
</tr>
<tr>
<td>• Internet domain names</td>
</tr>
<tr>
<td><strong>Energy</strong></td>
</tr>
<tr>
<td>• Easements</td>
</tr>
<tr>
<td>• Contracts; favorable/unfavorable contractual terms</td>
</tr>
<tr>
<td>• Contractual relationships</td>
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<tr>
<td>• Licenses and permits</td>
</tr>
<tr>
<td>• Rights of way; rights of use</td>
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<tr>
<td><strong>Entertainment and Media</strong></td>
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<tr>
<td>• Advertiser relationships/contracts</td>
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<tr>
<td>• Broadcast (FCC) licenses</td>
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<tr>
<td>• Carriage agreements</td>
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<tr>
<td>• Franchise rights</td>
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<tr>
<td>• Network affiliation agreements</td>
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<tr>
<td>• Programming rights</td>
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</table>
(Table continued)

<table>
<thead>
<tr>
<th>Intangible Assets Associated With Certain Industries</th>
<th>Pharmaceuticals</th>
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<tbody>
<tr>
<td><strong>Insurance</strong></td>
<td></td>
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<tr>
<td>• Distribution channels (agents/agencies)</td>
<td>• IPR&amp;D</td>
</tr>
<tr>
<td>• Insurance in-force; renewal rights; value of business acquired</td>
<td>• Partnering arrangements</td>
</tr>
<tr>
<td>• Insurance licenses; registrations</td>
<td>• Patents, product rights</td>
</tr>
<tr>
<td>• Reinsurance contracts</td>
<td>• Supplier contracts</td>
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<tr>
<td>• Service contracts; provider contracts</td>
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<tr>
<td><strong>Real Estate</strong></td>
<td></td>
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<tr>
<td>• Agency agreements</td>
<td>• Computer software</td>
</tr>
<tr>
<td>• In-place lease value</td>
<td>• Databases</td>
</tr>
<tr>
<td>• Licenses</td>
<td>• IPR&amp;D</td>
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<tr>
<td>• Listing agreements</td>
<td>• Internet domain names</td>
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<tr>
<td>• Tenant relationships</td>
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<tr>
<td><strong>Telecommunications</strong></td>
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<td>• Easements</td>
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<tr>
<td>• FCC licenses</td>
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<tr>
<td>• Licenses; rights of use</td>
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4.10.4.7 R&D Assets

Under ASC 805 and ASC 350, an acquirer recognizes all tangible and intangible R&D assets acquired in a business combination (IPR&D) at fair value as of the acquisition date and subsequently accounts for them as indefinite-lived intangible assets until completion or abandonment of the associated R&D efforts. An acquirer recognizes and measures such assets independently of (1) whether the acquiree had previously capitalized any amounts related to its R&D activities or (2) the amounts previously expended by the acquiree in connection with those activities.

An acquirer recognizes tangible and intangible assets that result from, or are to be used in, R&D activities as assets regardless of whether the acquired assets have an alternative future use. Acquired IPR&D assets must be measured at their acquisition-date fair values. Uncertainty about the outcome of an individual project does not affect the recognition of IPR&D but does affect its fair value measurement. Even though the guidance describes R&D as a single asset, ASC 730 defines the terms “research” and “development” separately, as follows:

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.
ASC 730-10 lists examples of activities that are within the scope of ASC 730, and ASC 730-10-55-2 notes those that are not.

### Examples of Activities Typically Included in Research and Development

**55-1** The following activities typically would be considered research and development within the scope of this Topic (unless conducted for others under a contractual arrangement — see paragraph 730-10-15-4[a]):

- Laboratory research aimed at discovery of new knowledge
- Searching for applications of new research findings or other knowledge
- Conceptual formulation and design of possible product or process alternatives
- Testing in search for or evaluation of product or process alternatives
- Modification of the formulation or design of a product or process
- Design, construction, and testing of preproduction prototypes and models
- Design of tools, jigs, molds, and dies involving new technology
- Design, construction, and operation of a pilot plant that is not of a scale economically feasible to the entity for commercial production
- Engineering activity required to advance the design of a product to the point that it meets specific functional and economic requirements and is ready for manufacture
- Design and development of tools used to facilitate research and development or components of a product or process that are undergoing research and development activities.

### Examples of Activities Typically Excluded From Research and Development

**55-2** The following activities typically would not be considered research and development within the scope of this Topic:

- Engineering follow-through in an early phase of commercial production
- Quality control during commercial production including routine testing of products
- Trouble-shooting in connection with break-downs during commercial production
- Routine, ongoing efforts to refine, enrich, or otherwise improve upon the qualities of an existing product
- Adaptation of an existing capability to a particular requirement or customer's need as part of a continuing commercial activity
- Seasonal or other periodic design changes to existing products
- Routine design of tools, jigs, molds, and dies
- Activity, including design and construction engineering, related to the construction, relocation, rearrangement, or start-up of facilities or equipment other than the following:
  1. Pilot plants (see [h] in the preceding paragraph)
  2. Facilities or equipment whose sole use is for a particular research and development project (see paragraph 730-10-25-2[a]).
- Legal work in connection with patent applications or litigation, and the sale or licensing of patents.

R&D activities are only considered to be within the scope of ASC 730 if they are not “conducted for others under a contractual arrangement.” If R&D activities are conducted for others under a contractual arrangement, the costs should not be recognized as part of the acquired IPR&D.

If an entity acquires IPR&D in a business combination that it intends to use in a manner other than its highest and best use (e.g., it has plans to discontinue the R&D project after the acquisition even though a marketplace participant would continue the R&D efforts), it would still be required to recognize an intangible asset at fair value for the IPR&D (see Section 4.9).
Chapter 4 — Recognizing and Measuring the Identifiable Assets Acquired and Liabilities Assumed

The guidance in ASC 805 does not affect the accounting for R&D expenditures incurred outside of a business combination. Therefore, if R&D costs related to an acquired IPR&D project are incurred after the acquisition date, an acquirer would expense them in accordance with ASC 730, unless they have an alternative future use.

Also, see Section C.3.4.2 for information about accounting for IPR&D acquired in an asset acquisition.

Once complete, R&D projects may become other identifiable assets such as patents, formulas, trade secrets, or blueprints.

The AICPA Accounting & Valuation Guide Assets Acquired to Be Used in Research and Development Activities outlines best practices for the recognition and measurement of IPR&D assets acquired in a business combination or an asset acquisition. While the guide focuses primarily on the software, electronic devices, and pharmaceutical industries, it is a useful reference for recognizing and measuring acquired IPR&D assets in all industries. The guide indicates that both of the following conditions must be met for an IPR&D asset to be recognized in a business combination:

- The acquired asset (whether tangible or intangible) meets the definition of an asset on the acquisition date and is part of what the acquirer and acquiree exchanged in the business combination.
- There is persuasive evidence that the specific IPR&D project has substance and is incomplete.

If the acquired IPR&D asset does not meet both of those criteria, it does not qualify for recognition. However, even if the acquired asset does not qualify as IPR&D, it may still be recognized in the business combination. For example, if a project has substance but is complete, the IPR&D may represent another identifiable intangible asset such as a patent, formula, trade secret, or blueprint.

4.10.4.8 Defensive Intangible Assets

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<th>ASC 350-30</th>
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**Defensive Intangible Assets**

55-1 This implementation guidance addresses the determination of whether or not an intangible asset meets the definition of a defensive intangible asset. A defensive intangible asset could include any of the following:

- An asset that the entity will never actively use
- An asset that will be used by the entity during a transition period when the intention of the entity is to discontinue the use of that asset.

55-1B The determination of whether an intangible asset is a defensive intangible asset is based on the intentions of the reporting entity and that determination may change as the reporting entity’s intentions change. For example, an intangible asset that was accounted for as a defensive intangible asset on the date of acquisition will cease to be a defensive asset if the entity subsequently decides to actively use the asset. Examples 9C and 9D (see paragraphs 350-30-55-28G through 55-28L) illustrate the determination of whether an acquired intangible asset is a defensive intangible asset.
Sometimes, an entity may acquire an asset that it either does not intend to use or intends to use in a manner other than its highest and best use. Such an asset is commonly called a defensive intangible asset, which the ASC master glossary defines as “[a]n acquired intangible asset in a situation in which an entity does not intend to actively use the asset but intends to hold (lock up) the asset to prevent others from obtaining access to the asset.” For example, an entity may decide not to use the acquired trade name of a competitor but intend to keep the name (rather than sell it) solely to prevent others from using it. In this case, the asset is determined to have value to the acquirer albeit in a defensive manner (i.e., by denying others access to its use). When measuring the fair value of a defensive intangible asset in accordance with ASC 820, an acquirer should assume its highest and best use by market participants.

The implementation guidance in ASC 350-30-55 provides examples of defensive intangible assets:

<table>
<thead>
<tr>
<th>ASC 350-30</th>
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<tbody>
<tr>
<td><strong>Example 9C: Trade Name</strong></td>
</tr>
<tr>
<td><strong>55-28H</strong> Entity A, a consumer products manufacturer, acquires an entity that sells a product that competes with one of Entity A’s existing products. Entity 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 the trade name. As a result, Entity A’s existing product is expected to experience an increase in market share. Entity A does not have any current plans to reintroduce the acquired trade name in the future.</td>
</tr>
<tr>
<td><strong>55-28I</strong> Because Entity A does not intend to actively use the acquired trade name, but intends to hold the rights to the trade name to prevent others from using it, the trade name meets the definition of a defensive intangible asset.</td>
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</table>

| **Example 9D: Internally Developed Software** |
| **55-28K** Entity A acquires a group of assets, one of which is billing software developed by the selling entity for its own use. After a six month transition period, Entity A plans to discontinue use of the internally developed billing software. In valuing the billing software in connection with the acquisition, Entity 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, Entity A does not intend to use the asset in a way that is at its highest and best use. Due to the specialized nature of the software, Entity A does not believe the software could be sold to a third party without the other assets acquired. |
| **55-28L** Although Entity A does not intend to actively use the internally developed billing software after a six month transition period, Entity A is not holding the internally developed software to prevent others from using it. Therefore, the internally developed software asset does not meet the definition of a defensive intangible asset. |
4.10.4.8.1 Subsequent Accounting for Defensive Intangible Assets

ASC 350-30

Defensive Intangible Assets

25-5 A defensive intangible asset, other than an intangible asset that is used in research and development activities, shall be accounted for as a separate unit of accounting. Such a defensive intangible asset shall not be included as part of the cost of an entity's existing intangible asset(s). For implementation guidance on determining whether an intangible asset is a defensive intangible asset, see paragraph 350-30-55-1. For guidance on intangible assets acquired in a business combination or in an acquisition by a not-for-profit entity that are used in research and development activities (regardless of whether they have an alternative future use), see paragraph 350-30-35-17A. For guidance on intangibles that are purchased from others for a particular research and development project and that have no alternative future uses (in other research and development projects or otherwise), see Subtopic 730-10.

35-5A This guidance addresses the application of paragraphs 350-30-35-1 through 35-4 to a defensive intangible asset other than an intangible asset that is used in research and development activities. A defensive intangible asset shall be assigned a useful life that reflects the entity's consumption of the expected benefits related to that asset. The benefit a reporting entity receives from holding a defensive intangible asset is the direct and indirect cash flows resulting from the entity preventing others from realizing any value from the intangible asset (defensively or otherwise). An entity shall determine a defensive intangible asset's useful life, that is, the period over which an entity consumes the expected benefits of the asset, by estimating the period over which the defensive intangible asset will diminish in fair value. The period over which a defensive intangible asset diminishes in fair value is a 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.

35-5B It would be rare for a defensive intangible asset to have an indefinite life because the fair value of the defensive intangible asset will generally diminish over time as a result of a lack of market exposure or as a result of competitive or other factors. Additionally, if an acquired intangible asset meets the definition of a defensive intangible asset, it shall not be considered immediately abandoned.

The guidance on the subsequent accounting for defensive intangible assets was developed in EITF Issue 08-7, which was codified in ASC 350-30. In Issue 08-7, the EITF concluded that intangible assets that an acquirer intends to use as defensive assets are a unit of account that is separate from any of the acquirer's existing assets. The EITF also indicated that an acquirer should assign a useful life to a defensive intangible asset that reflects the period over which the entity consumes the asset's expected benefits — that is, the direct and indirect cash flows resulting from the entity's preventing others from realizing any value from the asset (defensively or otherwise). An acquirer should determine a defensive intangible asset's useful life by estimating the period over which the asset will diminish in value, which is a proxy for the period over which the acquirer expects a defensive intangible asset to contribute directly or indirectly to its future cash flows.

While that Issue did not preclude an acquirer from assigning an indefinite life to a defensive intangible asset, the EITF concluded that it would be rare for an acquirer to do so. The fair value of a defensive intangible asset is generally expected to diminish over time as a result of a lack of market exposure, investment, competitive, and other factors. In addition, the EITF indicated that if an acquired intangible asset meets the definition of a defensive intangible asset, it cannot be considered immediately abandoned and written off.
4.10.5 Subsequent Accounting for Intangible Assets

ASC 805 clarifies that except for reacquired rights, an acquirer should apply the guidance in ASC 350-30 on the subsequent accounting for intangible assets acquired in a business combination.

4.11 Assets and Liabilities Associated With Revenue Contracts

The sections below address the accounting for assets and liabilities associated with revenue contracts after an entity adopts ASC 606. For public entities, ASC 606 became effective for annual reporting periods (including interim reporting periods within those periods) beginning after December 15, 2017. For nonpublic entities that did not elect early adoption, ASC 606 became effective for annual reporting periods beginning after December 15, 2018, and interim reporting periods within annual reporting periods beginning after December 15, 2019.

4.11.1 Contract Assets and Contract Liabilities

Before a business combination, an acquiree may have entered into revenue contracts for which it has recognized contract assets, contract liabilities, or both under ASC 606 in its preacquisition financial statements. Contract assets and liabilities that arise outside of a business combination are measured in accordance with the measurement principles in ASC 606; however, contract assets and liabilities that arise in a business combination must be measured on the basis of the guidance in ASC 805 at their acquisition-date fair values, and those values may be different from the amounts that the acquiree recognized under ASC 606. The acquisition-date fair value of a contract asset or liability measured in accordance with ASC 805 is not affected by the timing of revenue recognition after the acquisition (over time or point in time) or by the acquirer's revenue recognition policies.

See Deloitte’s *A Roadmap to Applying the New Revenue Recognition Standard* for more information.

Changing Lanes

The FASB has an active project on its agenda to address the accounting for acquired revenue contracts with customers in a business combination. Practitioners should monitor the developments in that project for potential changes.

4.11.1.1 Contract Assets

The ASC master glossary (pending content) defines a contract asset as:

> An entity’s right to consideration in exchange for goods or services that the entity has transferred to a customer when that right is conditioned on something other than the passage of time (for example, the entity’s future performance).

As described in ASC 606-10-45-1, the existence of a contract asset depends “on the relationship between the entity’s performance and the customer’s payment.” For example, a contract asset exists when an entity has a contract with a customer for which revenue has been recognized (i.e., goods or services have been transferred to the customer) but the customer’s payment is contingent on a
future event (e.g., billed on an agreed-upon future schedule or only along with completion of additional
performance obligations). Such an asset might be referred to as an unbilled receivable or as a progress
payment to be billed. If the entity’s right to consideration is contingent only on the passage of time, the
right represents a receivable.

An acquiree’s contract assets and receivables are both recognized at fair value in a business
combination and are similar in that they both represent an entity’s right to consideration for the transfer
of goods or services, but there are different risks associated with each. The fair value of a receivable
takes into account the time value of money and the customer’s credit risk (see Section 4.5), whereas
the fair value of a contract asset incorporates the same risks as receivables as well as other risks (e.g.,
risks associated with additional performance obligations or price variability). Contract assets should be
presented separately from receivables in the financial statements.

### 4.11.1.2 Contract Liabilities

The ASC master glossary (pending content) defines a contract liability as:

> An entity's obligation to transfer goods or services to a customer for which the entity has received consideration
> (or the amount is due) from the customer.

As described in ASC 606-10-45-1, the existence of a contract liability depends “on the relationship
between the entity's performance and the customer's payment.” A contract liability exists when an entity
has received consideration but has not yet transferred the promised goods or services to the customer.
Such a liability might be referred to as deferred revenue or unearned revenue.

An acquirer recognizes an assumed contract liability when the acquiree has received consideration
under a revenue contract but still retained a performance obligation (even if partially satisfied) as of the
acquisition date. The ASC master glossary (pending content) defines a performance obligation as:

> A promise in a contract with a customer to transfer to the customer either:
> a. A good or service (or a bundle of goods or services) that is distinct
> b. A series of distinct goods or services that are substantially the same and that have the same pattern of
> transfer to the customer.

ASC 606-10-25-14 through 25-22 provide guidance on identifying performance obligations. In
accordance with ASC 606-10-25-19, a promised good or service is distinct (and therefore a performance
obligation) if it is both of the following:

- **Capable of being distinct** — “The customer can benefit from the good or service either on its own
  or together with other resources that are readily available to the customer.”
- **Distinct within the context of the contract** — “The entity’s promise to transfer the good or service to
  the customer is separately identifiable from other promises in the contract.”

Under ASC 606, a performance obligation may be created not only on the basis of the terms of a
contract but also on a customer’s reasonable expectations and may include promises that are implied
by an entity’s customary business practices or industry norms.

If the acquirer determines that it has assumed an unsatisfied (or partially satisfied) performance
obligation, it recognizes a contract liability at its acquisition-date fair value, which is the amount the
acquirer would have to pay a third party to assume the liability. Under ASC 606, the contract liability
recognized on the acquiree’s preacquisition balance sheet typically represents the consideration the
acquiree received in advance from the customer, less the amount recognized for services performed to
date. Therefore, the amount recognized by the acquiree before the business combination is unlikely to
equal its fair value. After the acquisition, the acquirer recognizes revenue and derecognizes the contract liability as it satisfies its obligation by transferring the promised goods or services to the customer under the contract.

In practice, there are two methods for measuring a contract liability at fair value in accordance with ASC 820. Under one method, sometimes called the cost build-up method, the liability is measured as the direct incremental cost of fulfilling the remaining performance obligation, plus a reasonable profit margin. Such a margin should take into account the level of effort required or risk assumed by the acquirer after the acquisition date but should not include any profit related to the selling, marketing, or other efforts completed by the acquiree before the acquisition.

Under the other method, the liability is measured by using market data about the amount of revenue that an entity would earn in a transaction to provide the remaining performance obligation in the contract, less the cost of the selling effort that was already performed by the acquiree before the acquisition date, plus a reasonable profit margin on that effort. This method is less common since relevant market data are often unavailable.

Regardless of the method used, entities should perform the fair value measurement from the perspective of a market participant.

4.11.1.3 Costs of Obtaining a Contract

Before a business combination, an acquiree may have recognized an asset for the incremental costs of obtaining a contract with a customer (e.g., sales commissions) in accordance with ASC 340-40-25-1. While we do not believe that the acquirer of such an entity should recognize an asset for those costs in its postcombination financial statements, we do believe that the costs incurred to obtain a customer may be reflected in the value of another asset, such as a customer relationship intangible asset.

4.11.2 Long-Term Revenue Contracts

Long-term revenue contracts are common in the service, construction, and aerospace and defense industries, and they arise in other industries as well. If an acquiree has long-term revenue contracts that are partially complete at the time of a business combination, the acquirer must measure the assets and liabilities related to such contracts at fair value as of the acquisition date by using the principles in ASC 820, even though the assets and liabilities were probably not recognized at fair value in the acquiree’s preacquisition financial statements.

Once these assets and liabilities are recognized and measured as of the acquisition date, the acquirer will need to determine whether the revenue from these contracts should be recognized over time or at a point in time under the guidance in ASC 606. For more information about determining whether revenue should be recognized at a point in time or over time, see Deloitte’s A Roadmap to Applying the New Revenue Recognition Standard.

The fair value of any assumed contract assets or liabilities is not affected by the method that the acquirer will use to recognize revenue under the assumed contract after the acquisition. That is, regardless of the manner in which revenue is recognized, the acquirer is entitled to the same amount of cash flows from the contract and will incur the same costs.
Often, an individual revenue contract (whether long term or not) may have multiple assets or liabilities associated with it and may therefore have several units of account. For example, an acquired long-term revenue contract may include a customer relationship intangible asset, a backlog intangible asset, an asset or a liability if the pricing in the contract is not at market terms, or a contract asset or liability if costs exceeded billings or billings exceeded costs. Determining the appropriate unit of account may be difficult because of the interrelationships between the various assets and liabilities. Generally, the assets (and liabilities) would be recognized separately if the assets’ useful lives and the patterns in which their economic benefits are consumed differ. In addition, some contracts may result in the recognition of assets, and others may result in the recognition of liabilities. It is generally not appropriate to net the assets and liabilities of different contracts.

For revenue contracts that qualify for revenue recognition over time, the measure of progress should be based on the acquirer’s remaining effort after the acquisition date and should exclude the acquiree’s efforts before the acquisition. For revenue contracts that qualify for point-in-time revenue recognition, the postacquisition revenue and project costs that are eligible for capitalization should be recognized once control of the asset has been transferred to the customer.

4.11.3 Business Combinations Before the Adoption of ASC 606
An acquirer may have recognized assets or liabilities from acquired revenue contracts as part of a business combination that occurred before it adopted ASC 606. An acquired revenue contract has the same fair value regardless of whether it is subsequently accounted for under ASC 605 or ASC 606 (i.e., the cash flows related to a contract are the same regardless of the subsequent accounting). Accordingly, we believe that entities should not remeasure those assets and liabilities upon adoption of ASC 606.

Because the definitions of contract assets and contract liabilities did not exist under ASC 605, we believe that entities could recognize different assets or liabilities for acquired revenue contracts after adopting ASC 606 than they recognized under ASC 605 (e.g., a shift between a contract asset and a receivable or a customer relationship intangible asset). However, we do not believe that entities are required to reclassify the assets or liabilities recognized in association with revenue contracts upon adopting ASC 606.

4.12 Debt
An acquirer in a business combination is required to recognize any debt of the acquiree that it assumes at fair value on the acquisition date. The acquiree’s debt issuance costs do not meet the definition of an asset in FASB Concepts Statement 6. Therefore, the acquiree’s unamortized debt issuance costs are not recognized in a business combination.

Further, an acquirer may incur new debt with a third party to fund the acquisition. Such debt is neither a liability assumed in the business combination nor part of the consideration transferred.

4.12.1 Reporting Consideration Related to Debt and Other Liabilities of the Acquiree Settled at or in Close Proximity to the Acquisition Date
An acquirer may sometimes use cash to settle debt or other liabilities of the acquiree on, or in close proximity to, the acquisition date. In such cases, it is necessary to determine whether the cash distributed should be reported as consideration transferred to effect the acquisition or as cash paid to settle the debt or other liabilities assumed in the acquisition. While cash paid on the acquisition date to settle debt of the acquiree is generally reported as consideration transferred, cash paid to settle debt of the acquiree in close proximity to the acquisition date might also be reported as consideration transferred if the acquirer is deemed to not have assumed the risks inherent in the debt (e.g., when the separation of the payment from the acquisition date is more administrative).
If it is determined that the acquiree’s debt was not assumed by the acquirer, the debt repayment is considered part of the consideration transferred and is not a liability assumed in the acquisition accounting. If it is determined that the debt was assumed by the acquirer, the debt is accounted for as a liability assumed at fair value in the acquisition accounting and not part of the consideration transferred. The amount of goodwill reported will not change as a result of this determination (see Examples 4-8 and 4-9).

The acquirer should ensure that its financial statements are presented consistently throughout. That is, if it concludes that it did not assume the acquiree’s debt (i.e., that it repaid the debt on the acquiree’s behalf), the amount paid to settle the debt should be disclosed as part of the consideration transferred. In addition, the acquirer should present the payment as an investing cash outflow in a manner consistent with how it would present cash consideration paid in a business combination.

By contrast, if the acquirer concludes that it assumed the acquiree’s debt, the debt should be accounted for and disclosed as a liability assumed in the acquisition accounting. In addition, the acquirer would present the payment as a financing cash outflow in a manner consistent with how it would present the repayment of its own debt obligations outside of a business combination. See Deloitte’s *A Roadmap to the Preparation of the Statement of Cash Flows* for more information about cash flow presentation.

### Example 4-8

**Acquirer Does Not Assume Acquiree’s Debt**

Company A acquires Company B in a business combination. Before the acquisition, B had outstanding debt owed to a third-party bank. Company A pays the seller $5 million in cash and repays $1 million for the debt at the closing of the business combination. Company A concludes that it did not assume B’s debt (i.e., that it repaid the debt on B’s behalf). As of the acquisition date, B’s net assets recognized in accordance with ASC 805 are $4 million. Company A calculates the goodwill resulting from the acquisition of B as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash consideration paid to the seller</td>
<td>$5,000,000</td>
</tr>
<tr>
<td>Repayment of B’s debt</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Total consideration transferred to acquire B</td>
<td>$6,000,000</td>
</tr>
<tr>
<td>Less: B’s net assets under ASC 805</td>
<td>(4,000,000)</td>
</tr>
<tr>
<td>Goodwill</td>
<td>$2,000,000</td>
</tr>
</tbody>
</table>

Because A did not assume B’s debt, the total consideration transferred is $6 million in cash. Therefore, A should present the $6 million as an investing outflow in its statement of cash flows.
Example 4-9

**Acquirer Assumes Acquiree’s Debt**

Assume the same facts as in Example 4-8, except that Company A concludes that it assumed Company B’s debt. As a result, B’s net assets recognized in accordance with ASC 805 are $3 million (i.e., $4 million less $1 million in debt). Company A calculates the goodwill resulting from the acquisition of B as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consideration transferred to acquire B</td>
<td>$ 5,000,000</td>
</tr>
<tr>
<td>B’s net assets under ASC 805, excluding debt assumed</td>
<td>4,000,000</td>
</tr>
<tr>
<td>Add: Liability assumed for B’s debt</td>
<td>(1,000,000)</td>
</tr>
<tr>
<td>Less: B’s total net assets under ASC 805</td>
<td>(3,000,000)</td>
</tr>
<tr>
<td>Goodwill</td>
<td>$ 2,000,000</td>
</tr>
</tbody>
</table>

Because A assumed B’s debt, the consideration transferred is $5 million in cash paid to the seller, and the $1 million to repay B’s debt is a liability assumed in the acquisition accounting. Therefore, A should present $5 million as an investing outflow and $1 million as a financing outflow in its statement of cash flows.

**SEC Considerations**

Under ASC 805, an acquirer’s conclusion about whether it assumed the acquiree’s debt affects the amount of the consideration transferred in the business combination. In accordance with SEC Regulation S-X, Rule 3-05, a registrant must perform three tests to determine (1) the significance of the business acquisition or probable business acquisition and (2) whether the registrant should file the acquiree’s separate annual and interim financial statements and, if so, for which periods. The three tests are the investment test, the asset test, and the income test.

When an entity performs the investment test, the registrant’s “investment in” the acquiree is the consideration transferred under ASC 805. Debt that the acquirer assumes from the acquiree is not included as part of the consideration transferred. However, debt that is not assumed by the acquirer and is included as part of the consideration transferred would be included in the investment test.

On May 20, 2020, the SEC issued a final rule that amends SEC Regulation S-X, Rule 3-05, and the financial statement requirements for acquisitions and dispositions of businesses, including real estate operations. The final rule is effective for fiscal years beginning after December 31, 2020; however, early application is permitted. See Appendix D for more information.

### 4.12.2 Prepayment Penalty

Sometimes the acquiree’s debt must be extinguished concurrently with a business combination. For example, a debt agreement sometimes contains a preexisting a change-in-control provision. If it is determined that the debt was assumed by the acquirer (see Section 4.12.1), the debt is accounted for as a liability assumed at fair value in the acquisition accounting. If the debt contains a preexisting prepayment penalty, the terms of that provision would be factored into the fair value measurement of the debt.
4.12.3 Changes in an Acquirer’s Debt as a Result of a Business Combination

The acquirer in a business combination may have outstanding debt with provisions that result in an increase in the interest rate in the event of an acquisition. If the interest rate on the acquirer’s debt is increased as a result of the business combination, the additional interest costs are not part of the business combination transaction and therefore are not included in the consideration transferred. The additional interest costs are recognized by the acquirer as incurred or accreted. In addition, if an acquirer incurs any prepayment penalties for settling its own debt in contemplation of a business combination, such penalties should be recognized as an expense in the acquirer’s financial statements.

4.12.4 Accounting for Debt Between the Acquirer and the Acquiree in a Business Combination

A business combination may result in the effective extinguishment of debt between the acquirer and acquiree. See Section 6.2 for guidance on accounting for the settlement of such a preexisting relationship in a business combination.

4.13 Guarantees

Liabilities for guarantees made by the acquiree that are assumed by the acquirer must be measured at fair value as of the acquisition date. After assets and liabilities are initially recognized in a business combination, other GAAP generally provide accounting for them. However, ASC 460 does not provide detailed guidance on how to measure the guarantor’s liability for its obligations under the guarantee after its initial recognition. Typically, the liability that an acquirer initially recognizes as of the acquisition date would be reduced (by a credit to earnings) as it is released from risk under the guarantee. In some instances, the release from risk does not occur until the expiration of the guarantee’s settlement. ASC 460-10-35-2 states, in part:

A guarantor shall not use fair value in subsequently accounting for the liability for its obligations under a previously issued guarantee unless the use of that method can be justified under generally accepted accounting principles (GAAP). For example, fair value is used to subsequently measure guarantees accounted for as derivative instruments under Topic 815.

At the 2003 AICPA Conference on Current SEC Developments, then SEC OCA Professional Accounting Fellow Gregory Faucette stated the following:

So what do we believe the appropriate “day two” accounting for the obligation to stand ready would be? . . . It would seem a systematic and rational amortization method would most likely be the appropriate accounting. . . .

We understand that some believe that a fair value model for these guarantee liabilities and recourse obligations is the right accounting. However, we find it difficult to support such an approach in the current literature.

ASC 460 does not apply to guarantees between parents and their subsidiaries. If an acquirer and acquiree previously entered into a guarantee arrangement, the guarantee is not recognized as part of the business combination; however, the acquirer must determine whether the transaction represents the settlement of a preexisting relationship (see Section 6.2.2). The acquirer would also be subject to the disclosure requirements in ASC 460.
Chapter 4 — Recognizing and Measuring the Identifiable Assets Acquired and Liabilities Assumed

4.14 Liabilities for Exit or Restructuring Activities

**ASC 805-20**

**25-2** To qualify for recognition as part of applying the acquisition method, the identifiable assets acquired and liabilities assumed must meet the definitions of assets and liabilities in FASB Concepts Statement No. 6, Elements of Financial Statements, at the acquisition date. For example, costs the acquirer expects but is not obligated to incur in the future to effect its plan to exit an activity of an acquiree or to terminate the employment of or relocate an acquiree’s employees are not liabilities at the acquisition date. Therefore, the acquirer does not recognize those costs as part of applying the acquisition method. Instead, the acquirer recognizes those costs in its postcombination financial statements in accordance with other applicable generally accepted accounting principles (GAAP).

The costs that the acquirer expects to incur in the future related to its plans to (1) exit an activity, (2) involuntarily terminate employees, or (3) relocate the acquiree’s employees (commonly called restructuring costs) generally would not qualify as liabilities assumed in the business combination. To qualify as such, the restructuring costs would need to meet the recognition criteria in ASC 420-10 as of the acquisition date. ASC 420-10-25-2 states:

A liability for a cost associated with an exit or disposal activity is incurred when the definition of a liability included in FASB Concepts Statement No. 6, Elements of Financial Statements, is met. Only present obligations to others are liabilities under the definition. An obligation becomes a present obligation when a transaction or event occurs that leaves an entity little or no discretion to avoid the future transfer or use of assets to settle the liability. An exit or disposal plan, by itself, does not create a present obligation to others for costs expected to be incurred under the plan; thus, an entity’s commitment to an exit or disposal plan, by itself, is not the requisite past transaction or event for recognition of a liability.

An acquirer is not likely to meet the recognition criteria in ASC 420-10 as of the acquisition date unless the acquiree previously recognized a restructuring liability in accordance with ASC 420-10 in its preacquisition financial statements and the acquirer assumes that obligation. An entity should carefully examine an arrangement that the acquiree entered into after negotiations for the business combination had started to determine whether it meets the criteria to be recognized as part of the business combination (see Section 6.2).

4.15 Instruments Indexed to or Settled in Shares and Classified as Liabilities

An acquiree may have issued securities that are equity in legal form but classified and accounted for as a liability under ASC 480 or ASC 715. Regardless of their legal form or accounting classification, if the instruments remain outstanding after the business combination, an acquirer must recognize them on the acquisition date as part of the business combination and measure them at their fair value. Equity instruments classified as liabilities are not considered noncontrolling interests.

4.16 Conforming Accounting Policies

Financial statements are more transparent and relevant if the policies used to account for similar assets, liabilities, operations, and transactions are the same. Therefore, the acquirer and acquiree should conform their accounting policies in the consolidated financial statements if there is no justification for differences between them.
In some cases, an acquirer may choose to conform the accounting principles of the acquiree to its own. Because acquisition accounting results in a new basis of accounting for the acquiree, the acquirer’s accounting principles may be applied without regard to the acquiree’s previous accounting principles and there is no need to assess the preferability of the acquirer’s principles. If an acquirer chooses to change one or more of its accounting policies to conform to the acquiree’s policies, such a change would represent a voluntary change in accounting principle under ASC 250-10 and would be permitted only if the acquirer could justify the preferability of the acquiree’s accounting principle.

Only in limited circumstances is it acceptable for a parent and one or more of its subsidiaries to apply different accounting policies in the parent’s consolidated financial statements. For example, entities may have different accounting policies for inventory, or they may use one method (e.g., LIFO) to measure some inventories and another method (e.g., FIFO or average cost) to measure others. In addition, policies that are transaction-specific could result in the use of different accounting policies for similar items in the consolidated financial statements. For example, the fair value option under ASC 825-10 can generally be elected on an instrument-by-instrument basis.

Entities may sometimes be required to apply different accounting policies to comply with industry-specific guidance. ASC 810-10-25-15 states that “[f]or the purposes of consolidating a subsidiary subject to guidance in an industry-specific Topic, an entity shall retain the industry-specific guidance applied by that subsidiary.” This guidance is not intended to result in the use of multiple accounting policies but rather to retain the industry-specific guidance applied by the subsidiary in the consolidated financial statements even if the parent itself or any of its other subsidiaries are not subject to that guidance.

Moreover, the facts and circumstances may support a conclusion that a subsidiary’s accounting policies should be different from that of its parent in the subsidiary’s stand-alone financial statements. For example, a subsidiary may be acquired in a business combination in which pushdown accounting is not applied. The subsidiary would continue to apply the policies it used before the acquisition in its stand-alone financial statements, which might be different from the parent’s accounting policies. If the subsidiary wanted to adopt the parent’s policies in its stand-alone financial statements, such a change would represent a voluntary change in accounting principle under ASC 250-10 and would be permitted only if the subsidiary could justify the preferability of the parent’s accounting principle.

In addition, in its separate financial statements, a subsidiary may adopt a new standard in a period other than the period in which the parent adopts it or may use a different transition method for its adoption. In such cases, even though the subsidiary may use different accounting policies in its stand-alone financial statements, the subsidiary’s policies must be conformed to those of the parent in the parent’s consolidated financial statements.
4.17 Subsequent Measurement of Assets Acquired and Liabilities Assumed

Generally, assets acquired and liabilities assumed in a business combination are accounted for after the acquisition date in accordance with applicable GAAP on the basis of the nature of the assets and liabilities. Accordingly, ASC 805 does not provide subsequent accounting guidance for assets acquired and liabilities assumed in a business combination, except for the following:

- Indemnification assets, including those arising from government-assisted acquisitions of financial institutions — see Section 4.3.4.
- Assets and liabilities arising from contingencies — see Section 4.3.6.
- Reacquired rights — see Section 4.3.7.
- Leasehold improvements — see Section 4.3.11.1.9 after adoption of ASC 842 and Section 4.3.11.2.7 before adoption of ASC 842.
- Insurance and reinsurance contracts — see Section 4.3.12.
- Intangible assets, including R&D assets — see Section 4.10.
- Contingent consideration arrangements of an acquiree assumed by the acquirer — see Section 5.7.5.
Chapter 5 — Measurement of Goodwill or Gain From a Bargain Purchase, and Consideration Transferred in a Business Combination

This chapter discusses the fourth and final step in the acquisition method, which is recognizing and measuring goodwill or a gain from a bargain purchase. It also addresses the consideration transferred in a business combination, which is used to measure goodwill or a gain from a bargain purchase.

5.1 Measuring Goodwill

The ASC master glossary defines goodwill as “[a]n asset representing the future economic benefits arising from other assets acquired in a business combination or an acquisition by a not-for-profit entity that are not individually identified and separately recognized.” Because goodwill is not a separately identifiable asset, it cannot be measured directly. It is therefore measured as a residual and calculated as the excess of the sum of (1) the consideration transferred, (2) the fair value of any noncontrolling interest in the acquiree, and (3) the fair value of the acquirer’s previously held equity interest in the acquiree over the net of the acquisition-date values of the identifiable assets acquired and the liabilities assumed.

Occasionally, the sum of (1) through (3) above is less than the net of the acquisition-date values of the identifiable assets acquired and the liabilities assumed. In such a case, the acquirer recognizes a gain, referred to as a bargain purchase gain, in earnings on the acquisition date. Conceptually, goodwill represents both the fair values of the going-concern element of the acquired business and the expected synergies of combining the acquirer’s and acquiree’s businesses. However, because goodwill is measured as a residual, it includes other components as well.

One such component is the difference between the fair values and the amounts at which items that are exceptions to the recognition and measurement principles are recognized. ASC 805 requires entities to measure most assets, liabilities, equity interests, and items of consideration exchanged in a business combination at their fair values as of the acquisition date. However, some items exchanged in a business combination are exceptions to the recognition or measurement principle (or both) and are therefore either recognized or measured in accordance with other guidance or not recognized or measured at all.

For example, income taxes are measured in accordance with ASC 740 rather than at fair value, and preacquisition contingencies are often unrecognized in a business combination. Nonrecognition of items or recognition of items at amounts other than fair value either increases or decreases goodwill. Accordingly, while the FASB strived to reduce the number of exceptions to the fair value and recognition principles in ASC 805, exceptions still exist.
Another component of goodwill is overpayments. In paragraph B382 of the Basis for Conclusions of Statement 141(R), the FASB “acknowledged that overpayments are possible and, in concept, an overpayment should lead to the acquirer's recognition of an expense (or loss) in the period of the acquisition.” However, the Board noted that “in practice any overpayment is unlikely to be detectable or known at the acquisition date [and] is best addressed through subsequent impairment testing when evidence of a potential overpayment first arises.” Underpayments, however, are not a component of goodwill because ASC 805-30 requires entities to recognize a bargain purchase as a gain in earnings on the acquisition date (see Section 5.2).

ASC 805-30 provides the following guidance on measuring goodwill:

<table>
<thead>
<tr>
<th>ASC 805-30</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>30-1</strong> The acquirer shall recognize goodwill as of the acquisition date, measured as the excess of (a) over (b):</td>
</tr>
<tr>
<td>a. The aggregate of the following:</td>
</tr>
<tr>
<td>1. The consideration transferred measured in accordance with this Section, which generally requires acquisition-date fair value (see paragraph 805-30-30-7)</td>
</tr>
<tr>
<td>2. The fair value of any noncontrolling interest in the acquiree</td>
</tr>
<tr>
<td>3. In a business combination achieved in stages, the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree</td>
</tr>
<tr>
<td>b. The net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed measured in accordance with this Topic</td>
</tr>
</tbody>
</table>

In some business combinations, the acquirer obtains a controlling financial interest but less than 100 percent of the equity interests in the acquiree. Such acquisitions, referred to as partial acquisitions, require the acquirer to include the fair value of the noncontrolling interest in the measurement of goodwill. See Section 6.4 for more information about the accounting for partial acquisitions.

In other business combinations, an acquirer obtains a controlling financial interest in an acquiree in which it held a noncontrolling equity interest immediately before the acquisition date. For example, an acquirer may hold a 25 percent noncontrolling equity interest in a business and then acquire an additional equity interest, giving it control of the business. ASC 805 refers to such an acquisition as a business combination achieved in stages, which is also commonly referred to as a step acquisition. In a step acquisition, the acquirer must also include the fair value of its previously held interest in the goodwill calculation. See Section 6.5 for more information about the accounting for step acquisitions.

Once recognized, goodwill is tested for impairment in accordance with ASC 350-20, which also provides an accounting alternative for the subsequent accounting for goodwill for entities that do not meet the definition of a PBE or are not-for-profit entities. Such entities may elect to amortize goodwill acquired in a business combination and to use a simplified, one-step impairment test. See Chapter 8 for more information about accounting alternatives available to private companies and not-for-profit entities.
5.2 Measuring a Bargain Purchase Gain

**ASC 805-30**

25-2 Occasionally, an acquirer will make a bargain purchase, which is a business combination in which the amount in paragraph 805-30-30-1(b) exceeds the aggregate of the amounts specified in (a) in that paragraph. If that excess remains after applying the requirements in paragraph 805-30-25-4, the acquirer shall recognize the resulting gain in earnings on the acquisition date. The gain shall be attributed to the acquirer. Example 1 (see paragraph 805-30-55-14) provides an illustration of this guidance.

25-3 A bargain purchase might happen, for example, in a business combination that is a forced sale in which the seller is acting under compulsion. However, the recognition or measurement exceptions for particular items identified in paragraphs 805-20-25-16, and 805-20-30-10 also may result in recognizing a gain (or change the amount of a recognized gain) on a bargain purchase.

Bargain purchases are expected to be infrequent and should not result from recognition or measurement errors since ASC 805-30 requires the acquirer to reassess both recognition and measurement before recognizing a bargain purchase gain. ASC 805-30-25-4 and ASC 805-30-30-5 and 30-6 state the following:

**ASC 805-30**

25-4 Before recognizing a gain on a bargain purchase, the acquirer shall reassess whether it has correctly identified all of the assets acquired and all of the liabilities assumed and shall recognize any additional assets or liabilities that are identified in that review. See paragraphs 805-30-30-4 through 30-6 for guidance on the review of measurement procedures in connection with a reassessment required by this paragraph.

30-5 Paragraph 805-30-25-4 requires the acquirer to reassess whether it has correctly identified all of the assets acquired and all of the liabilities assumed before recognizing a gain on a bargain purchase. As part of that required reassessment, the acquirer shall then review the procedures used to measure the amounts this Topic requires to be recognized at the acquisition date for all of the following:

   a. The identifiable assets acquired and liabilities assumed
   b. The noncontrolling interest in the acquiree, if any
   c. For a business combination achieved in stages, the acquirer’s previously held equity interest in the acquiree
   d. The consideration transferred.

30-6 The objective of the review is to ensure that the measurements appropriately reflect consideration of all available information as of the acquisition date.

Bargain purchases could result from what might be viewed as market imperfections, including situations in which the seller may not have had adequate time to market the business and thus did not subject the sale to a competitive bidding process, or in which the seller was compelled to sell, such as in a forced liquidation or distressed sale. However, because it is expected that a seller would not accept less than fair value for its business and that additional potential buyers also would emerge to take advantage of a potential bargain and thus increase the price, bargain purchases resulting from underpayments relative to fair value do not occur frequently.
More commonly, bargain purchase gains occur because not all assets acquired or liabilities assumed are recognized or measured at their fair values. For example, an acquirer would be expected to pay less for a business that has a contingent liability associated with it, but that liability may go unrecognized when the business combination is accounted for if the liability does not meet the recognition criteria in ASC 805. The risk related to that liability would be reflected in what the acquirer paid for the acquiree, resulting in a mismatch between the consideration transferred and the net assets recognized. That mismatch could lead to the recognition of a bargain purchase gain.

If, even after reassessing both recognition and measurement, the acquirer continues to calculate a bargain purchase, the acquirer recognizes the gain in earnings. If a gain is recognized from a bargain purchase, the acquirer cannot also recognize goodwill from that acquisition because there can be only one residual amount calculated. In addition, ASC 805-30-25-2 states that if the acquirer obtains a controlling but less than a 100 percent interest in the acquiree in a partial acquisition, the gain must be attributed to the acquirer.

Under ASC 805-30-50-1(f), the acquirer must disclose the amount of the gain, the line item in which the gain is recognized, and a description of why the acquisition resulted in a gain (e.g., why the acquirer was able to acquire a business for less than its fair value or whether the gain was a result of the recognition or measurement of items at amounts other than their fair values). See Section 7.5 for more information.

ASC 805-30-55-14 through 55-16 provide an example of how to account for a bargain purchase:

<table>
<thead>
<tr>
<th>ASC 805-30</th>
<th>Example 1: Bargain Purchases</th>
</tr>
</thead>
<tbody>
<tr>
<td>55-14</td>
<td>Paragraphs 805-30-25-2 through 25-4 establish the required accounting for a bargain purchase. This Example provides additional guidance on bargain purchases and illustrates its application.</td>
</tr>
<tr>
<td>55-15</td>
<td>On January 1, 20X5, the acquiring entity, or Acquirer, acquires 80 percent of the equity interests of the acquiree, or Target, a private entity, in exchange for cash of $150. Because the former owners of Target needed to dispose of their investments in Target by a specified date, they did not have sufficient time to market Target to multiple potential buyers. The management of Acquirer initially measures the separately recognizable identifiable assets acquired and the liabilities assumed as of the acquisition date in accordance with the requirements of the Business Combinations Topic. The identifiable assets are measured at $250, and the liabilities assumed are measured at $50. Acquirer engages an independent consultant who determines that the fair value of the 20 percent noncontrolling interest in Target is $42. The amount of Target’s identifiable net assets ($200, calculated as $250 – $50) exceeds the fair value of the consideration transferred plus the fair value of the noncontrolling interest in Target. Therefore, Acquirer reviews the procedures it used to identify and measure the assets acquired and liabilities assumed and to measure the fair value of both the noncontrolling interest in Target and the consideration transferred. After that review, Acquirer decides that the procedures and resulting measures were appropriate. Acquirer measures the gain on its purchase of the 80 percent interest as follows.</td>
</tr>
<tr>
<td>Identifiable net assets acquired ($250 – $50)</td>
<td>$ 200</td>
</tr>
<tr>
<td>Less: Fair value of the consideration transferred for Acquirer’s 80 percent interest in Target; plus</td>
<td></td>
</tr>
<tr>
<td>Fair value of noncontrolling interest in Target</td>
<td>42</td>
</tr>
<tr>
<td>150</td>
<td></td>
</tr>
<tr>
<td>Gain on bargain purchase of 80 percent interest</td>
<td>192</td>
</tr>
<tr>
<td>8</td>
<td></td>
</tr>
</tbody>
</table>
5.2.1 Recognition of a Provisional Bargain Purchase Gain During the Measurement Period

As part of the initial accounting for a business combination, an acquirer may initially calculate a bargain purchase gain but may still be waiting for additional information to finalize the accounting for the business combination. In situations in which that information does not become available before the end of the reporting period, some have questioned whether the acquirer should recognize a “provisional bargain purchase gain” or whether it should defer recognition of any gain (i.e., recognize a provisional deferred credit) until the accounting for the business combination is complete.

Some have looked to the guidance in ASC 805-10-25-13 as support for recognizing a provisional bargain purchase gain in earnings of the reporting period. That guidance states that “[i]f 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.” Others have looked to the guidance in ASC 805-30-25-4 and ASC 805-30-30-5 as support for recognizing a deferred credit (i.e., a liability) rather than a provisional bargain purchase gain until the accounting for the acquisition is complete (i.e., the end of the measurement period). That guidance requires an acquirer to reassess whether it has correctly identified and measured all of the assets acquired and liabilities assumed before recognizing a gain.

We believe that either approach is acceptable. Entities should disclose (1) that the initial accounting is still provisional and the gain or deferred credit recognized may therefore be subject to future adjustments and (2) the amount of the gain or deferred credit, the line item in which it is recognized, and a description of why the acquisition may result in a gain in accordance with ASC 805-30-50-1(f). The acquirer should also provide the other disclosures required by ASC 805-20-50-4A when the initial accounting for a business combination is incomplete (see Section 7.11).

Some have suggested that a provisional gain should be recognized as a contra-asset if the acquirer believes that the gain may be related to the overstatement of a specific asset or assets, such as identifiable intangible assets, which would be confirmed once the valuations are complete. However, we believe that such an approach suggests that the acquirer’s estimates of fair value may not be appropriate, even provisionally.
5.2.2 Accounting for Income Taxes in a Business Combination That Resulted in a Bargain Purchase

The acquirer calculates the gain on the bargain purchase after the deferred taxes on the inside basis differences are recorded on the acquiree's assets and liabilities. This recognized gain increases the acquirer's investment in the acquiree and causes a corresponding increase in the acquiree's equity for financial reporting purposes. However, for tax purposes, the bargain purchase gain is generally not included in the tax basis of the investment in the acquiree. Therefore, a difference arises between the investment in the acquiree for financial reporting purposes and the investment in the acquiree for tax purposes. If deferred taxes are recorded on the outside basis difference caused by the bargain purchase gain, the tax effects would be recorded outside the business combination as a component of income tax expense. See Deloitte's *A Roadmap to Accounting for Income Taxes* for more information.

5.3 Measuring the Consideration Transferred

<table>
<thead>
<tr>
<th>ASC 805-30</th>
</tr>
</thead>
</table>

30-7 The consideration transferred in a business combination shall be measured at fair value, which shall be calculated as the sum of 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. (However, any portion of the acquirer's share-based payment awards exchanged for awards held by the acquiree's employees that is included in consideration transferred in the business combination shall be measured in accordance with paragraph 805-20-30-21 rather than at fair value.) Examples of potential forms of consideration include the following:

a. Cash  
b. Other assets  
c. A business or a subsidiary of the acquirer  
d. Contingent consideration (see paragraphs 805-30-25-5 through 25-7)  
e. Common or preferred equity instruments  
f. Options  
g. Warrants  
h. Member interests of mutual entities.

<table>
<thead>
<tr>
<th>Pending Content (Transition Guidance: ASC 718-10-65-11)</th>
</tr>
</thead>
</table>

30-7 The consideration transferred in a business combination shall be measured at fair value, which shall be calculated as the sum of 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. (However, any portion of the acquirer's share-based payment awards exchanged for awards held by the acquiree's grantees that is included in consideration transferred in the business combination shall be measured in accordance with paragraph 805-20-30-21 rather than at fair value.) Examples of potential forms of consideration include the following:

a. Cash  
b. Other assets  
c. A business or a subsidiary of the acquirer  
d. Contingent consideration (see paragraphs 805-30-25-5 through 25-7)  
e. Common or preferred equity instruments  
f. Options  
g. Warrants  
h. Member interests of mutual entities.
The consideration transferred by the acquirer to the seller is commonly in the form of cash, equity instruments of the acquirer, or a combination of both. However, it can take many other forms, including liabilities incurred to the seller (e.g., contingent consideration or a seller note). The consideration transferred in a business combination is measured at fair value as of the acquisition date, which is consistent with the fair value measurement and recognition principles of ASC 805, with one exception: replacement share-based payment awards are calculated by using a fair-value-based measure in accordance with ASC 718 (see Section 5.6).

If an acquirer transfers noncash assets to the seller as consideration in a business combination and loses control of those assets, the acquirer should remeasure them at their fair values as of the acquisition date and recognize the resulting gains or losses, if any, in earnings (see Section 5.8). However, if an acquirer transfers noncash assets to the acquiree as consideration in a business combination and does not lose control of those assets (i.e., they stay within the combined entity after the acquisition), the acquirer would not recognize a gain or loss on the acquisition date. An acquirer should not recognize a gain or loss in earnings on assets it controls both before and after an acquisition (see Section 5.8.1).

Sometimes an acquisition agreement includes payments to the seller that are not in exchange for the business, such as payments to (1) compensate for services, (2) use property, or (3) settle preexisting relationships, contracts, or disputes. Such payments should be accounted for separately from the business combination in accordance with their nature. See Section 6.2 for more information about accounting for transactions that are separate from a business combination.

Other times, a buyer and a seller may enter into a business combination and one or more other arrangements at or near the same time, such as an acquisition agreement and a supply agreement. The acquirer must assess whether such arrangements should be accounted for separately or as one single arrangement. See Section 6.3 for more information about determining whether multiple arrangements should be accounted for as one.

### 5.3.1 Consideration Held in Escrow Pending Resolution of Representation and Warranty Provisions

Acquisition agreements may require that a specified portion of the consideration be held in escrow pending resolution of the agreement’s general representation and warranty provisions. If such consideration is in the form of shares or other securities, the arrangement typically stipulates that the risks and rewards of ownership are transferred to the seller. Voting rights and any dividends related to the shares or other securities held in escrow are also generally conveyed to the seller during the escrow period.

The escrowed shares or other securities are a means for an acquirer to gain further assurance that the acquisition agreement’s representations and warranties are accurate and, if they are not, to readily obtain restitution. Representation and warranty provisions generally lapse within a short period after the acquisition date.

In the absence of evidence to the contrary, since the representations and warranties in an acquisition agreement are assumed to be accurate, release of the consideration from escrow is likely to occur. Accordingly, it is generally considered appropriate to include amounts held in escrow in the total consideration transferred as of the acquisition date. However, if the amount held in escrow is related to the outcome of an uncertain future event rather than to circumstances that existed as of the acquisition date, the acquirer should consider whether the amount is contingent consideration (see Section 5.7). The terms of each escrow arrangement must be evaluated individually.
An acquirer also should carefully evaluate the legal terms of the business combination agreement and escrow agreement to determine whether cash held in escrow should continue to be presented as an asset on the acquirer’s balance sheet (e.g., the cash is held in an account legally owned by the acquirer). If the escrowed cash still qualifies for presentation as an asset on its balance sheet, the acquirer should consider whether to recognize a corresponding liability to the seller, which would be a liability incurred to the seller and included as a component of the consideration transferred.

### 5.3.2 Working Capital Adjustments

Acquisition agreements may include provisions that adjust the consideration transferred for excesses or shortfalls in the stipulated amount of working capital as of the acquisition date as defined by the parties to the combination. Such provisions establish the amount of working capital that should exist as of the acquisition date.

Excesses or shortfalls in working capital that result in the acquirer’s payment or receipt of amounts after the acquisition date should adjust the consideration transferred if the adjustment is made before the end of the measurement period. Working capital adjustments paid or received after the end of the measurement period should be recognized in earnings.

Occasionally, disputes may arise over a working capital provision (e.g., after the acquisition date, entities might question how working capital is defined or how to measure the inputs used in its calculation). In these cases, it is necessary to evaluate whether the nature of the settlement of any such disputes represents the operation of the working capital adjustment or the settlement, in whole or in part, of a dispute arising from the business combination (see Section 6.2.6).

### 5.3.3 Ticking Fees

Some acquisition agreements include a provision stipulating that the amount paid by the acquirer is increased if the transaction closes after a specified date. Such a provision, which may be included in the initial agreement or added at a later date, is sometimes referred to as a “ticking fee” because it increases the amount the acquirer pays as more time elapses or “as the clock ticks.” Since the ticking fee begins accruing from an agreed-on date until the acquisition closes, it provides incentive to the acquirer to not unnecessarily delay the closing of the transaction. The provision may specify that the amount paid must be increased on specific dates or when a particular event occurs, or it may set out a constant rate of increase per day from the time the provision becomes effective until the closing of the transaction.

Whether included in the acquisition agreement initially or added at a later date, ticking fees are generally accounted for as part of the consideration transferred, provided that the business combination closes. In other words, the consideration transferred increases if the provision is triggered. However, entities should consider whether any overpayment resulting from the triggered provision may indicate that the goodwill is not recoverable in subsequent goodwill impairment testing under ASC 350-20 or represents payment for something other than the business acquired. See Section 6.2 for more information about accounting for transactions separately from the business combination.
5.3.4 Hedging the Commitment to Enter Into a Business Combination

ASC 815-20-25-43(c)(5) states that a “firm commitment . . . to enter into a business combination” is not eligible for designation as a fair value hedge. In addition, ASC 815-20-25-15(g) states that if a forecasted transaction involves a “business combination subject to the provisions of Topic 805,” the transaction is not eligible for “designation as a hedged transaction in a cash flow hedge.” While firm commitments may be used as economic hedges of various risks related to a business combination, they generally are not eligible for hedge accounting under ASC 815-20-25-12, ASC 815-20-25-43, and ASC 815-20-25-15(g). Rather, these instruments are treated as freestanding financial instruments on the acquirer’s books.

Accordingly, the costs of and proceeds from using these instruments (including subsequent gains and losses) are not part of the consideration transferred in a business combination and instead are accounted for in accordance with other applicable GAAP (e.g., ASC 815). For example, if a derivative is executed in connection with a business combination to economically hedge the foreign currency risk associated with the consideration to be transferred, the acquirer initially recognizes the derivative at fair value and records subsequent changes in the derivative’s fair value in earnings.

Example 5-1

Foreign Currency Hedge of a Forecasted Business Combination

On January 1, 20X0, Company A, a U.S. company whose functional currency is the U.S. dollar, announced a tender offer to acquire all of the common stock of Company B, a British company. Company A offered £6.90 for each share of B, £3.5 billion in total. The transaction is expected to close sometime in the third quarter of 20X0. Company A is exposed to foreign currency risk during the tender period because of the higher cost it would incur as a result of a strengthening of the pound. Company Z, an investment banker, has provided A with a hedging proposal under which the currency exposure would be mitigated by use of at-the-money call options on pounds. Under ASC 815-20-25-15(g), the forecasted business combination does not meet the criteria to qualify as the hedged item in a foreign currency cash flow hedge because it involves a business combination. In addition, ASC 815-20-25-43(c) states that a firm commitment to enter into a business combination cannot be the hedged item in a fair value hedge.

5.4 Acquisition-Related Costs

ASC 805-10

25-23 Acquisition-related costs are costs the acquirer incurs to effect a business combination. Those costs include finder’s fees; advisory, legal, accounting, valuation, and other professional or consulting fees; general administrative costs, including the costs of maintaining an internal acquisitions department; and costs of registering and issuing debt and equity securities. The acquirer shall account for acquisition-related costs as expenses in the periods in which the costs are incurred and the services are received, with one exception. The costs to issue debt or equity securities shall be recognized in accordance with other applicable GAAP.

Both the acquirer and the acquiree may incur costs related to effecting the business combination. Because acquisition-related costs incurred by the acquirer are not part of the fair value exchanged between the acquirer and the seller for the acquired business, those costs are accounted for separately from the business combination in accordance with their nature.
5.4.1 **Acquirer’s Acquisition-Related Costs**

The acquirer’s acquisition-related costs are the costs that the acquirer incurs to effect a business combination and include:

- **Direct costs** of the acquisition, such as third-party costs for finders’ fees as well as advisory, legal, accounting, valuation, and other professional or consulting fees.
- **Indirect costs** of the acquisition, such as general and administrative costs, including the costs of maintaining an internal acquisitions department.
- **Financing costs**, such as the costs of registering and issuing debt or equity securities to fund the acquisition.

The acquirer’s acquisition-related costs are not part of the consideration transferred. ASC 805-10-25-23 states that “[t]he acquirer shall account for acquisition-related costs as expenses in the periods in which the costs are incurred and the services are received, with one exception. The costs to issue debt or equity securities shall be recognized in accordance with other applicable GAAP.” Therefore, the acquirer should account for the direct and indirect costs of the acquisition as expenses in the periods in which the costs are incurred and the services are received.

In SAB Topic 5.A, the SEC staff states that “[s]pecific incremental costs directly attributable to a proposed or actual offering of securities may properly be deferred and charged against the gross proceeds of the offering.” Therefore, the costs to issue equity securities are generally reflected as a reduction of the amount that would have otherwise been recognized in additional paid-in capital (APIC).

SAB Topic 5.A goes on to say:

[M]anagement salaries or other general and administrative expenses may not be allocated as costs of the offering and deferred costs of an aborted offering may not be deferred and charged against proceeds of a subsequent offering. A short postponement (up to 90 days) does not represent an aborted offering.

If the acquirer incurs debt to fund the acquisition, it should present the debt issuance costs in the balance sheet as a direct deduction from the face amount of the debt and amortize the costs as interest expense in accordance with ASC 835-30-45.

**Connecting the Dots**

In April 2015, the FASB issued **ASU 2015-03**, which amends ASC 835-30 by (1) requiring “debt issuance costs related to a note [to] be reported in the balance sheet as a direct deduction from the face amount of that note” and (2) eliminating the guidance that allowed entities to report “issue costs . . . as deferred charges.”

In our discussions with the FASB staff, the staff confirmed that the ASU does not address the presentation of issuance costs associated with line-of-credit or revolving-debt arrangements. Accordingly, an entity should elect an accounting policy for the presentation of such costs.

At the EITF’s June 18, 2015, meeting, the SEC staff made an announcement clarifying that the ASU does not address issuance costs associated with revolving-debt arrangements and announced that it would “not object to an entity deferring and presenting [such] costs as an asset and subsequently amortizing the . . . costs ratably over the term of the line-of-credit arrangement.”
If an entity adopts the method outlined by the SEC staff on June 18, 2015, as its accounting policy, it would present remaining unamortized debt issuance costs associated with a line-of-credit or revolving-debt arrangement as an asset even if the entity currently has a recognized debt liability for amounts outstanding under the arrangement. Further, such costs are amortized over the life of the arrangement even if the entity repays previously drawn amounts.

The SEC staff's announcement does not address whether other accounting policies might be acceptable. Therefore, when previously drawn amounts are repaid or the remaining unamortized costs exceed the amount of the obligation, an entity is encouraged to consult with its accounting adviser before electing a policy that could result in (1) a write-off of remaining unamortized costs before the end of the term of the arrangement or (2) the presentation of a negative liability balance for the arrangement.

This guidance is limited to line-of-credit or revolving-debt arrangements that are not reported at fair value and should not be applied by analogy to other types of debt liabilities.

SAB Topic 2.A.6 discusses a scenario in which an investment banker provides both advisory services and underwriting services associated with issuing debt or equity securities in connection with a business combination and the costs are billed to the acquirer as a single amount. The interpretative response to Question 1 of SAB Topic 2.A.6 states:

Fees paid to an investment banker in connection with a business combination or asset acquisition, when the investment banker is also providing interim financing or underwriting services, must be allocated between acquisition related services and debt issue costs.

When an investment banker provides services in connection with a business combination or asset acquisition and also provides underwriting services associated with the issuance of debt or equity securities, the total fees incurred by an entity should be allocated between the services received on a relative fair value basis. The objective of the allocation is to ascribe the total fees incurred to the actual services provided by the investment banker.

While SAB Topic 2.A.6 states that “the total fees incurred by an entity should be allocated between the services received on a relative fair value basis,” we believe that the amounts allocated to debt issuance costs should result in an effective interest rate on the debt that is consistent with an effective market interest rate. Likewise, we believe that the amounts allocated to equity issuance costs should be consistent with fees an underwriter would charge.

The interpretive response to Question 2 of SAB Topic 2.A.6 also addresses the amortization of debt issue costs related to interim “bridge financing.” It states:

Debt issue costs should be amortized by the interest method over the life of the debt to which they relate. Debt issue costs related to the bridge financing should be recognized as interest cost during the estimated interim period preceding the placement of the permanent financing with any unamortized amounts charged to expense if the bridge loan is repaid prior to the expiration of the estimated period. Where the bridged financing consists of increasing rate debt, the guidance issued in FASB ASC Topic 470, Debt, should be followed. [Footnote omitted]

Any debt issuance costs allocated to bridge financing should be amortized over the estimated term of the bridge financing. If the bridge financing is repaid before the end of the originally estimated term, the unamortized amount of the debt issuance costs of such financing is written off as interest cost in accordance with ASC 340-10-999. When bridge financing consists of increasing-rate debt and term-extending debt (i.e., debt that can be extended upon maturity at the option of the issuer with specified interest rate increases each time the maturity is extended), acquirers should consider the guidance in ASC 470-10-35-1 and 35-2 and ASC 835-30 on the application of the effective interest method. They should also consider the guidance in ASC 815-15 and ASC 815-10-55-19 through 55-21 on determining whether to bifurcate embedded derivatives related to the option to extend.
5.4.1.1 **Reimbursing the Acquiree for Paying the Acquirer’s Acquisition-Related Costs**

ASC 805-10-25-21 provides examples of separate transactions that are not to be included in the application of the acquisition method, including “[a] transaction that reimburses the acquiree or its former owners for paying the acquirer’s acquisition-related costs.” Accordingly, any such payments to the acquiree or its former owners do not represent a cost of the acquisition but instead should be reflected in the acquirer’s financial statements in accordance with the payment’s nature (i.e., direct, indirect, financing), as described above.

5.4.2 **Acquiree’s Acquisition-Related Costs**

An acquiree’s acquisition-related costs associated with the business combination, such as legal fees or sell-side due diligence costs, should be recognized in the acquiree’s separate financial statements in the periods in which the services are received. On the acquisition date, the acquiree may have a liability recognized related to its acquisition-related expenses incurred but not yet paid. The acquirer may agree to pay the liability for the acquiree’s acquisition-related expenses on, or in close proximity to, the acquisition date. In such cases, it is necessary to determine whether the cash distributed should be reported as consideration transferred to effect the acquisition or as cash paid to settle a liability assumed in the acquisition. See **Section 4.12.1** for more information about making this determination.

We believe that the acquirer’s direct expenses for acquisition-related costs should not be recognized in the acquiree’s separate financial statements unless the acquirer incurred such costs on behalf of, or for the benefit of, the acquiree. The interpretive response to Question 1 of **SAB Topic 1.B.1** states that “[i]n general, the staff believes that the historical income statements of a registrant should reflect all of its costs of doing business. Therefore, in specific situations, the staff has required the subsidiary to revise its financial statements to include certain expenses incurred by the parent on its behalf.” See **Section A.12** for more information.

**SAB Topic 5.T** also discusses the concept of reflecting costs incurred by a shareholder on behalf of a company in the company’s financial statements. It states that a transaction in which “a principal stockholder pays an expense for the company, unless the stockholder’s action is caused by a relationship or obligation completely unrelated to his position as a stockholder or such action clearly does not benefit the company,” should be reflected as an expense in the company’s financial statements, with a corresponding credit to APIC. While the guidance in SAB Topics 1.B and 5.T pertains to public companies, we believe that private companies should also apply it when evaluating the recognition of acquisition-related costs.

5.4.3 **Success Fees**

In some situations, an acquirer or an acquiree may agree to make a payment to a third party (e.g., adviser, investment banker) that is contingent on the closing of the transaction. Such a payment may be called a success fee. Because there is no obligation to pay the fee until the business combination closes, we generally believe that by analogy to the guidance in ASC 805-20-55-51, it would not be appropriate for either the acquirer or the acquiree to recognize the success fee as a liability until the acquisition date. ASC 805-20-55-51, which addresses a liability that will be triggered by a business combination for contractual termination benefits and curtailment losses under employee benefit plans, states that the liability “shall not be recognized when it is probable that the business combination will be consummated; rather it shall be recognized when the business combination is consummated.”
If the success fee is the legal obligation of the acquirer, an entity recognizes it as an expense in the acquirer’s financial statements at the time of the business combination. See Section A.17.1 for guidance on accounting for expenses of the acquiree triggered by a business combination in the separate financial statements of an acquiree that applies pushdown accounting.

5.5 **Acquirer’s Equity Securities Issued as Consideration**

If the acquirer issues its equity securities (e.g., common or preferred shares, options, or warrants) as consideration in the business combination, it measures the equity securities at fair value as of the acquisition date by applying ASC 820. If its equity instruments are publicly traded, the acquirer determines the fair value on the basis of quoted market prices. If the shares are not publicly traded, the acquirer must use other valuation techniques to measure the fair value the equity instruments.

5.5.1 **Issuance of Subsidiary Shares as Consideration**

The consideration transferred in a business combination could include shares of a subsidiary of the acquirer. If so, such shares issued would be measured as of the acquisition date at fair value under ASC 820. If the acquirer retains its controlling interest in the subsidiary, the acquirer would account for the issuance of its subsidiary’s shares as an equity transaction under ASC 810-10-45-23. That guidance states that “[t]he carrying amount of the noncontrolling interest shall be adjusted to reflect the change in its ownership interest in the subsidiary” and that “[a]ny difference between the fair value of the consideration received or paid and the amount by which the noncontrolling interest is adjusted shall be recognized in equity attributable to the parent.”

5.6 **Replacement of Share-Based Payment Awards**

In a business combination, share-based payment awards held by grantees of the acquiree are often exchanged for share-based payment awards of the acquirer. ASC 805 refers to the new awards as “replacement awards.” The acquirer must analyze the terms of both the preexisting and the replacement awards to determine what portion of the replacement awards is related to precombination vesting (i.e., past goods or services) and therefore part of the consideration transferred in the business combination. The portion of replacement awards that is related to postcombination vesting (i.e., future goods or services) should be recognized as compensation cost in the postcombination period.

For more information about accounting for replacement awards in a business combination, see Deloitte’s *A Roadmap to Accounting for Share-Based Payment Awards*.

5.7 **Contingent Consideration**

The ASC master glossary defines contingent consideration as:

> Usually an obligation of the acquirer to transfer additional assets or equity interests to the former owners of an acquiree as part of the exchange for control of the acquiree if specified future events occur or conditions are met. However, contingent consideration also may give the acquirer the right to the return of previously transferred consideration if specified conditions are met.

Contingent consideration arrangements in which the acquirer may be required to make a future payment are commonly referred to as “earn-out” provisions. The acquirer and acquiree may specify future events or conditions such as (1) the acquiree’s postcombination performance measured on the basis of certain financial targets (e.g., revenue, EBITDA, or operating profit) over a specified period after the acquisition, (2) the market price of the acquirer’s shares after the acquisition, or (3) the occurrence of a discrete event, such as the FDA’s approval of a drug candidate of the acquiree that is under development as of the acquisition date.
Chapter 5 — Measurement of Goodwill or Gain From a Bargain Purchase, and Consideration Transferred in a Business Combination

5.7.1 Initial Measurement of Contingent Consideration

**ASC 805-30**

25-5 The consideration the acquirer transfers in exchange for the acquiree includes any asset or liability resulting from a contingent consideration arrangement. The acquirer shall recognize the acquisition-date fair value of contingent consideration as part of the consideration transferred in exchange for the acquiree.

Contingent consideration is part of the consideration transferred for the acquiree and therefore must be measured and recognized at fair value as of the acquisition date, which can be challenging. Acquirers need to identify the key inputs of the arrangement and use market participant assumptions when determining the fair value of contingent consideration. Key inputs may include estimated timing and the probability that the conditions or milestones in the arrangement will be met. Acquirers also need to apply judgment when assessing the probability that each potential outcome will be achieved.

Not all payments to be made to the seller in the future should be classified as contingent consideration. For example:

- Consideration held in escrow, or payments related to working capital adjustments, are not contingent consideration because they are not contingent on a future event; such amounts are payable on the basis of facts and circumstances that existed as of the acquisition date (see Sections 5.3.1 and 5.3.2).
- A conditional future payment linked to continuing employment should be accounted for as compensation in the acquirer's postcombination financial statements (see Section 6.2.3.3.1).
- Obligations to deliver consideration in the future that are not contingent on the occurrence of a future event (e.g., a seller note or a payment for the use of property) should be accounted for by using other applicable GAAP, depending on the nature of the obligation. Like contingent consideration, noncontingent obligations would generally be initially measured at fair value; however, the subsequent accounting may differ.

**Example 5-2**

**Noncontingent Arrangement to Transfer Consideration in the Future**

Company A acquires Company B for $2 million in cash in a transaction accounted for as a business combination. The acquisition agreement also obligates A to pay additional cash consideration of $1 million to the seller on the fifth anniversary of its acquisition of B. Because the obligation to transfer additional cash of $1 million is not contingent on a future event and the payment is based solely on the passage of time, the obligation is not contingent consideration but rather seller financing. Company A measures the obligation at fair value as of the acquisition date, taking into account the financing component, and includes the fair value as an element of the consideration transferred. After the acquisition, A accounts for the obligation under ASC 835-30.
5.7.2 Initial Classification of Contingent Consideration

**ASC 805-30**

25-6 The acquirer shall classify an obligation to pay contingent consideration as a liability or as equity in accordance with Subtopics 480-10 and 815-40 or other applicable generally accepted accounting principles (GAAP). For example, Subtopic 480-10 provides guidance on whether to classify as a liability a contingent consideration arrangement that is, in substance, a put option written by the acquirer on the market price of the acquirer’s shares issued in the business combination.

25-7 The acquirer shall classify as an asset a right to the return of previously transferred consideration if specified conditions are met.

While ASC 805 specifies that contingent consideration must be recognized at its acquisition-date fair value, it refers to other GAAP for determining the classification of such consideration as of the acquisition date as a liability, as equity, or (less frequently) as an asset. How an acquirer classifies a contingent consideration arrangement determines the subsequent accounting for the arrangement.

The classification of many contingent consideration arrangements will be evident. For example, arrangements are classified as liabilities if they obligate the acquirer to deliver to the seller cash, other assets, or equity securities of a third party. Similarly, contingent consideration arrangements are classified as assets (or as equity if appropriate under ASC 815-40) if they require the seller to return previously transferred consideration to the acquirer if the contingency is met in the future.

**Example 5-3**

Arrangement to Transfer Cash Consideration in the Future on the Basis of Security Prices

Company A acquires Company B for 1 million shares of A’s common stock and an agreement to pay cash if the quoted market price of A’s common stock is below $25 on the one-year anniversary of the acquisition date. The total cash, if any, paid by A on the one-year anniversary date will be the amount necessary to guarantee the $25 per share price. Because the value of the arrangement is contingent on a future event (i.e., the market price of A’s common stock), the arrangement is contingent consideration and is measured at fair value on the acquisition date. Company A concludes that this arrangement is a liability because A is obligated to deliver cash to B if the price of its common stock is below $25 on the one-year anniversary of the acquisition date.

Often, contingent consideration arrangements obligate the acquirer to deliver its own equity instruments (or the equity instruments of one of the acquirer’s substantive subsidiaries) to the seller. Determining the classification of a contingent consideration arrangement that is settleable in the acquirer’s own equity can be challenging. ASC 805 does not provide guidance on classifying such contingent consideration arrangements, but it refers to other accounting standards for guidance (generally ASC 480-10 and ASC 815). To determine the classification of a contingent consideration arrangement that is settleable in the acquirer’s own equity, an acquirer should consider the following guidance:

- ASC 480-10 on distinguishing liabilities from equity.
- ASC 815-10-15 on determining whether an arrangement meets the definition of a derivative instrument and is within the scope of ASC 815-10.
- ASC 815-40-15-5 through 15-8 on determining whether an arrangement is indexed to the acquirer’s own shares.
- ASC 815-40-25 on determining whether an arrangement is classified in equity in the acquirer’s statement of financial position.
Most contingent consideration arrangements will be classified as liabilities under the above guidance. However, entities should base their determination on their specific facts and circumstances. Depending on the complexity of the arrangement, they may decide to consult with a financial instruments specialist. The discussion below highlights some common contingent consideration scenarios but does not provide comprehensive guidance.

**Changing Lanes**

In August 2020, the FASB issued **ASU 2020-06**, which simplifies the accounting for certain financial instruments with characteristics of liabilities and equity, including convertible instruments and contracts on an entity’s own equity. ASU 2020-06 amends ASC 815-20-45 to remove some of the conditions for equity classification related to an entity’s ability to settle a contract on its own equity by delivering shares. For more information about ASU 2020-06, see Deloitte’s August 5, 2020, *Heads Up*.

**5.7.2.1 Unit of Account for Contingent Consideration Arrangements**

Before classifying a contingent consideration arrangement, an acquirer must determine the arrangement’s unit of account. Contingent consideration arrangements often specify that the issuance of shares under the arrangement depends on whether successive or cumulative performance targets (e.g., earnings or revenues) for the acquired entity are met. For example, an arrangement may require the entity to deliver (1) 100,000 of its equity shares if the subsidiary’s revenue exceeds $100 million in the first year after the acquisition and (2) an additional 50,000 of its equity shares if the subsidiary’s revenue exceeds $125 million in the second year after the acquisition. If so, the entity should evaluate whether the contingent consideration arrangement contains one or multiple units of account.

The entity’s determination of whether the contingent arrangement contains one or multiple units of account may affect whether the arrangement qualifies as equity in whole or in part. If an entity determines that an arrangement includes multiple payment conditions, triggers, or targets that are independent of one another and that would, if met, result in the issuance of specified consideration regardless of whether any other targets were met, each target-based payment is treated as a separate unit of account (contract) that must be assessed for classification. If the payment conditions or targets are cumulative or not independent of one another, the arrangement is considered one contract that requires delivery of a variable number of shares.
The following are examples that illustrate this approach to identifying the appropriate units of account for contingent consideration arrangements:

<table>
<thead>
<tr>
<th>Contingent Consideration Arrangement — Acquirer Must Deliver 10,000 of Its Equity Shares to the Seller if the Acquiree:</th>
<th>Analysis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Has earnings of at least $100 million in the year after the acquisition (otherwise, no shares will be delivered).</td>
<td>One unit of account. There is only one payment condition and target.</td>
</tr>
<tr>
<td>Has earnings of at least $100 million in the first year after the acquisition (otherwise, no shares will be delivered at the end of the first year). In addition, the acquirer must deliver 10,000 of its equity shares if the acquiree has earnings of at least $100 million in the second year after the acquisition (otherwise, no shares will be delivered at the end of the second year).</td>
<td>Two units of account. There are two independent payment conditions and targets.</td>
</tr>
<tr>
<td>Has earnings of at least $100 million in the year after the acquisition. The acquirer will deliver an additional 5,000 shares if earnings in that year exceed $125 million. Otherwise, no shares will be delivered.</td>
<td>One unit of account. There are two targets, but they cover the same period, and that period has multiple outcomes.</td>
</tr>
<tr>
<td>Has earnings of at least $100 million in the first year after the acquisition (otherwise, no shares will be delivered at the end of the first year). In addition, the acquirer is required to deliver 10,000 of its equity shares if the acquiree has cumulative earnings of at least $200 million in the first two years after the acquisition (otherwise, no shares will be delivered at the end of the second year).</td>
<td>Two units of account. There are two targets that cover different periods.</td>
</tr>
</tbody>
</table>

For more information about determining the unit of account for contingent consideration arrangements, see Deloitte’s *A Roadmap to Accounting for Contracts on an Entity’s Own Equity*.

### 5.7.2.2 Distinguishing Liabilities From Equity Under ASC 480-10

ASC 480-10 establishes standards for an issuer’s classification of certain financial instruments with characteristics of both liabilities and equity. Contingent consideration arrangements that obligate an acquirer to deliver its own equity instruments meet the definition of a financial instrument. We believe that a contingent consideration arrangement must be analyzed as if it is a separate freestanding instrument. ASC 480-10 requires a freestanding financial instrument to be classified as a liability (or, in some circumstances, an asset) if the instrument has any of the following characteristics:

1. It is mandatorily redeemable (e.g., the instrument unconditionally requires the issuer to redeem it by transferring its assets on a specified date (or dates) or upon an event that is certain to occur other than liquidation or termination of the reporting entity).
2. It is not an outstanding share and, at inception, embodies an obligation to repurchase the issuer’s equity shares (e.g., forward purchase contracts or written put options that are to be physically settled) or is indexed to such an obligation (e.g., a warrant on puttable shares or a written put option that is cash settled) and requires or may require the issuer to settle the obligation by transferring assets.
3. It will or may be settled by the issuance of a variable number of the issuer’s shares, and at inception the monetary value of the instrument is solely or predominantly based on any one of the following:
   a. A fixed amount (e.g., a payable for a fixed amount that is settleable with a variable number of the issuer’s equity shares).
b. Being derived from something other than the fair value of the issuer’s equity shares (e.g., an obligation to deliver shares indexed to the S&P 500 and settleable with a variable number of the issuer’s equity shares).

c. Movement in a direction opposite to the value of the issuer’s equity shares (e.g., a written put option that can be net share settled).

Contingent consideration arrangements are often evaluated under the third item above because they involve instruments that require delivery of the acquirer’s shares, and the value of the obligation is solely or predominantly based on whether certain contingencies or target thresholds are met. If an arrangement varies on the basis of the extent to which contingencies or metrics are met (e.g., the number of shares delivered depends on how much EBITDA exceeds a target), we believe that a determination of whether it is within the scope of ASC 480 depends on whether its monetary value, at inception, is based solely or predominantly on the exercise contingency (e.g., EBITDA or revenue target) or share price. If the monetary value is based solely or predominately on the exercise contingency, the arrangement is likely to be classified as a liability under ASC 480. If, however, the monetary value is based solely or predominately on the share price, the arrangement is likely to be outside the scope of ASC 480, but entities would need to consider the guidance in ASC 815. Further, we believe that the determination of whether an arrangement’s monetary value, at inception, is based solely or predominately on the exercise contingency or share price depends on the entity’s particular facts and circumstances.

ASC 480 discusses the underlying in a contingent consideration arrangement and notes that instruments that “solely or predominantly” vary on the basis of something other than the entity’s shares do not qualify for equity treatment.

Since ASC 805 specifically addresses the subsequent measurement of contingent consideration, the subsequent measurement guidance in ASC 480 does not apply. See Section 5.7.3 for more information about subsequent measurement of the contingent consideration.

**Example 5-4**

**Determining the Classification of Contingent Consideration Under ASC 480-10 — Issuance of a Fixed Number of the Acquirer’s Shares if an Earnings Target Is Met**

Company A acquires Company B for 1 million shares of A’s common stock and an agreement to issue an additional 250,000 shares if B’s earnings exceed a specified target for the 12-month period after the acquisition.

The terms of the contingent consideration arrangement obligate A to issue a fixed number of its shares if the earnings target is met. The arrangement is not within the scope of ASC 480-10 because it (1) is not mandatorily redeemable, (2) does not embody an obligation to repurchase the issuer’s equity shares, and (3) does not obligate A to deliver a variable number of its shares. While the obligation does require A to deliver its own shares, the number of shares delivered is fixed at 250,000. However, A still must consider whether it has to classify the arrangement as a liability in accordance with ASC 815-40 (see Example 5-8).
Example 5-5

Determining the Classification of Contingent Consideration Under ASC 480-10 — Issuance of a Fixed Number of the Acquirer’s Shares for Each Year That Earnings Exceed a Specified Amount

Company A acquires Company B for 1 million shares of A’s common stock and an agreement to issue, for five years, an additional 25,000 shares for each 12-month postacquisition period in which B’s earnings exceed $2 million. The shares must be issued within a reasonable period after the end of each year in which the earnings target is achieved.

Because each yearly delivery of the 25,000 shares is independent of the others, the arrangement is considered five separate units of account. The arrangements are not within the scope of ASC 480-10 because each arrangement (1) is not mandatorily redeemable, (2) does not embody an obligation to repurchase the issuer’s equity shares, and (3) does not obligate A to deliver a variable number of its shares. However, A still must consider whether it has to classify the arrangements as liabilities in accordance with ASC 815-40 (see Example 5-9).

Example 5-6

Determining the Classification of Contingent Consideration Under ASC 480-10 — Issuance of a Variable Number of the Acquirer’s Shares as a Security Price Guarantee

Company A acquires Company B for 1 million shares of A’s common stock and an agreement to issue additional shares if the quoted market price of A’s common stock is below $25 on the one-year anniversary of the acquisition date. The number of shares, if any, that A will issue will be the amount necessary to guarantee the price of $25 per share.

In accordance with ASC 480-10-25-14(c), A concludes that this arrangement should be classified as a liability because it requires A to settle the obligation by issuing a variable number of its own equity shares, the monetary value of which move in the direction opposite to the value of its shares.

Example 5-7

Determining the Classification of Contingent Consideration Under ASC 480-10 — Issuance of a Fixed Number of the Acquirer’s Shares for Each Increment of Earnings That Exceeds a Specified Amount

Company A acquires Company B for 1 million shares of A’s common stock and an agreement to issue an additional 25,000 shares for each $500,000 increment of B’s earnings that exceeds $2 million, not to exceed $5 million for the 12-month period after the acquisition.

Because each delivery of 25,000 increment of shares is not independent of the others, the arrangement is one unit of account. In accordance with ASC 480-10-25-14(b), A concludes that the arrangement should be classified as a liability because it requires A to issue a variable number of its shares, the value of which is derived from something other than the fair value of A’s equity shares (derived from B’s earnings over a 12-month period).

5.7.2.3 Definition of a Derivative in ASC 815-10-15

To determine whether a contingent consideration arrangement that is settleable in an acquirer’s own equity is a derivative instrument, the acquirer must consider the guidance in ASC 815-10-15-83, which states that a derivative is a financial instrument or other contract with all of the following characteristics:

- It has one or more underlyings and notional amounts or payment provisions or both.
- It has “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 [respond similarly] to changes in market factors.”
- It can be net settled.
A contingent consideration arrangement that is a derivative is classified as a liability unless the arrangement meets a scope exception that allows equity classification. ASC 815-10-15-74(a) provides a scope exception for an entity's contracts that are both (1) indexed to the entity's own shares and (2) classified in equity in the entity's statement of financial position.

### 5.7.2.4 Indexed to the Acquirer's Own Shares Under ASC 815-40-15

ASC 815-40-15-5 through 15-8 discuss how to determine whether a contingent consideration arrangement that is settleable in an acquirer's own equity is indexed to the acquirer's own shares. Under that guidance, an acquirer performs the two-step evaluation discussed below.

#### 5.7.2.4.1 Step 1 — Evaluate Contingent Exercise Provisions

Contingent consideration, by its nature, has an exercise contingency, which the ASC master glossary defines as “a provision that entitles the entity (or the counterparty) to exercise an equity-linked financial instrument (or embedded feature) based on changes in an underlying, including the occurrence (or nonoccurrence) of a specified event.” For example, exercise contingencies include provisions that:

- Affect whether an instrument becomes exercisable or settleable.
- Accelerate the timing of (1) an entity's ability to exercise an instrument or (2) the settlement of an instrument.
- Extend or defer the timing of (1) an entity's ability to exercise an instrument or (2) the settlement of an instrument.
- Result in the cancellation of an instrument.

An arrangement with an exercise contingency is not necessarily classified as a liability. According to ASC 815-40-15-7A, the only contingent exercise provisions that would preclude an arrangement from being considered indexed to the entity's own shares are those that are based on either of the following (emphasis added):

- “An observable market, other than the market for the issuer's stock (if applicable).”
- “An observable index, other than an index calculated or measured solely by reference to the issuer's own operations (for example, sales revenue of the issuer; earnings before interest, taxes, depreciation, and amortization of the issuer; net income of the issuer; or total equity of the issuer).”

ASC 815-40-15-5C indicates that an instrument is not precluded from being considered indexed to the entity's own shares under ASC 815-40-15-5 through 15-8 if the payoff is based, in whole or in part, on the shares of a consolidated subsidiary as long as the subsidiary is a substantive entity. If the subsidiary is not a substantive entity, the instrument is not considered to be indexed to the entity's own shares. If an acquiree meets the definition of a business in ASC 805 and is therefore substantive, we believe that the guidance in ASC 815-40-15-5C applies and that a contingent consideration arrangement based on the performance of the acquired business can be considered indexed to the entity's shares. ASC 815-40-15-5C clarifies that the guidance applies regardless of whether the parent or consolidated subsidiary entered into the arrangement.

If the exercise contingency does not preclude an arrangement from being considered indexed to the acquirer's own shares, the next step is to evaluate the settlement provisions.

For additional discussion of the effect of exercise contingencies on the classification of a contract, see Deloitte's *A Roadmap to Accounting for Contracts on an Entity's Own Equity*. 
5.7.2.4.2 Step 2 — Evaluate Settlement Provisions

ASC 815-40-15-7C states, in part, that an arrangement is considered indexed to an entity's own shares if its settlement amount will equal the difference between:

- "The fair value of a fixed number of the entity's equity shares."
- "A fixed monetary amount."

In addition, ASC 815-40-15-7D states:

An instrument’s strike price or the number of shares used to calculate the settlement amount are not fixed if its terms provide for any potential adjustment [to the strike price or number of shares used to calculate the settlement amount], regardless of the probability of such adjustment(s) or whether such adjustments are in the entity's control. If the instrument's strike price or the number of shares used to calculate the settlement amount are not fixed, the instrument (or embedded feature) shall still be considered indexed to an entity's own stock if the only variables that could affect the settlement amount would be inputs to 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 (1) the entity's share price, (2) the strike price of the instrument, (3) the term of the instrument, (4) expected dividends or other dilutive activities, (5) share borrow cost, (6) interest rates, (7) share price volatility, (8) the entity's credit spread, and (9) the ability to maintain a standard hedge position in the underlying shares.

An instrument cannot be considered indexed to the entity's own shares if (1) the instrument's settlement calculation incorporates variables other than those used to determine the fair value of a fixed-for-fixed forward or an option on equity shares or (2) the instrument contains a feature (such as a leverage factor) that increases exposure to the additional variables listed in the preceding paragraph in a manner that is inconsistent with a fixed-for-fixed forward or an option on equity shares.

For additional discussion of the effect of settlement provisions on the classification of a contract, see Deloitte’s *A Roadmap to Accounting for Contracts on an Entity’s Own Equity*.

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**Example 5-8**

**Determining the Classification of Contingent Consideration Under ASC 815-40-15 — Issuance of a Fixed Number of the Acquirer's Shares on the Basis of an Earnings Target**

Company A acquires Company B for 1 million shares of A's common stock and an agreement to issue an additional 250,000 shares if the earnings of B exceed a specified target for the 12-month period after the acquisition. Company A determined that this arrangement is not within the scope of ASC 480-10 (see Example 5-4) and concluded as follows as a result of performing the two-step assessment in ASC 815-40-15-5 through 15-8:

- **Step 1** — The exercise contingency (i.e., exceeding the earnings target) is based on an observable index, but it can only be measured by reference to B's operations. Therefore, step 1 does not preclude A from considering the contingent consideration arrangement to be indexed to its own shares.
- **Step 2** — The settlement amount is considered fixed-for-fixed because it equals the difference between the fair value of a fixed number of A's shares (i.e., the fair value of 250,000 of A's own shares) and a fixed exercise price (i.e., zero).

The contingent consideration arrangement is therefore considered indexed to A's own shares. However, A still must determine whether the arrangement qualifies for equity classification or must be classified as a liability in accordance with ASC 815-40-25.
Example 5-9

**Determining the Classification of Contingent Consideration Under ASC 815-40-15 — Issuance of a Fixed Number of the Acquirer’s Shares for Each Year That Earnings Exceed a Specified Amount**

Company A acquires Company B for 1 million shares of A’s common stock and an agreement to issue an additional 25,000 shares for each 12-month postacquisition period in which B’s earnings exceed $2 million for five years. In each year in which the earnings target is achieved, the shares must be issued within a reasonable period after the end of the year.

Because each yearly delivery of the 25,000 shares is independent of the others, the arrangement is considered to contain five units of account. Company A determined that this arrangement is not within the scope of ASC 480-10 and concluded the following as a result of performing the two-step assessment in ASC 815-40-15-5 through 15-8 (see Example 5-5):

- **Step 1** — The exercise contingency (i.e., exceeding the earnings target) is based on an observable index, but it can be measured only by reference to B’s operations. Therefore, step 1 does not preclude each arrangement from being considered indexed to A’s own shares.
- **Step 2** — The settlement amount is considered fixed-for-fixed because it equals the difference between the fair value of a fixed number of A’s shares (i.e., the fair value of 25,000 of A’s own shares) and a fixed exercise price (i.e., zero).

The five separate contingent consideration arrangements are therefore considered indexed to A’s own shares. However, A still must consider whether the arrangement qualifies for equity classification or must be classified as a liability in accordance with ASC 815-40-25.

Example 5-10

**Determining the Classification of Contingent Consideration Under ASC 815-40-15 — Issuance of a Fixed Number of the Acquirer’s Shares as a Security Price Guarantee**

Company A acquires Company B for 1 million shares of A’s common stock and an agreement to issue an additional 25,000 shares if the quoted market price of A’s common stock is below $25 on the one-year anniversary of the acquisition date. Company A determined that this arrangement is not within the scope of ASC 480-10 and concluded the following as a result of performing the two-step assessment in ASC 815-40-15-5 through 15-8:

- **Step 1** — The exercise contingency (i.e., the quoted market price of A’s common stock is below $25 on the one-year anniversary) is based on an observable market, but it is the market for A’s shares. Therefore, step 1 does not preclude the arrangement from being considered indexed to A’s own shares.
- **Step 2** — The settlement amount is considered fixed-for-fixed because it equals the difference between the fair value of a fixed number of A’s shares (i.e., the fair value of 25,000 of A’s own shares) and a fixed exercise price (i.e., zero).

The contingent consideration arrangement is therefore considered indexed to A’s own shares. However, A still must consider whether the arrangement qualifies for equity classification or must be classified as a liability in accordance with ASC 815-40-25.
Example 5-11

**Determining the Classification of Contingent Consideration Under ASC 815-40-15 — Issuance of a Fixed Number of the Acquirer’s Shares on the Basis of an Observable Market Increase**

Company A acquires Company B for 1 million shares of A’s common stock and an agreement to issue an additional 25,000 shares in three years if the S&P 500 Index increases 1,000 points within any given calendar year during that three-year period. The arrangement meets the definition of a derivative instrument in ASC 815-10-15. Company A determined that this arrangement is not within the scope of ASC 480-10 and concluded the following as a result of performing the two-step assessment in ASC 815-40-15-5 through 15-8:

- **Step 1** — The exercise contingency (i.e., a 1,000-point increase in the S&P 500 Index) is based on an observable index that is not measured solely by reference to A’s (or B’s) own operations. Therefore, the arrangement is not considered indexed to A’s own shares.

- **Step 2** — Not necessary.

The contingent consideration arrangement is not indexed to A’s shares. Since the arrangement does not qualify for equity classification in accordance with ASC 815-40-25, it must be classified as a liability.

Example 5-12

**Determining the Classification of Contingent Consideration Under ASC 815-40-15 — Issuance of a Fixed Number of the Acquirer’s Shares on the Basis of Regulatory Approval**

Company A acquires Company B for 1 million shares of A’s common stock and an agreement to issue an additional 250,000 shares if B obtains regulatory approval for a drug within three years of the acquisition date. Company A determined that this arrangement is not within the scope of ASC 480-10 and concluded the following as a result of performing the two-step assessment in ASC 815-40-15-5 through 15-8:

- **Step 1** — The exercise contingency (i.e., obtaining regulatory approval) is not based on an observable market or index. Therefore, step 1 does not preclude the arrangement from being considered indexed to A’s own shares.

- **Step 2** — The settlement amount is considered fixed-for-fixed because it equals the difference between the fair value of a fixed number of A’s shares (i.e., the fair value of 250,000 of A’s own shares) and a fixed exercise price (i.e., zero).

The contingent consideration arrangement is therefore considered indexed to A’s own shares. However, A still must consider whether the arrangement qualifies for equity classification or must be classified as a liability in accordance with ASC 815-40-25.

5.7.2.5 **Determining Whether Contingent Consideration Is Classified as Equity Under ASC 815-40-25**

If the acquirer determines that a contingent consideration arrangement (1) is not required to be classified as a liability under ASC 480-10 and (2) is indexed to the entity’s own shares under ASC 815-40-15-5 through 15-8, the acquirer must consider whether the arrangement meets the criteria in ASC 815-40-25 to be classified in equity. If an entity determines that a contingent consideration arrangement is indexed to the entity’s own shares, it applies the guidance in ASC 815-40-25, which generally permits equity classification for instruments that require settlement in their own shares (physical settlement or net share settlement) or gives the issuer a choice of net cash settlement or physical settlement as long as certain conditions are met.
A contingent consideration arrangement that is not precluded from equity classification under ASC 480-10 and ASC 815-40-15 may be classified in equity only if it meets all of the following conditions in ASC 815-40-25:

- It is required to be physically settled in shares or net share settled or the acquirer has a choice of net cash settlement or settlement in shares (either net share settlement or physical settlement).
- If an event could trigger net cash settlement that is outside the issuer’s control, the arrangement requires net cash settlement only in specific circumstances in which holders of shares underlying the contract also would receive cash in exchange for their shares.
- It permits the acquirer to settle in unregistered shares.
- The acquirer has sufficient authorized and unissued shares to settle the contract. In making that determination, the acquirer must consider all other commitments or potentially dilutive instruments (e.g., options, warrants, convertible arrangements) that may require the issuance of shares during the maximum period the arrangement could remain outstanding.
- The arrangement contains an explicit limit on the number of shares to be delivered in a share settlement (but see Changing Lanes discussion below).
- There are no required cash payments to the seller in the event the acquirer fails to make timely filings with the SEC.
- There are no cash-settled top-off or make-whole provisions.
- There are no provisions in the arrangement that indicate that the seller has rights that rank higher than those of a holder of the shares underlying the contract (but see Changing Lanes discussion below).
- There is no requirement in the contract to post collateral at any point or for any reason (but see Changing Lanes discussion below).

These conditions are discussed in detail in ASC 815-40-25, and entities should consider them carefully in determining whether an arrangement would be classified in equity. In addition, entities must reassess a contingent consideration arrangement as of each reporting date. If equity classification is no longer appropriate, the arrangement must be reclassified as a liability. Similarly, if equity classification becomes appropriate, the arrangement must be reclassified as equity. For additional discussion, see Deloitte’s *A Roadmap to Accounting for Contracts on an Entity’s Own Equity*.

### Changing Lanes

In August 2020, the FASB issued ASU 2020-06, which simplifies the accounting for certain financial instruments with characteristics of liabilities and equity, including convertible instruments and contracts on an entity’s own equity. ASU 2020-06 amends ASC 815-20-45 to remove the following three conditions for equity classification related to an entity’s ability to settle a contract on its own equity by delivering shares:

- Settlement permitted in unregistered shares; however, the ASU clarifies that if a contract explicitly states that cash settlement is required if registered shares are unavailable, the contract will not qualify as equity.
- There are no provisions in the arrangement that indicate that the seller has rights that rank higher than those of a holder of the shares underlying the contract.
- There is no requirement in the contract to post collateral at any point or for any reason.

For more information about ASU 2020-06, see Deloitte’s August 5, 2020, *Heads Up*. 
**Example 5-13**

**Determining the Classification of Contingent Consideration Under ASC 815-40-25 — Issuance of a Fixed Number of the Acquirer's Shares on the Basis of an Earnings Target**

Company A acquires Company B for 1 million shares of A's common stock and an agreement to issue an additional 250,000 shares if the earnings of B exceed a specified target for the 12-month period after the acquisition. The arrangement was previously determined (1) not to be within the scope of ASC 480-10 (see Example 5-4) and (2) to be indexed to A's shares in accordance with ASC 815-10-15 (see Example 5-8).

The arrangement requires A to physically deliver shares to the former owners if the contingency is met. In addition, A must consider the other conditions in ASC 815-10-25 for equity classification, including:

- Whether the arrangement limits the number of shares A would have to deliver (250,000).
- Whether A has sufficient authorized and unissued shares. In making that determination, A must consider all of its other commitments and any potentially dilutive instruments that may require the issuance of its shares during the 12-month period in which the arrangement will be outstanding.

After reviewing all of its other arrangements (e.g., options, warrants, convertible arrangements), A determines that it has sufficient shares available. Further, the arrangement does not include any:

- Provisions that require A to settle in registered shares.
- Required cash payments to the former owners if the acquirer fails to make timely filings with the SEC.
- Cash-settled top-off or make-whole provisions.
- Provisions that indicate that the former owners have rights that rank higher than those of a shareholder of the shares underlying the contract.
- Requirements related to posting collateral.

If the above criteria are met, and after considering the guidance in ASC 480-10, ASC 815-40-15, and ASC 815-40-25, A could conclude that the contingent consideration arrangement qualifies for equity classification.

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**5.7.3 Subsequent Accounting for Contingent Consideration**

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Some changes in the fair value of contingent consideration that the acquirer recognizes after the acquisition date may be the result of additional information about facts and circumstances that existed at the acquisition date that the acquirer obtained after that date. Such changes are measurement period adjustments in accordance with paragraphs 805-10-25-13 through 25-18 and Section 805-10-30. However, changes resulting from events after the acquisition date, such as meeting an earnings target, reaching a specified share price, or reaching a milestone on a research and development project, are not measurement period adjustments. The acquirer shall account for changes in the fair value of contingent consideration that are not measurement period adjustments as follows:

a. Contingent consideration classified as equity shall not be remeasured and its subsequent settlement shall be accounted for within equity.

b. Contingent consideration classified as an asset or a liability shall be remeasured to fair value at each reporting date until the contingency is resolved. The changes in fair value shall be recognized in earnings unless the arrangement is a hedging instrument for which Topic 815 requires the changes to be initially recognized in other comprehensive income.
A contingent consideration arrangement that is classified as an asset or a liability is remeasured at fair value each reporting period until the contingency is resolved. The acquirer recognizes changes in fair value in earnings each period unless it designates the arrangement as a cash flow hedging instrument that is subject to ASC 815-10.

If the contingent consideration is classified as an equity instrument, it is not remeasured. The initial amount recognized for contingent consideration classified as equity is not adjusted even if the fair value of the arrangement changes. The subsequent settlement of the arrangement on the date the contingency is resolved is accounted for in equity.

Adjustments made during the measurement period that pertain to facts and circumstances that existed as of the acquisition date are recognized as adjustments to goodwill. The acquirer must consider all pertinent factors in determining whether information obtained after the acquisition date should result in an adjustment to the provisional amounts recognized or whether that information results from events that occurred after the acquisition date. Changes in fair value resulting from events that occur after the acquisition date are recognized in earnings and not as adjustments to goodwill.

ASC 350-20-35-30 requires entities to test a reporting unit’s goodwill for impairment between annual dates if an event occurs or circumstances change that would more likely than not reduce the reporting unit’s fair value below its carrying amount. The acquirer should consider whether a reduced likelihood that a contingent consideration payment will be made is an indicator of impairment for any reporting units to which the arrangement is related (e.g., the earnings targets specified in an arrangement are no longer expected to be achieved or the likelihood of achievement is significantly reduced).

Example 5-14

Subsequent Accounting for a Contingent Consideration Arrangement Classified as a Liability

Company A acquires Company B for $15 million and an agreement to pay an additional $6 million to the former owners if the cumulative net income of B reaches $10 million within three years of the acquisition date. The contingent consideration arrangement is classified as a liability and has an acquisition-date fair value of $4 million.

At the end of each reporting period after the acquisition date, the arrangement is remeasured at its fair value, with changes in fair value recorded in earnings. For example, if the likelihood of meeting the target increases, the fair value of the contingent consideration would most likely increase. If the target is met and the $6 million contingent consideration is payable, $2 million will have been recorded cumulatively in the income statement (the difference between the $6 million payment and the $4 million originally recorded on the acquisition date) by the time the $6 million is paid. Conversely, if the contingency is not met or its fair value declines, any accrued liability would be reversed in the income statement.

5.7.4 Effect of Contingently Issuable Equity on EPS Calculations

Contingent consideration agreements under which the acquirer is obligated to issue additional common shares upon resolution of a contingency may affect the acquirer’s computation of EPS, if presented, during the contingency period. ASC 260-10-45-13 and ASC 260-10-45-48 through 45-57 address the accounting for contingently issuable shares. Such shares, which include shares placed in escrow and shares that are issued but contingently returnable, are those whose issuance is contingent on the satisfaction of certain conditions. An agreement that requires an entity to issue common shares or potential common shares after the mere passage of time is not considered a contingently issuable share arrangement because the passage of time is not a contingency.

For additional discussion of the effect of contingently issuable shares on EPS calculations, see Deloitte’s *A Roadmap to the Presentation and Disclosure of Earnings per Share*.
5.7.5  **Acquiree Contingent Consideration Arrangements Assumed by the Acquirer**

If an acquired entity was a party to a contingent consideration arrangement from a previous business combination, the accounting would depend on whether the acquiree was the acquirer or the acquiree in that previous transaction.

### 5.7.5.1  **Acquiree Was the Acquirer in a Previous Business Combination**

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<thead>
<tr>
<th>ASC 805-20</th>
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<tbody>
<tr>
<td><strong>25-15A</strong> Contingent consideration arrangements of an acquiree assumed by the acquirer in a business combination shall be recognized initially at fair value in accordance with the guidance for contingent consideration arrangements in paragraph 805-30-25-5.</td>
</tr>
<tr>
<td><strong>30-9A</strong> Contingent consideration arrangements of an acquiree assumed by the acquirer in a business combination shall be measured initially at fair value in accordance with the guidance for contingent consideration arrangements in paragraph 805-30-25-5.</td>
</tr>
<tr>
<td><strong>35-4C</strong> Contingent consideration arrangements of an acquiree assumed by the acquirer in a business combination shall be measured subsequently in accordance with the guidance for contingent consideration arrangements in paragraph 805-30-35-1.</td>
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<th>ASC 805-30</th>
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<tbody>
<tr>
<td><strong>35-1A</strong> Contingent consideration arrangements of an acquiree assumed by the acquirer in a business combination shall be measured subsequently in accordance with the guidance for contingent consideration arrangements in the preceding paragraph.</td>
</tr>
</tbody>
</table>

Before the acquisition date, an acquiree may have completed a prior business combination in which it was the acquirer and had issued contingent consideration to the seller. Consequently, at the time of the new acquisition, the acquiree may have a liability (or asset) recognized for the contingent consideration. The nature of contingent consideration does not change because of the subsequent acquisition of the acquiree. Therefore, if an acquirer assumes a preexisting contingent consideration liability (or asset) in a business combination, the acquirer measures and recognizes that arrangement at fair value and classifies it in the same manner as if it had entered into that arrangement at the same time as the current business combination.

After initial recognition, such contingent consideration arrangements are accounted for in accordance with the requirements for acquirer contingent consideration in ASC 805-30-35-1. However, acquiree contingent consideration arrangements are assumed liabilities (or acquired assets) rather than part of the consideration transferred in the business combination because they are payable to (or receivable from) parties other than the sellers in the current business combination.
5.7.5.2 Acquiree Was the Seller in a Previous Business Combination

An acquirer may obtain the right to receive contingent consideration from an acquiree that previously was the seller of a business. The acquirer should account for that acquired right to receive (or obligation to pay) contingent consideration as an asset (or liability) arising from a contingency (see Section 4.3.6). Therefore, if the acquirer can determine the acquisition-date fair value during the measurement period, the acquiree’s contingent consideration should be recognized and measured at fair value. In accordance with ASC 805-20-25-20, if an acquirer cannot determine the acquisition-date fair value of a contingency during the measurement period, it recognizes the contingency at its estimated amount if (1) “it is probable that an asset existed or that a liability had been incurred at the acquisition date” and (2) “[t]he amount of the asset or liability can be reasonably estimated.” If an asset or liability arising from a contingency does not qualify for recognition during the measurement period, it would be accounted for in accordance with other GAAP (e.g., ASC 450) separately from the business combination.

5.8 Noncash Assets Transferred as Consideration

An acquirer may transfer as consideration tangible or intangible assets whose fair value differs from their carrying amounts in the acquirer’s financial statements as of the acquisition date. Examples include financial assets, inventory, property, or intangible assets. An acquirer may also transfer a business or subsidiary that includes liabilities. If the carrying amount of an asset (or liability) transferred to the seller differs from the acquisition-date fair value of the asset, the acquirer recognizes a gain or a loss in earnings (separately from the business combination transaction) for any difference between the asset’s or liability’s acquisition-date fair value and its carrying amount.
Example 5-15

Acquisition of a Business by Transferring Noncash Consideration to the Seller

Company A enters into an agreement to acquire Company B for consideration of $1 million in cash and a building, both of which are transferred to the seller. Company A accounts for the transaction as a business combination. On the acquisition date, the building’s carrying amount in A’s financial statements is $100,000 and its fair value is $250,000. Under ASC 805, the amount recognized as of the acquisition date for B’s net identifiable assets is $700,000. The gain on the building transferred and the goodwill recognized as part of the acquisition are calculated as follows:

<table>
<thead>
<tr>
<th>Gain recognized on the acquisition date:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value of the building on the acquisition date</td>
<td>$250,000</td>
</tr>
<tr>
<td>Less: Carrying amount of the building on the acquisition date</td>
<td>(100,000)</td>
</tr>
<tr>
<td>Gain recognized by A on the acquisition date</td>
<td>$150,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Consideration transferred:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Fair value of the building</td>
<td>250,000</td>
</tr>
<tr>
<td>Total consideration transferred</td>
<td>1,250,000</td>
</tr>
<tr>
<td>Less: Fair value of B’s net identifiable assets</td>
<td>(700,000)</td>
</tr>
<tr>
<td>Goodwill</td>
<td>550,000</td>
</tr>
</tbody>
</table>

This measurement of goodwill would be the same if A had sold the building to a third party at its fair value and included the cash received in the consideration transferred.

5.8.1 Noncash Assets That Are Used as Consideration and That Remain Within the Combined Entity

The consideration transferred may include noncash assets or liabilities that the acquirer transfers to the acquiree rather than to the seller. Any assets (or liabilities) used as consideration that remain within the combined entity must be measured at their carrying amounts in the acquirer’s financial statements immediately before the acquisition date. As described in ASC 805-30-30-8, the acquirer is precluded from recognizing a gain or loss in earnings on assets (and liabilities) that it controls both before and after the business combination. This is true even if the acquirer obtains a controlling financial interest in, but less than 100 percent of, an acquiree. If the acquisition is a partial acquisition and includes assets used as consideration that stay within the combined entity, ASC 805 does not address how to measure the noncontrolling interest. The example below illustrates one way to measure the noncontrolling interest, although other alternatives may exist.
Example 5-16

Acquisition of a Business by Transferring Noncash Consideration to the Acquiree

Company A enters into an agreement to acquire an 80 percent interest in Company B in exchange for A’s transfer of its wholly owned subsidiary, Sub X, to B. The transaction is determined to be a business combination, and A is identified as the acquirer. On the acquisition date, Sub X’s fair value is $4,000 and its carrying amount is $2,000. (This example includes simplified assumptions and ignores the effects of a discount for lack of control or income taxes.) The fair value of B is $1,000. The following diagram illustrates the ownership structure immediately before and after the acquisition:

**Before the acquisition:**

Before the acquisition:

- **Company A**
  - 100%
- **Sub X**
  - Fair value = $4,000; carrying amount = $2,000
- **Parent of Company B**
  - 100%
- **Company B**
  - Fair value = $1,000

**After the acquisition:**

After the acquisition:

- **Company A**
  - 80%
- **Former Parent of Company B**
  - 20%
- **Company B**
  - 100%
- **Sub X**
  - 100%

Because A controls Sub X both before and after the acquisition, A must recognize Sub X’s assets and liabilities at their carrying amounts (i.e., the transfer of Sub X to B is similar to a common-control transaction). Therefore, A cannot recognize a gain or loss in earnings for the difference between the fair value and the carrying amount of Sub X’s assets and liabilities. Company A accounts for the reduction in its ownership interest in Sub X from 100 percent to 80 percent as an equity transaction under ASC 810-10-45-23 (i.e., as an adjustment to APIC).
Example 5-16 (continued)

Company A recognizes the following:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
<th>Note</th>
</tr>
</thead>
<tbody>
<tr>
<td>B’s net assets</td>
<td>$ 1,000</td>
<td>Recognized at their fair values under ASC 805.</td>
</tr>
<tr>
<td>Noncontrolling interest in B</td>
<td>$ 600</td>
<td>Calculated as 20% of the carrying amount of Sub X’s net assets (20% × $2,000 = $400) plus 20% of the fair value of B (20% × $1,000 = $200).</td>
</tr>
<tr>
<td>Increase to APIC</td>
<td>$ 400</td>
<td>Calculated as the excess of the fair value received (80% of B’s $1,000 fair value = $800) over the carrying amount of the interest transferred (20% of X’s $2,000 carrying amount = $400). The increase in APIC represents the increase in the fair value of A’s interest in Sub X that it sold but cannot recognize as a gain in earnings.</td>
</tr>
</tbody>
</table>

Because A was identified as the acquirer of B, the transaction would be accounted for as the acquisition of B by Sub X in B’s stand-alone financial statements (i.e., as a reverse acquisition). Therefore, Sub X is the accounting acquirer/legal acquiree and B is the accounting acquiree/legal acquirer. The consideration transferred in the transaction is equal to 20 percent of Sub X, which was exchanged for 80 percent of B. In B’s stand-alone financial statements, B’s net assets are recognized at their acquisition-date fair value of $1,000, and Sub X’s net assets are recognized at their carrying amount of $2,000. The financial statements before the acquisition would present the assets, liabilities, and operations of Sub X, and B would not be included in the financial statements until the acquisition date. See Section 6.8 for more information about the accounting for reverse acquisitions.

5.9 Liabilities Incurred as Consideration

ASC 805-30-30-7 states that the consideration transferred includes “liabilities incurred by the acquirer to former owners of the acquiree.” For example, liabilities incurred include contingent consideration and seller notes or loans to the acquirer. They do not include the acquiree’s preexisting liabilities payable to third parties that may be assumed by the acquirer in a business combination or settled on behalf of the acquiree or its seller at the closing of the acquisition.

See Section 4.12 for more information about accounting for an acquiree’s debt in a business combination. In addition, the acquirer may incur new debt with a third party to fund the acquisition, which also is not part of the consideration transferred.

5.10 When Consideration Transferred Is Not Reliably Measurable or a Business Is Acquired Without the Transfer of Consideration

<table>
<thead>
<tr>
<th>Paragraph 30-2</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>30-2</td>
<td>In a business combination in which the acquirer and the acquiree (or its former owners) exchange only equity interests, the acquisition-date fair value of the acquiree’s equity interests may be more reliably measurable than the acquisition-date fair value of the acquirer’s equity interests. 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.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Paragraph 30-3</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>30-3</td>
<td>To determine the amount of goodwill in a business combination in which no consideration is transferred, the acquirer shall use the acquisition-date fair value of the acquiree’s interest in the acquiree determined using a valuation technique in place of the acquisition-date fair value of the consideration transferred (see paragraph 805-30-30-1(a)(1)). Paragraphs 805-30-55-3 through 55-5 provide additional guidance on applying the acquisition method to combinations of mutual entities, including measuring the acquisition-date fair value of the acquiree’s equity interests using a valuation technique.</td>
</tr>
</tbody>
</table>
Most business combinations include the transfer of consideration, and that consideration is used to measure the fair value of the business acquired. In some acquisitions, however, either no consideration is transferred or the consideration transferred is less reliably measurable than a direct measurement of the business acquired (e.g., when the acquiree’s shares were publicly traded before the business combinations and the acquirer’s shares were not). ASC 805-30-30-2 states that when only equity interests are exchanged, goodwill should be calculated by using the fair value of the acquiree’s equity interests if they are more reliably measurable than the fair value of the acquirer’s equity interests. When no consideration is transferred (e.g., if control is obtained through a lapse in minority veto rights), the acquirer substitutes the acquisition-date fair value of its interest in the acquiree for the acquisition-date fair value of the consideration transferred to measure goodwill or a gain on a bargain purchase. The acquisition-date fair value of the acquirer’s interest in the acquiree is determined by using appropriate valuation techniques instead of the fair value of the consideration transferred.

5.10.1 Business Combinations Between Mutual Entities

A mutual entity is a private company whose owners are also its customers. As owner-customers, they are entitled to receive the profits or income generated by the mutual entity. Such profits may be in the form of dividends or lower costs that are distributed pro rata on the basis of the amount of business each customer conducts with the mutual entity. Examples of mutual entities include mutual insurance companies, cooperatives, credit unions, and savings and loans.
As discussed in Section 2.2.2, acquisitions between mutual entities are within the scope of ASC 805. Accordingly, one of the combining entities must be identified as the acquirer on the basis of the factors in ASC 805-10-55-11 through 55-15 (see Section 3.1). Typically, no consideration is transferred in a combination between mutual entities. The combination is effected through the exchange of member interests. To apply the acquisition method, the entity must determine which is more reliably measurable, the fair value of the member interests transferred by the entity identified as the acquirer or the fair value of the member interests of the entity identified as the acquiree (i.e., the fair value of the acquiree as a whole). In some cases, because member interests of mutual entities are not publicly traded, the fair value of the entity identified as the acquiree is more reliably measurable. Therefore, the fair value of the acquiree as a whole would be used as a substitute for the consideration transferred. In a business combination between mutual entities, goodwill is measured on the basis of the amount by which the acquiree's fair value as a whole exceeds the fair value of its net assets. The acquiree's assets acquired, including identifiable intangible assets, and liabilities assumed must be measured in accordance with ASC 805, generally at their fair values. The fair value of the acquiree is added directly to the acquirer's equity (e.g., generally APIC) and not to its retained earnings.
Chapter 6 — Other Acquisition Method Guidance

This chapter discusses other aspects of the acquisition method, including the measurement period, assessing whether a transaction is separate from the business combination (e.g., a compensation arrangement), business combinations achieved in stages (i.e., step acquisitions), partial acquisitions, and reverse acquisitions.

6.1 Measurement Period

<table>
<thead>
<tr>
<th>ASC 805-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>25-15</strong></td>
</tr>
<tr>
<td>a. The identifiable assets acquired, liabilities assumed, and any noncontrolling interest in the acquiree</td>
</tr>
<tr>
<td>b. The consideration transferred for the acquiree (or the other amount used in measuring goodwill in accordance with paragraphs 805-30-30-1 through 30-3)</td>
</tr>
<tr>
<td>c. In a business combination achieved in stages, the equity interest in the acquiree previously held by the acquirer (see paragraph 805-30-30-1(a)(3))</td>
</tr>
<tr>
<td>d. The resulting goodwill recognized in accordance with paragraph 805-30-30-1 or the gain on a bargain purchase recognized in accordance with paragraph 805-30-25-2.</td>
</tr>
</tbody>
</table>

| **30-1** | Paragraph 805-10-25-15 establishes that the measurement period provides the acquirer with a reasonable time to obtain the information necessary to identify and measure various items in a business combination. |

An acquirer may not have the information necessary to complete the accounting for a business combination by the end of the reporting period after the acquisition, especially when the business combination closes shortly before the end of the acquirer's reporting period or when the acquiree's operations are significant or complex. Thus, ASC 805-10-25-15 provides a measurement period during which an acquirer can obtain the information it needs to identify and measure the consideration transferred, assets acquired, and liabilities assumed, as well as any previously held or noncontrolling interests. The objective of the measurement period is to give the acquirer a reasonable period in which to obtain the information necessary to complete the accounting for the business combination while maintaining normal reporting schedules.
The measurement period for a particular asset, liability, or equity instrument ends once the acquirer determines that either (1) the necessary information has been obtained or (2) the information is not available. However, the measurement period for all items is limited to one year from the acquisition date. See Section 7.11 for a discussion of the specific disclosure requirements for situations in which the accounting for a business combination has not been completed by the end of the reporting period.

6.1.1 Recognition of Provisional Amounts

### ASC 805-10

25-13 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, in accordance with paragraph 805-10-25-17, the acquirer shall adjust the provisional amounts recognized 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 recognized as of that date.

25-14 During the measurement period, the acquirer also shall recognize 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 one year from the acquisition date.

55-16 Paragraphs 805-10-25-14 through 25-19 and 805-10-30-2 through 30-3 discuss requirements related to the measurement period in a business combination. If the initial accounting for a business combination is incomplete at the end of the financial reporting period in which the combination occurs, paragraph 805-10-25-13 requires that the acquirer recognize in its financial statements provisional amounts for the items for which the accounting is incomplete. During the measurement period, the acquirer recognizes adjustments to the provisional amounts needed 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 recognized as of that date. Paragraph 805-10-25-17 requires the acquirer to recognize such adjustments with a corresponding adjustment to goodwill in the reporting period the adjustments are determined. The effects of adjustments to provisional amounts to periods after the acquisition date are included in the earnings of the adjustment period.

If the acquirer does not have the information necessary to complete the accounting for the business combination by the next reporting date, it must recognize provisional amounts for those items for which the accounting is incomplete by using its best estimates of their fair value (or other measurement as required by ASC 805) on the basis of the information available. See Section 7.11 for a discussion of the specific disclosure requirements for provisional measurements.

When the accounting for a business combination is incomplete at the end of the reporting period, the acquirer must not knowingly understate or overstate an asset or liability, as might be the case if no amount, a nominal amount, or the acquiree’s carrying amount were to be used as the provisional amount until the measurement has been completed. Instead, the acquirer must determine provisional amounts by using the best information available. If the acquirer becomes aware of new information during the measurement period related to conditions that existed as of the acquisition date, it must make subsequent adjustments to the provisional amounts, and additional assets acquired or liabilities assumed might be identified for recognition and measurement.
### 6.1.2 Adjustments Identified During the Measurement Period

**ASC 805-10**

**25-16** The acquirer recognizes an increase (decrease) in the provisional amount recognized for an identifiable asset (liability) by means of a decrease (increase) in goodwill. However, new information obtained during the measurement period sometimes may result in an adjustment to the provisional amount of more than one asset or liability. 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 liability 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 to the provisional amount recognized for the liability would be offset (in whole or in part) by a corresponding adjustment to goodwill resulting from a change to the provisional amount recognized for the claim receivable from the insurer.

**25-17** During the measurement period, the acquirer shall recognize adjustments to the provisional amounts with a corresponding adjustment to goodwill in the reporting period in which the adjustments to the provisional amounts are determined. Thus, the acquirer shall adjust its financial statements as needed, including recognizing in its current-period earnings the full effect of changes in depreciation, amortization, or other income effects, by line item, if any, as a result of the change to the provisional amounts calculated as if the accounting had been completed at the acquisition date. Paragraph 805-10-55-16 and Example 1 (see paragraph 805-10-55-27) provide additional guidance.

**25-18** Paragraphs 805-10-30-2 through 30-3 require consideration of all pertinent factors in determining whether information obtained after the acquisition date should result in an adjustment to the provisional amounts recognized or whether that information results from events that occurred after the acquisition date.

**30-2** The acquirer shall consider all pertinent factors in determining whether information obtained after the acquisition date should result in an adjustment to the provisional amounts recognized or whether that information results from events that occurred after the acquisition date. Pertinent factors include the time at which additional information is obtained and whether the acquirer can identify a reason for a change to provisional amounts.

**30-3** Information that is obtained shortly after the acquisition date is more likely to reflect circumstances that existed at the acquisition date than is information obtained several months later. For example, unless an intervening event that changed its fair value can be identified, the sale of an asset to a third party shortly after the acquisition date for an amount that differs significantly from its provisional fair value determined at that date is likely to indicate an error in the provisional amount.

In September 2015, the FASB issued **ASU 2015-16**, which amended the guidance in ASC 805 on the accounting for measurement-period adjustments. As described in paragraph BC3 of the ASU, an acquirer must “recognize adjustments to provisional amounts that are identified during the measurement period in the reporting period in which the adjustment amount is determined.” The adjustments are calculated as if the accounting had been completed on the acquisition date. When an acquirer adjusts a provisional amount, the offsetting entry generally increases or decreases goodwill but may also result in adjustments to other assets and liabilities. For example, if an acquirer recognizes a liability for a contingency and has an offsetting indemnification asset, an adjustment to the liability may result in an offsetting increase or decrease in the indemnification asset.
Measurement-period adjustments may also affect the income statement. In accordance with the guidance in ASU 2015-16, an acquirer must recognize, in the reporting period in which the adjustment amounts are determined (rather than retrospectively), the “effect on earnings of changes in depreciation, amortization, or other income effects, if any, as a result of the change to the provisional amounts, calculated as if the accounting had been completed at the acquisition date.” For example, if a measurement-period adjustment increases the value of fixed assets or finite-lived intangible assets, the acquirer should recognize any catch-up depreciation or amortization in the reporting period in which the adjustment is determined.

According to ASU 2015-16, acquirers must also “present separately on the face of the income statement or disclose in the notes the portion of the amount recorded in current-period earnings by line item that would have been recorded in previous reporting periods if the adjustment to the provisional amounts had been recognized as of the acquisition date.” See Section 7.11 for more information about the disclosure requirements for measurement-period adjustments.

ASC 805-10 provides the following example illustrating the accounting for measurement-period adjustments:

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**ASC 805-10**

**Example 1: Appraisal That Is Incomplete at the Reporting Date**

55-27 This Example illustrates the measurement period guidance in paragraph 805-10-55-16. Acquirer acquires Target on September 30, 20X7. Acquirer seeks an independent appraisal for an item of property, plant, and equipment acquired in the combination, and the appraisal was not complete by the time Acquirer issued its financial statements for the year ended December 31, 20X7. In its 20X7 annual financial statements, Acquirer recognized a provisional fair value for the asset of $30,000. At the acquisition date, the item of property, plant, and equipment had a remaining useful life of five years. Six months after the acquisition date, Acquirer received the independent appraisal, which estimated the asset’s acquisition-date fair value as $40,000.

55-28 In its interim financial statements for the quarter ended March 31, 20X8, Acquirer adjusts the provisional amounts recorded and the related effects on that period’s earnings as follows:

a. The carrying amount of property, plant, and equipment as of March 31, 20X8, is increased by $9,000. That adjustment is measured as the fair value adjustment at the acquisition date of $10,000 less the additional depreciation that would have been recognized had the asset’s fair value at the acquisition date been recognized from that date ($1,000 for 6 months’ depreciation).

b. The carrying amount of goodwill as of March 31, 20X8, is decreased by $10,000.

c. Depreciation expense for the period ended March 31, 20X8, is increased by $1,000 to reflect the effect on earnings as a result of the change to the provisional amount recognized.

55-29 In accordance with paragraph 805-20-50-4A, Acquirer discloses both of the following:

a. In its 20X7 financial statements, that the initial accounting for the business combination has not been completed because the appraisal of property, plant, and equipment has not yet been received

b. In its March 31, 20X8 financial statements, the amounts and explanations of the adjustments to the provisional values recognized during the current reporting period. Therefore, Acquirer discloses that the increase to the fair value of the item of property, plant, and equipment was $10,000, with a corresponding decrease to goodwill. Additionally, the change to the provisional amount resulted in an increase in depreciation expense and accumulated depreciation of $1,000, of which $500 relates to the previous quarter.
The measurement period is not intended to allow for subsequent adjustments of the amounts recognized as part of the business combination that result from the uncertainties and related risks the acquirer assumed in the combination. Adjustments that are due to decisions made by the combined company or changes in facts and circumstances or economic conditions that occurred after the acquisition date are not measurement-period adjustments; rather, they are included in the determination of net income in the period in which they are made. For example, if acquired equipment is damaged after the acquisition date, the decrease in the equipment’s value is the result of changes in facts and circumstances after the acquisition date and should not be recognized as a measurement-period adjustment.

Determining whether an adjustment to an item’s value is a measurement-period adjustment or is due to a change in fact or circumstance after the acquisition date may require significant judgment. New information received soon after a business combination is more likely to reflect facts and circumstances that existed as of the acquisition date than information received later during an open measurement period; however, before reaching a conclusion, an acquirer must consider all pertinent factors to determine whether information it obtained after the acquisition date is related to facts and circumstances that existed as of the acquisition date or occurred after the acquisition date. For example, deferred taxes recognized in a business combination should reflect the structure of the combined entity as it existed on the acquisition date. Generally, the tax effects of subsequent transaction steps that may be considered acquisition-related integration steps are not measurement-period adjustments and are accounted for separately from the business combination.

**Example 6-1**

**Potential Litigation Known as of the Acquisition Date**

On January 1, 20X9, Company A acquires Company B in a transaction accounted for as a business combination. As a result of due diligence activities associated with the acquisition, A was aware of a potential liability related to a claim that B had breached a contract with a customer before the business combination. On the basis of its understanding of the claim as of the acquisition date, A recognizes a provisional liability of $500,000 as part of its initial accounting for the acquisition and asks its legal counsel to fully evaluate the claim. On April 1, 20X9, A’s legal counsel confirms to A’s management that the claim does have merit since it appears that B breached the contract. On the basis of this legal analysis, A determines that it should increase the provisional liability it recognized to $750,000.

Because the new information became available during the measurement period and is related to a circumstance that existed on the acquisition date, A should recognize an increase of $250,000 to the liability, with a corresponding adjustment to goodwill.

**Example 6-2**

**Potential Litigation Not Known as of the Acquisition Date**

Assume the same facts as in Example 6-1, except that Company A did not know about Company B’s breach of contract as of the acquisition date. Therefore, in the initial accounting for the acquisition of B, A did not recognize a liability. On March 1, 20X9, A becomes aware of B’s potential breach of contract and asks its legal counsel to evaluate the claim. On May 1, 20X9, A’s legal counsel notifies A’s management that the claim does have merit and that B may have breached the contract. Company A determines that it should have recognized a liability of $750,000 as part of the initial accounting for the acquisition.

The breach of contract was a circumstance that existed as of the acquisition date, even though A was not aware of it on that date. Because the new information became available during the measurement period and was related to a circumstance that existed as of the acquisition date, A should recognize a liability for $750,000 as part of the business combination accounting with a corresponding adjustment to goodwill.
6.1.2.1 Settlement of Litigation Shortly After the Acquisition Date

An acquiree may have ongoing litigation at the time of the business combination. We believe that, by analogy to the subsequent-events guidance in ASC 855, if the litigation is settled shortly after the acquisition date during an open measurement period, the acquirer should consider whether that settlement provides evidence about facts and circumstances that existed as of the acquisition date. ASC 855-10-25-1 states, in part, that “[a]n entity shall recognize in the financial statements the effects of all subsequent events that provide additional evidence about conditions that existed at the date of the balance sheet” (i.e., recognized subsequent events). ASC 855-10-55-1 provides the following example of a recognized subsequent event:

If the events that gave rise to litigation had taken place before the balance sheet date and that litigation is settled after the balance sheet date but before the financial statements are issued or are available to be issued, for an amount different from the liability recorded in the accounts, then the settlement amount should be considered in estimating the amount of liability recognized in the financial statements at the balance sheet date.

If an adjustment results from a settlement that occurs after the measurement period — either because it occurs after the one-year anniversary of the acquisition or because the acquirer concludes that it is no longer waiting for information about that item — the change should be recognized in the income statement. In addition, if the event that gives rise to the claim takes place after the acquisition date, settlement of litigation does not result in a measurement-period adjustment and should be recognized in the income statement.

6.1.3 Adjustments Identified After the Measurement Period Has Ended

| ASC 805-10 25-19 | After the measurement period ends, the acquirer shall revise the accounting for a business combination only to correct an error in accordance with Topic 250. |

ASC 805-10-25-19 states that “[a]fter the measurement period ends, the acquirer shall revise the accounting for a business combination only to correct an error in accordance with Topic 250” (emphasis added). ASC 250-10-45-23 requires that an “error in the financial statements of a prior period discovered after the financial statements are issued or are available to be issued . . . shall be reported as an error correction, by restating the prior-period financial statements." If an adjustment identified after the measurement period is not the result of an error, it must be recognized in current-period earnings. Entities must use judgment in determining whether an identified adjustment should be considered an error correction or the result of events occurring after the acquisition date that require prospective treatment in a manner consistent with a change in estimate.

ASC 250-10-20 defines an error in previously issued financial statements (an “error”) as follows:

An error in recognition, measurement, presentation, or disclosure in financial statements resulting from mathematical mistakes, mistakes in the application of generally accepted accounting principles (GAAP), or oversight or misuse of facts that existed at the time the financial statements were prepared. A change from an accounting principle that is not generally accepted to one that is generally accepted is a correction of an error.

When considering whether a change is a correction of an error, an entity should use judgment to determine (1) whether the correct information was or should have been “reasonably knowable” or was “readily accessible” from the acquiree’s books and records in a prior reporting period and (2) whether use of that information at that time would have resulted in different reporting.
Connecting the Dots

In his remarks at the 2016 AICPA Conference on Current SEC and PCAOB Developments, then SEC OCA Associate Chief Accountant Jonathan Wiggins noted that although ASU 2015-16 eliminated the requirement to retrospectively account for measurement-period adjustments, it “does not change the measurement period or apply when an adjustment represents the correction of an accounting error.” He also reminded registrants that they “should ensure they have sufficient internal control over financial reporting to identify and account for measurement period adjustments appropriately and separately identify accounting errors.”

Example 6-3

Accounting for an Adjustment Outside the Measurement Period

Company A acquires Company B on November 30, 20X1, in a nontaxable business combination accounted for under ASC 805. Company A sought an independent valuation for several of the intangible assets it acquired in the combination, but the valuation has not been completed as of the time A issues its financial statements for the year ended December 31, 20X1. Thus, A includes a provisional measurement of the intangible assets and the related deferred tax liabilities in its annual financial statements.

In June 20X2, A receives the final independent valuation of the intangible assets, which increases the fair value it recorded as a provisional amount. Because this information pertained to the facts and circumstances that existed as of the acquisition date, A adjusts its intangible-asset balances and recognizes any catch-up amortization to account for this updated information in its interim financial statements for the quarter ended June 30, 20X2. Company A then concludes that the measurement period has closed because it is not waiting for any additional information regarding the provisional amounts.

In January 20X3 (i.e., after the measurement period has ended), A discovers that although the financial statements were adjusted for the change in fair value of its acquired intangible assets, the related deferred tax liability was not adjusted accordingly. Company A concludes that in accordance with ASC 250, this was an error in the accounting for the business combination.

6.2 Assessing Whether a Transaction Is Separate From the Business Combination

ASC 805-10

Determining What Is Part of the Business Combination Transaction

25-20 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, 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).
**ASC 805-10 (continued)**

**25-21** A transaction entered into by or on behalf of the acquirer or 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, 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 preexisting relationships between the acquirer and acquiree (see paragraphs 805-10-55-20 through 55-23)

b. A transaction that compensates employees or former owners of the acquiree for future services (see paragraphs 805-10-55-24 through 55-26)

c. A transaction that reimburses the acquiree or its former owners for paying the acquirer’s acquisition-related costs (see paragraph 805-10-25-23).

As part of its accounting for an acquisition, an acquirer must assess whether the items exchanged include amounts that are separate from the business combination. In some cases, an acquirer and seller (or acquiree) may have an arrangement or relationship — such as a supply, distribution, franchise, or licensing agreement; lease contracts; or potential or ongoing litigation — that arose before the negotiations for the acquisition began. ASC 805 refers to such arrangements as preexisting relationships. In other cases, an acquirer and seller (or acquiree) may enter into agreements or arrangements in close proximity to the business combination. ASC 805 provides guidance for assessing whether particular transactions or arrangements are part of the business combination or should be accounted for separately from the business combination accounting.

### 6.2.1 Determining What Should Be Accounted for Separately From a Business Combination

To determine what is or is not part of a business combination, an entity must consider the relevant facts and circumstances of the arrangement. ASC 805-10-25-20 states, in part, that “[t]he 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).” Specifically, ASC 805-10-55-18 provides three factors, which “are neither mutually exclusive nor individually conclusive,” for an entity to consider when making this determination:

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.

Determining what is or is not part of a business combination requires judgment, particularly when both the acquirer and acquiree may benefit from a particular transaction.

ASC 805-10-25-21 specifies that “[a] transaction entered into by or on behalf of the acquirer or 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, is likely to be a separate transaction.” However, it also states that the following are transactions that must be accounted for separately from the business combination:

- “A transaction that in effect settles preexisting relationships between the acquirer and acquiree” — see ASC 805-10-55-20 through 55-23 and Section 6.2.2 below.
- “A transaction that compensates employees or former owners of the acquiree for future services” — see ASC 805-10-55-24 through 55-26 and Section 6.2.3.
- “A transaction that reimburses the acquiree or its former owners for paying the acquirer’s acquisition-related costs” — see ASC 805-10-25-23 and Section 5.4.1.1.

These are examples only. Acquirers must assess whether other transactions with the acquiree should be accounted for separately from the business combination.

### 6.2.2 Effective Settlement of Preexisting Relationships Between the Acquirer and Acquiree

**ASC 805-10**

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**55-21** If the business combination in effect settles a preexisting relationship, the acquirer recognizes a gain or loss, measured as follows:

- a. For a preexisting noncontractual relationship, such as a lawsuit, fair value
- b. For a preexisting contractual relationship, the lesser of the following:
  1. The amount by which the contract is favorable or unfavorable from the perspective of the acquirer when compared with pricing for current market transactions for the same or similar items. An unfavorable contract is a contract that is unfavorable in terms of current market terms. 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.
  2. The amount of any stated settlement provisions in the contract available to the counterparty to whom the contract is unfavorable. If this amount is less than the amount in (b)(1), the difference is included as part of the business combination accounting.
A preexisting relationship between an acquirer and acquiree may be contractual (e.g., a lease contract or a supply, distribution, franchise, licensing, or debt agreement) or noncontractual (e.g., a dispute or litigation between the acquirer and the seller or acquiree). Such a relationship is considered effectively settled as part of the business combination even if it is not legally cancelled since, upon the acquisition date, it becomes an “intercompany” relationship that is eliminated in consolidation in the postcombination financial statements. A reacquired right is also a preexisting relationship (see Section 4.3.7). When there is more than one contract or agreement between the parties to the business combination, the effective settlement of each preexisting relationship should be assessed separately. ASC 805 provides guidance on measuring any gain or loss from the effective settlement of a preexisting relationship. The measurement depends on whether the relationship is contractual or noncontractual, as discussed below.

### 6.2.2.1 Effective Settlement of a Noncontractual Preexisting Relationship

If a business combination results in the effective settlement of a noncontractual preexisting relationship such as a lawsuit, threatened litigation, or dispute, the gain or loss should be recognized and measured at fair value in accordance with the guidance in ASC 805-10-55-21. However, measuring the fair value of the effective settlement of such a noncontractual preexisting relationship may be challenging, and the gain or loss may differ from the amount the acquirer previously recognized, if any. For example, the fair value of the settlement of a lawsuit would most likely differ from the amount the acquiree would have recognized under ASC 450.

In his remarks at the 2007 AICPA Conference on Current SEC and PCAOB Developments, then SEC OCA Associate Chief Accountant Eric West discussed the accounting for litigation settlements that occur in combination with other arrangements. He stated, in part:

> [W]e believe that it would be acceptable to value each element of the arrangement and allocate the consideration paid to each element using relative fair values. To the extent that one of the elements of the arrangement just can’t be valued, we believe that a residual approach may be a reasonable solution. In fact, we have found that many companies are not able to reliably estimate the fair value of the litigation component of any settlement and have not objected to judgments made when registrants have measured this component as a residual. In a few circumstances companies have directly measured the value of the litigation settlement component.
These remarks indicate that if an entity cannot measure the fair value of an element of a transaction, such as litigation, it can measure the element as a residual. However, we believe that the measurement of the fair value of the acquiree should exclude any preexisting relationships. That is, while a market participant would include the preexisting relationship in its measurement of the acquiree, the guidance requires the acquirer to account for that preexisting relationship separately from the business combination. Therefore, the acquirer’s measurement of the acquiree should be exclusive of any relationships that are effectively settled as part of the combination.

While Mr. West’s speech was delivered before Statement 141(R) was issued, we believe that the guidance continues to be relevant under ASC 805.

### Example 6-4

**Effective Settlement of a Lawsuit in a Business Combination**

Company A files a lawsuit against Company B for unauthorized use of A’s intellectual property. Company A concludes that any potential settlement with B would be a contingent gain and therefore does not recognize an asset in its financial statements. Likewise, B does not recognize a liability in its financial statements for the contingent loss related to the lawsuit because it believes that no amount of loss is probable. Company A acquires B and accounts for the acquisition as a business combination.

As part of the accounting for the acquisition, A determines that a gain exists related to the effective settlement of the lawsuit. Company A should measure that gain at fair value and recognize it separately from the accounting for the acquisition. If A cannot directly determine the lawsuit’s fair value, A can measure it as the difference between the amount paid for the acquisition and the fair value of B without the lawsuit. While a market participant would include the lawsuit in its measurement of B, we believe that A’s exclusion of it is consistent with the requirement to account for preexisting relationships separately from the business combination.

### 6.2.2.2 Effective Settlement of a Contractual Preexisting Relationship

When a business combination results in the effective settlement of a preexisting contractual relationship, entities should recognize and measure the resulting gain or loss in accordance with the guidance in ASC 805-10-55-21(b). That guidance requires that the settlement gain or loss for a contractual preexisting relationship be measured as the lesser of the following:

- “The amount by which the contract is favorable or unfavorable from the perspective of the acquirer when compared with pricing for current market transactions for the same or similar items. An unfavorable contract is a contract that is unfavorable in terms of current market terms. 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.”
- “The amount of any stated settlement provisions in the contract available to the counterparty to whom the contract is unfavorable. If this amount is less than the amount in (b)(1), the difference is included as part of the business combination accounting.”

If a contractual preexisting relationship is cancelable by either party without penalty, the stated settlement provision is zero and no settlement gain or loss should be recognized regardless of whether the contract is favorable or unfavorable to the acquirer. However, if there are no stated settlement provisions and the contract is not cancelable, entities should recognize a settlement gain or loss on the basis of the amount by which the contract is favorable or unfavorable to the acquirer (i.e., on the basis
of the settled contract’s acquisition-date fair value). ASC 805 provides the following example to illustrate the accounting for the effective settlement of a preexisting relationship when an acquirer does not have an amount previously recognized related to the contract:

**ASC 805-10**

**Example 2: Effective Settlement of a Supply Contract as a Result of a Business Combination**

55-30 This Example illustrates the guidance in paragraphs 805-10-55-20 through 55-21. Acquirer purchases electronic components from Target under a five-year supply contract at fixed rates. Currently, the fixed rates are higher than rates at which Acquirer could purchase similar electronic components from another supplier. The supply contract allows Acquirer to terminate the contract before the end of the initial 5-year term only by paying a $6 million penalty. With 3 years remaining under the supply contract, Acquirer pays $50 million to acquire Target, which is the fair value of Target based on what other market participants would be willing to pay.

55-31 Included in the total fair value of Target is $8 million related to the fair value of the supply contract with Acquirer. The $8 million represents a $3 million component that is at-market because the pricing is comparable to pricing for current market transactions for the same or similar items (selling effort, customer relationships, and so forth) and a $5 million component for pricing that is unfavorable to Acquirer because it exceeds the price of current market transactions for similar items. Target has no other identifiable assets or liabilities related to the supply contract, and Acquirer has not recognized any assets or liabilities related to the supply contract before the business combination.

55-32 In this Example, Acquirer recognizes a loss of $5 million (the lesser of the $6 million stated settlement amount and the amount by which the contract is unfavorable to the acquirer) separately from the business combination. The $3 million at-market component of the contract is part of goodwill.

6.2.2.3 Settlement of a Preexisting Relationship if the Acquirer Had Previously Recognized an Asset or Liability

If an acquirer has recognized an asset or liability related to the preexisting relationship before the acquisition, it should include that amount in calculating the settlement gain or loss. The scenario in Example 2 in ASC 805-10-55-30 through 55-32 is continued below in Example 3, which illustrates the accounting for the effective settlement of a preexisting relationship when an acquirer has an amount previously recognized related to the contract.

**ASC 805-10**

**Example 3: Effective Settlement of a Contract Between the Acquirer and Acquiree in Which the Acquirer Had Recognized a Liability Before the Business Combination**

55-33 This Example illustrates the guidance in paragraphs 805-10-55-20 through 55-21. Whether Acquirer had previously recognized an amount in its financial statements related to a preexisting relationship will affect the amount recognized as a gain or loss for the effective settlement of the relationship. In Example 2 (see paragraph 805-10-55-30), generally accepted accounting principles (GAAP) might have required Acquirer to recognize a $6 million liability for the supply contract before the business combination. In that situation, Acquirer recognizes a $1 million settlement gain on the contract in earnings at the acquisition date (the $5 million measured loss on the contract less the $6 million loss previously recognized). In other words, Acquirer has in effect settled a recognized liability of $6 million for $5 million, resulting in a gain of $1 million.
Chapter 6 — Other Acquisition Method Guidance

Example 6-4A

Company A acquires all of the outstanding shares of Company B in a business combination by paying $1 million in cash to the former owners of B. On the acquisition date, A has a $50,000 account receivable from B, and B has an equal account payable to A.

As a result of the acquisition of B, the account receivable and payable is effectively settled between the parties. Accordingly, the consideration transferred for B is $1,050,000 (i.e., $1 million in cash plus the forgiveness of the accounts receivable). Because there is no off-market amount or stated settlement provisions, A does not recognize a gain or loss upon the settlement.

6.2.2.3.1 Effective Settlement of Debt Between the Parties to a Business Combination

A business combination may result in the effective settlement of debt between an acquirer and an acquiree. If the acquirer was the issuer of the debt and it is settled as a result of the business combination, the acquirer would apply the guidance in ASC 470-50 to account for the debt extinguishment. An extinguishment gain or loss would be recognized if the reacquisition price (fair value or stated settlement amount) differs from the net carrying amount of the debt. Any settlement gain or loss would be recognized separately from the business combination.

Example 6-4B

On January 1, 20X2, Company A issued $50,000 in debt securities to Company B. On June 30, 20X3, A acquires all of the outstanding shares of B in a business combination by paying $1 million in cash to the former owners of B. On the acquisition date, the carrying amount of the debt is $40,000 and its fair value is $41,000.

As a result of the acquisition of B, A would recognize a $1,000 loss related to the settlement of the debt securities with B, calculated as the amount by which the fair value of the debt exceeds its carrying amount. The consideration transferred for B is $959,000, calculated as the cash paid to the former owners of B less the fair value of the debt.

If the acquiree was the issuer of the debt and it is settled as a result of the business combination, the acquirer would be effectively settling a receivable and would apply the guidance in ASC 805-10-55-21 related to the settlement of preexisting relationships in a business combination. See Section 6.2.2.4 below for more information.

6.2.2.4 Settlement of a Preexisting Relationship if the Acquirer Is a Customer of the Acquiree

If an entity acquires one of its vendors (i.e., the acquirer was a customer of the acquiree) in a business combination, the acquirer should recognize a settlement gain or loss in accordance with ASC 805-10-55-21 for the effective settlement of any contractual arrangements. However, even though the parties have a preexisting relationship, the acquirer would not recognize a customer-relationship intangible asset for its relationship with its former vendor because the customer relationship no longer exists after the acquisition (i.e., the acquirer would not record a customer relationship with itself as a result of the business combination). The guidance in ASC 805-10-55-32 (see above) demonstrates that the acquirer should not recognize a separate intangible asset for the customer relationship; instead, that amount should be part of goodwill.
6.2.2.5 Settlement of a Preexisting Relationship When Less Than 100 Percent of the Acquiree Is Acquired

The SEC staff has discussed the accounting for a preexisting relationship in a less than 100 percent acquisition. In prepared remarks at the 2005 AICPA Conference on Current SEC and PCAOB Developments, then SEC OCA Professional Accounting Fellow Brian Roberson discussed preexisting relationships between parties to a business combination in a partial acquisition:

One issue that has arisen is whether this issue applies to other than 100 percent acquisitions and, if so, how it is applied. The answer is that it applies anytime you have something that qualifies as a business combination. The harder part of the question is how to value the preexisting relationship and that is where facts and circumstances come into play.

For instance, assume you own 40 percent of an entity and another party owns 60 percent and that you have an unfavorable supply contract with the entity. If you buy an additional 15 percent interest in the entity and you, as the new controlling shareholder, have the ability to cancel the supply contract, you would likely have to pay the other shareholder its entire portion of the value of the supply contract since it will be giving up its favorable position in the contract. If, on the other hand, you buy the same 15 percent interest but cannot cancel the contract, you would likely only pay the other shareholder the value of the 15 percent interest in the contract as the other shareholder will still realize value for the 45 percent interest it retained. I do not mean to imply that all valuations will be this straightforward, but the important point is that determining the settlement gain or loss in a partial acquisition is not a simple mathematical exercise - you need to step back and consider all of the facts and circumstances and the impact they would have on the value lost or gained by the other interest holders.

While the SEC staff made these remarks before the FASB issued Statement 141(R), we believe that they continue to be relevant.

6.2.2.6 Reacquired Rights

A preexisting relationship may represent a reacquired right of the acquirer — for example, 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.” All reacquired rights are preexisting relationships, even though all preexisting relationships are not reacquired rights. If a preexisting relationship represents a reacquired right, the acquirer recognizes a settlement gain or loss, if any, separately from the business combination measured in accordance with ASC 805-10-55-21.

The acquirer also recognizes a reacquired right as an identifiable intangible asset separately from goodwill because it arises from contractual rights. However, reacquired rights are an exception to the measurement principle in ASC 805 because such rights must be measured on the basis of the remaining contractual term of the related contract, regardless of whether market participants would consider potential contractual renewals in determining the fair value of those rights. See Section 4.3.7 for more information about the measurement of reacquired rights.
6.2.2.7  Reimbursement of the Acquirer’s Acquisition-Related Costs

ASC 805-10-25-21(c) specifies that “[a] transaction that reimburses the acquiree or its former owners for paying the acquirer’s acquisition-related costs” is a separate transaction that should not be included in the application of the acquisition method. That is, if the acquirer and acquiree enter into an arrangement in which the acquiree pays the acquirer’s acquisition-related costs and the acquirer agrees to reimburse the acquiree either as part of the consideration transferred or otherwise, such costs must be accounted for separately from the business combination in accordance with their nature and not as part of the consideration transferred. See Section 5.4.1 for guidance on the accounting for the acquirer’s acquisition-related costs.

6.2.3  Compensation Arrangements

An acquiree in a business combination may have agreements in place to provide specified employees with additional compensation that is predicated on a change in control of the acquiree. Such arrangements could have been established either before or after the negotiations began for the business combination. When determining whether the acquirer should account for these arrangements as part of the business combination or separately as compensation, entities must use judgment and consider the specific facts and circumstances as discussed below. However, if a business combination results in additional compensation arrangements that include payments to the acquirer’s employees, such payments are always compensation.

6.2.3.1  Arrangements to Pay an Acquiree’s Employee Upon a Change in Control

Arrangements may be established with the objective of retaining one or more of the acquiree’s employees until the acquisition date and possibly for a defined period thereafter. Such arrangements — often referred to in practice as “stay bonuses,” “change in control payments,” or “golden parachutes” — may also provide additional compensation for performance related to the business combination or compensate employees who are terminated after the combination. An entity should account for these arrangements on the basis of their substance. In assessing the substance of an arrangement, an entity should consider the factors listed in ASC 805-10-55-18 (i.e., “[t]he reasons for the transaction,” “[w]ho initiated the transaction,” and “[t]he timing of the transaction”).

ASC 805-10-55-34 through 55-36 provide an example of a contingent payment to an acquiree’s employee:

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**ASC 805-10**

**Example 4: Arrangement for Contingent Payment to an Employee**

55-34 This Example illustrates the guidance in paragraphs 805-10-55-24 through 55-25 relating to contingent payments to employees in a business combination. Target hired a candidate as its new chief executive officer under a 10-year contract. The contract required Target to pay the candidate $5 million if Target is acquired before the contract expires. Acquirer acquires Target eight years later. The chief executive officer was still employed at the acquisition date and will receive the additional payment under the existing contract.

55-35 In this Example, Target entered into the employment agreement before the negotiations of the combination began, and the purpose of the agreement was to obtain the services of the chief executive officer. Thus, there is no evidence that the agreement was arranged primarily to provide benefits to Acquirer or the combined entity. Therefore, the liability to pay $5 million is included in the application of the acquisition method.
55-36 In other circumstances, Target might enter into a similar agreement with the chief executive officer at the suggestion of Acquirer during the negotiations for the business combination. If so, the primary purpose of the agreement might be to provide severance pay to the chief executive officer, and the agreement may primarily benefit Acquirer or the combined entity rather than Target or its former owners. In that situation, Acquirer accounts for the liability to pay the chief executive officer in its postcombination financial statements separately from application of the acquisition method.

If arrangements to pay an acquiree's employees upon a change in control are determined to be part of the business combination and are settled in equity on the acquisition date, the equity issued represents consideration transferred in the business combination as if the acquiree's employees had become owners of (or increased their ownership in) the acquiree as a result of the arrangement.

If arrangements to pay an acquiree's employees upon a change in control are determined to be part of the business combination and are to be settled in cash after the acquisition date, the acquirer accounts for the amount due as a liability assumed in the business combination.

Sometimes, the acquirer settles the arrangement by making a cash payment simultaneously with the close of the acquisition. In determining whether to present the amount paid as consideration transferred or as an assumed liability, an entity should use judgment and consider all relevant facts and circumstances when applying the guidance in ASC 805-10-55-18. (See Section 4.12.1 for a discussion of considerations related to the settlement of the acquiree's debt on or in close proximity to the acquisition date.)

Arrangements to pay an acquiree's employees upon a change in control that are determined to be separate from the business combination represent compensation cost of the acquirer. If no future service is required, the acquirer should recognize compensation cost on the acquisition date.

6.2.3.2 Dual- or Double-Trigger Arrangements

An employment agreement entered into before negotiations began for the business combination may include terms that require a payment or accelerate vesting upon (1) a change of control and (2) a second defined event or “trigger,” which is why such provisions are commonly called “dual trigger” or “double trigger” arrangements. The second defined event is generally the separation of the employee from the acquirer and might be limited to involuntary terminations or might also include resignation of the employee in specified conditions (sometimes referred to as “good reasons”) such as:

- A demotion or significant reduction in the employee's duties or responsibilities after the acquisition date.
- A significant reduction in the employee's salary after the acquisition date.
- The relocation of the employee's job site beyond a specified radius after the acquisition date.
Chapter 6 — Other Acquisition Method Guidance

The objective of such employment agreements, which are typically entered into before negotiations have begun for a business combination, is generally to obtain the employee’s services. While the three factors in ASC 805-10-55-18 (i.e., “[t]he reasons for the transaction,” “[w]ho initiated the transaction,” and “[t]he timing of the transaction”) might indicate that the payments should be accounted for as part of the business combination, such arrangements are generally accounted for separately from the business combination. This is because the decision to effect the second trigger (i.e., the employee’s involuntary termination or voluntary termination for “good reason”) is under the control of the acquirer and is therefore presumed to be made primarily for the acquirer’s benefit (e.g., to reduce cost by eliminating the unneeded employee).

Example 6-5

Dual- or Double-Trigger Arrangement Involving the Termination of Employment

Company A acquires Company B in a transaction accounted for as a business combination. Company B has an existing employment agreement with its CEO that was put in place before negotiations began for the combination. Under the agreement, all of the CEO’s unvested awards will fully vest upon (1) a change in the control of B and (2) the involuntary termination of the CEO’s employment within one year after the acquisition date.

Before the closing, A determines that it will not offer employment to the CEO after the combination has been completed. Thus, both conditions are triggered, and the vesting of the CEO’s awards is accelerated upon the closing of the acquisition.

The decision not to employ B’s former CEO was under A’s control and was made for A’s benefit (i.e., to reduce costs). Therefore, A should recognize compensation related to the accelerated vesting of the awards in its postcombination financial statements and not as part of the business combination.

Example 6-6

Dual- or Double-Trigger Arrangement in Which Employee Resigns for “Good Reason”

As in Example 6-5, Company A acquires Company B in a transaction accounted for as a business combination, and B has an existing employment agreement with its CEO. However, in this example, the agreement provides that all of the CEO’s unvested awards will fully vest upon (1) a change in the control of B and (2) either the involuntary termination of the CEO or the voluntary departure of the CEO for “good reason” within one year after the acquisition date. The agreement specifies that a significant reduction in job responsibilities would be a good reason. After the acquisition date, B’s CEO will not assume the role of CEO of the combined entity but instead will be assigned a position with significantly reduced responsibilities. In response, B’s CEO will resign upon the change in control.

The decision to significantly reduce the responsibilities of B’s former CEO after the acquisition date is within A’s control. Therefore, A should recognize compensation related to the accelerated vesting of the awards in its postcombination financial statements and not as part of the business combination.

6.2.3.3 Arrangements for Contingent Payments to Employees or Selling Shareholders

ASC 805-10-55-24 Whether arrangements for contingent payments to employees or selling shareholders are contingent consideration in the business combination or are separate transactions depends on the nature of the arrangements. Understanding the reasons why the acquisition agreement includes a provision for contingent payments, who initiated the arrangement, and when the parties entered into the arrangement may be helpful in assessing the nature of the arrangement.
During negotiations of the business combination, an acquirer may agree to a provision for contingent payments to employees or selling shareholders after the acquisition date. Such payments may be in cash, other assets, the acquirer’s equity instruments, or a combination thereof. The acquirer must evaluate any contingent payments (i.e., payments that include conditions other than the passage of time) to the acquiree’s former shareholders to determine whether they represent (1) consideration transferred (i.e., contingent consideration), which is part of the business combination, or (2) compensation, which is a transaction separate from the business combination. Payments to individuals who were not shareholders or owners of the acquiree before an acquisition should be accounted for as transactions that are separate from the business combination in accordance with the nature of the payment. Accordingly, contingent payments to individuals who were not the acquiree’s owners but become employees of the combined entity should be accounted for as compensation in the acquirer’s postcombination financial statements.

When deciding whether a contingent payment to a shareholder of the acquiree who becomes an employee of the combined entity is part of the consideration transferred or a transaction that is separate from the business combination, the acquirer should first consider the factors in ASC 805-10-55-18. Specifically, by applying the factors in ASC 805-10-55-18(a) and (b) to determine the reason for the payment and who initiated it, the acquirer may gain insight into the nature and intent of an arrangement. In addition, we note that in practice, the only time an acquirer would negotiate a payment to a shareholder of the acquiree that is contingent on the shareholder’s becoming an employee of the combined entity would be during the period leading up to the acquisition; thus, the guidance in ASC 805-10-55-18(c) on the timing of a transaction suggests that such a payment would be a separate transaction. However, the factors in ASC 805-10-55-18 are not intended to be a checklist, and no one factor is determinative.

Further, an acquirer should consider the following indicators in ASC 805-10-55-25 “[i]f it is not clear whether an arrangement for payments to employees or selling shareholders is part of the exchange for the acquiree or is a transaction separate from the business combination”:

- Continuing employment — see Section 6.2.3.3.1.
- Duration of continuing employment — see Section 6.2.3.3.2.
- Level of compensation — see Section 6.2.3.3.3.
- Incremental payments to employees — see Section 6.2.3.3.4.
- Number of shares owned — see Section 6.2.3.3.5.
- Linkage to valuation — see Section 6.2.3.3.6.
- Formula for determining compensation — see Section 6.2.3.3.7.
- Other arrangements and issues — see Section 6.2.4.

According to ASC 805-10-55-24, “whether arrangements for contingent payments to employees or selling shareholders are contingent consideration in the business combination or are separate transactions depends on the nature of the arrangements.” While ASC 805-10-55-25(a) (i.e., the continuing employment factor — see Section 6.2.3.3.1) states that “a contingent consideration arrangement in which the payments are automatically forfeited if employment terminates is compensation for postcombination services” (emphasis added), the other indicators in ASC 805-10-55-25 are not as conclusive. Thus, in the absence of the automatic forfeiture condition described in ASC 805-10-55-25(a), an acquirer must use judgment to determine the nature of an arrangement, especially if not all indicators point to the same conclusion.
6.2.3.3.1 Continuing Employment

ASC 805-10

**55-25(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 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.

If an arrangement requires a contingent payment to a selling shareholder who becomes an employee of the combined entity to be forfeited upon the termination of the shareholder's employment, the acquirer must account for the arrangement as compensation in its postcombination financial statements. The acquirer would not consider the other indicators in ASC 805-10-55-25 further, even if they suggest that the arrangement should be accounted for as part of the acquisition rather than compensation.

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**Example 6-7**

**Payment Contingent on Continuing Employment**

Company A acquires Company B in a transaction accounted for as a business combination. Company B's three shareholders are executive officers of B and agree to become employees of A after the acquisition. Under the terms of the acquisition agreement, each shareholder of B is entitled to an additional payment at the end of three years after the acquisition date if a specified revenue target is met and the individual is still employed by A.

Because the future payment for each shareholder of B is contingent on continued employment with A after the acquisition, A should recognize each arrangement as compensation in the postcombination period and not as contingent consideration in the business combination.

Assume the same facts as those above, except that under the terms of the acquisition agreement, each of the three shareholders would be entitled to the additional payment if they are no longer employed by A at the end of three years because of death, disability, or involuntary termination. If the shareholders are no longer employed by A at the end of three years because of voluntary resignation or because they were terminated for cause, they would not be entitled to the additional payment. Even though there are situations in which the shareholders could receive the additional payment without being employed by A at the end of three years, we believe that the future payment for each shareholder of B is contingent on continued employment with A after the acquisition. Therefore, A should recognize each arrangement as compensation in the postcombination period and not as contingent consideration in the business combination.

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**Example 6-8**

**Contingent Payment Reverts to Nonemployee Shareholder if Employment Terminates**

Company A acquires Company B from a single selling shareholder in a transaction accounted for as a business combination. Company A hires B's top salesperson and agrees to pay the individual a percentage of sales above a specified amount at the end of each year for three years provided the individual is employed by A at the end of each year. If the individual is not employed at a year-end, any amount due under the arrangement will instead be paid to B's selling shareholder.

Even though A is required to make the payments regardless of whether the salesperson remains employed by A, we believe that the substance of the arrangement is to induce the individual to remain employed. Therefore, A should account for the payments as compensation in its postcombination financial statements and not as part of the consideration transferred for the acquiree.
Arrangements with a shareholder of the acquiree who becomes an employee of the combined entity may contain some elements that are linked to continuing employment and some that are not. Because ASC 805-10-55-25(a) specifies that “a contingent consideration arrangement in which the payments are automatically forfeited if employment terminates is compensation for postcombination services,” a question arises regarding whether linking any portion of the arrangement to continuing employment causes the entire arrangement to be compensation for postcombination services. We believe that if arrangements involve a single shareholder of the acquiree who becomes an employee of the combined entity, an acquirer should separately account for each element.

**Example 6-9**

**Contingent Payment Affected in Part by Continuing Employment**

Company A acquires Company B in a transaction accounted for as a business combination. One of B’s shareholders (Shareholder Y) is an executive officer of B and agrees to become an employee of A after the acquisition. Under the terms of the acquisition agreement, all selling shareholders of B are entitled to an additional payment at the end of the first year after the acquisition date if certain performance targets have been met for that year; however, any amount due to Y will be paid at the end of the first year only if Y is then employed by A. If Y is not employed by A at that time, any contingent amount due under the acquisition agreement will be distributed at the end of the fifth year after the acquisition date.

Since it is possible for the executive officer to receive a payment even if he or she is no longer employed by A, we believe that it is appropriate for A to isolate the element that is contingent on continuing employment and account for that element as compensation in its postcombination financial statements. In this example, A is likely to measure the compensatory element of the arrangement as the value of receiving the amount that is due in one year rather than in five years.

Arrangements such as this might be viewed as containing a “floor” amount that is not affected by continued employment, and thus that amount is appropriately accounted for as contingent consideration in the business combination as long as it satisfies the other criteria for contingent consideration in ASC 805-10-55-25.

In general, if more than one shareholder of the acquiree becomes an employee of the combined entity and one or more of those individuals are required to continue employment, the arrangement is compensatory and not part of the exchange for the acquiree. However, there may be diversity in practice related to these arrangements.

**Example 6-10**

**Payment Contingent on the Continued Employment of a Specific Employee**

Company A acquires Company B in a transaction accounted for as a business combination. One of B’s three shareholders, its CEO, agrees to become A’s employee after the acquisition. The terms of the acquisition agreement require A to make an additional payment if B’s CEO is employed by A at the end of three years. The payment, if due, would be divided among the three shareholders on the basis of their relative ownership percentages in B. However, if B’s CEO is not employed by A for the full three-year period, none of the shareholders will receive their portion of the payment.

We believe that Company A should account for the entire payment as compensation in the postcombination period because all of the payment is contingent on continued employment, albeit on only one person’s employment.

We are also aware of an alternative view in which only the payments to the CEO would be considered contingent on continued employment and therefore be compensation. Under that view, the payments to the other two shareholders should be evaluated in accordance with the other factors in ASC 805-10-55-25.
The guidance in ASC 805-10-55-25(a) requires contingent consideration arrangements to be accounted for as compensation if the payments would be automatically forfeited upon the termination of employment. We believe that when evaluating a provision for forfeiture in the event of employment termination, an entity should assess the substance of any defined stay period. Accordingly, we believe that on the basis of an evaluation of the other indicators in ASC 805-10-55-25, an entity could conclude in unusual circumstances that payments that are contingent on a nonsubstantive stay period are eligible to be accounted for as consideration transferred. We expect such circumstances to be rare.

Example 6-11

**Postcombination Service Requirement Might Be Viewed as Nonsubstantive**

Company A acquires Company B in a transaction accounted for as a business combination. Company B's three shareholders are executive officers of B and agree to become employees of A after the acquisition. The terms of the acquisition agreement require that A pay B's shareholders (1) 50 percent of the consideration at the closing of the acquisition and (2) 50 percent of the consideration if the employees are employed by A one month after the closing of the acquisition. The payment will be divided among the shareholders on the basis of their relative ownership percentages in B. The amount of the contingent payment far exceeds the salary and benefits that the employees would earn in a one-month period.

We believe that before determining that the 50 percent payable one month after the closing is consideration transferred, entities should evaluate the reason for the agreed-upon employment period, the nature of the employees' activities, and other evidence to assess whether the required stay period is substantive. If it is determined to be nonsubstantive, further analysis of the specific facts and circumstances and the other factors in ASC 805-10-55-25 is necessary.

Example 6-12

**Conditional Payment Disproportional to Payment at Closing**

Company A acquires Company B, a manufacturing company, in a transaction accounted for as a business combination. Company B is a substantive operating company with revenues, expenses, inventory, PP&E, customers and customer contracts, and liabilities. Company A determines that B's fair value on the acquisition date is $20 million. Company B's three shareholders are executive officers of B and agree to become employees of A after the acquisition.

The terms of the acquisition agreement require A to pay B's shareholders (1) $1 million in cash consideration at the closing of the acquisition and (2) $25 million in three years from the acquisition date if the shareholders/employees remain employed by A. The conditional payment would be divided among those shareholders on the basis of their relative ownership percentages in B.

While the future payment is contingent on the executive officers' continuing employment with A after the acquisition, we believe that it is not clear whether the guidance in ASC 805-10-55-25(a) is applicable because of the insignificant amount of the consideration paid at closing compared with B's fair value.

For example, if A accounts for the contingent payment as compensation on the basis of applying ASC 805-10-55-25(a), it will be expected to recognize a bargain purchase gain (the difference between the $1 million in consideration transferred and the fair value of the net assets acquired as of the acquisition date) and compensation over the next five years. We believe that such facts might indicate that a portion of the future payments (i.e., the portion representing B's fair value) should be accounted for as consideration transferred and the remainder should be accounted for as compensation in the postcombination period. Further analysis of the specific facts and circumstances is warranted.
6.2.3.3.1.1 **Arrangements to Reallocate Forfeited Awards or Amounts**

An acquirer may issue share-based payment awards to a group of shareholders of the acquiree, all of whom become employees of the combined entity with such awards subject to vesting based on continued employment. The awards may be placed in a trust by the acquirer on the acquisition date. Such arrangements are sometimes referred to as “last man standing” arrangements if any forfeited awards must be reallocated to the remaining participants in the group. Some arrangements may not specify what happens if none of the participants are still employed by the acquirer at the end of the term; however, since these arrangements typically encompass many employees, it would be unlikely that none remain. Other arrangements may specify that the amounts revert to the acquiree’s former shareholders if none of the participants are still employed at the end of the term.

In his remarks at the 2000 AICPA Conference on Current SEC Developments, then SEC OCA Professional Accounting Fellow R. Scott Blackley provided the following example of such an arrangement:

For illustration, consider an example business combination where a company acquires another enterprise, XYZ Company, for cash and stock. All of the shareholders of XYZ Company are also employees. The acquiring company expects and desires to have the employee shareholders of XYZ Company continue as employees of the combined companies. Accordingly, of the shares issued to the shareholders of XYZ Company, a portion is held in an irrevocable trust, subject to a three year vesting requirement (“forfeiture shares”).

The forfeiture provision requires that if, prior to vesting, a shareholder resigns from employment or is terminated for cause, the shares held in the trust allocable to the employee shareholder be forfeited. Additionally, any shares actually forfeited are reallocated to the remaining employee shareholders based on their remaining ownership interests such that all of the forfeiture shares in the trust will ultimately be issued.

Mr. Blackley said that in this scenario, the SEC staff concluded that “the forfeiture shares must be accounted for as a compensation arrangement.” He noted that the staff placed “significant weight” on the shares’ vesting on the basis of continued employment even though the amount of consideration was fixed because it would not be returned to the acquirer under any circumstances. Although Mr. Blackley made these remarks before Statement 141(R) was issued, we believe that they remain relevant.

Therefore, in an arrangement in which share-based payment awards are issued to a group of shareholders of the acquiree, all of whom become employees of the combined entity on the basis of a requirement to continue employment, the forfeiture and subsequent redistribution of the awards are accounted for as (1) the forfeiture of the original award and (2) the grant of a new award. That is, the acquirer would reverse any compensation previously recognized for the forfeited award (on the basis of the original grant-date fair-value-based measure) and then recognize compensation for the new award (on the basis of the fair-value-based measure on the date the award is redistributed) over the remaining requisite service period.

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**Example 6-13**

**Arrangement to Reallocate Forfeited Awards to Remaining Shareholders/Employees**

On January 1, 20X1, Company A acquires Company B and, as part of the acquisition agreement, grants each of B’s 10 shareholders/employees 100 new share-based payment awards that vest at the end of five years of service (cliff vesting). The grant-date fair-value-based measure of each award as of the acquisition date is $10. The terms of the award state that if employment is terminated before the end of five years (i.e., the vesting date), the employee’s awards are forfeited and redistributed among the remaining employees within the group.

The total grant-date fair-value-based measure of the awards as of the acquisition date is $10,000 (10 employees × 100 awards × $10 grant-date fair-value-based measure), which A recognizes in the postcombination financial statements as compensation cost over the five-year service period ($2,000 per year). On December 31, 20X3, two employees in the group terminate their employment and forfeit their awards, which are then redistributed to the eight remaining group members. The fair-value-based measure of each redistributed (i.e., new) award is $12 on the date the awards are redistributed.
Example 6-13 (continued)

On December 31, 20X3, A should reverse $1,200 of previously recognized compensation cost (2 employees × 100 awards × $10 grant-date fair value × 60% for 3 out of 5 years of services rendered) corresponding to the forfeited awards. Company A should continue to recognize $1,600 in annual compensation cost (8 employees × 100 awards × $10 grant-date fair value ÷ 5 years) over each of the remaining two years of service for the original awards provided to the remaining employees. In addition, A should recognize $1,200 in additional annual compensation cost (200 awards × $12 grant-date fair value ÷ 2 years of remaining service) over each of the remaining two years of service for the redistributed awards.

In some cases, payments to the shareholders/employees may be made in cash rather than forfeitable shares. We do not believe that the form of the payment affects the conclusion that such arrangements are based on continued employment and therefore should be accounted for as compensation and not as part of the exchange for the acquiree.

6.2.3.3.1.2 Refundable Payments or Forgiveness of Loans to Selling Shareholders Who Become Employees of the Combined Entity

An acquirer may structure a contingent consideration arrangement such that payments to selling shareholders who become employees of the combined entity are distributed in advance but must be returned if specified conditions are not met. Such amounts might be characterized as refundable payments or loans subject to forgiveness and should be evaluated in accordance with the guidance in ASC 805-10-55-25(a). Accordingly, if the selling shareholders must remain employed by the combined entity for the amount to not become refundable or for the loan to be forgiven, the acquirer should account for the arrangement as compensation rather than contingent consideration.

6.2.3.3.2 Duration of Continuing Employment

ASC 805-10-55-25(b) states, in part, that “[i]f 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.”

ASC 805-10-55-25(b) states, in part, that “[i]f 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” (emphasis added). In evaluating this indicator, the acquirer should consider any employment and noncompetition agreements with a selling shareholder who becomes an employee of the combined entity and whether such agreements create a “requirement” to remain employed with the acquirer.

6.2.3.3.3 Level of Compensation

ASC 805-10-55-25(c) states, in part, that “Level of compensation. Situations in which employee compensation 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.”
As indicated in ASC 805-10-55-25(c), if the compensation, excluding the contingent payment to the selling shareholder who becomes an employee of the combined entity, “is at a reasonable level in comparison to that of other key employees in the combined entity,” the contingent payment may represent contingent consideration. However, assessing the compensation may be difficult because the responsibilities of such an employee may not be readily comparable to those of the acquirer’s other key employees, and levels of compensation may vary significantly within the combined entity on the basis of other factors.

6.2.3.3.4 Incremental Payments to Employees

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<td>55-25(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.</td>
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There may be differences between the per-share contingent payments made to selling shareholders who become employees of the combined entity and the payments made to those who do not. Such differences may be indicators that a portion or all of the payments are compensation. For example:

- The selling shareholders who become employees of the combined entity may be entitled to receive higher contingent payments on a per-share basis than selling shareholders who do not become the entity’s employees. Such a scenario may be an indicator that the incremental portion paid to the selling shareholders/employees is compensation.
- Only selling shareholders who become employees of the combined entity may be entitled to receive the contingent payments. Such a scenario may be an indicator that the contingent payments are compensation.

Example 6-14

**Incremental Contingent Payment to Shareholder Who Becomes an Employee**

Company A acquires Company B in a transaction accounted for as a business combination. Company B is owned equally by three shareholders. One of those shareholders, B’s CEO, agrees to become A’s employee after the acquisition. The terms of the acquisition agreement require A to pay B’s shareholders a fixed amount upon the closing of the acquisition. In addition, A must pay (1) the two shareholders who do not become employees 5 percent of B’s EBITDA above $1 million for each of the next five years and (2) B’s CEO/shareholder 12 percent of B’s EBITDA above $1.5 million for each of the next five years.

The fact that B’s CEO received a higher contingent payment and is employed by A after the business combination indicates that the incremental amount paid (12 percent of B’s EBITDA above $1.5 million less 5 percent of B’s EBITDA above $1 million) is compensation in A’s postcombination financial statements, whereas the remainder of the payments should be accounted for as contingent consideration provided that they qualify as such on the basis of the other factors in ASC 805-10-55-25.
6.2.3.3.5 Number of Shares Owned

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<td><strong>55-25(e)</strong> 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 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.</td>
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The proportion of shares owned by selling shareholders who become employees of the combined entity may be an indicator of whether a contingent payment is a profit-sharing arrangement. For example, if the owners of substantially all of the acquiree’s shares become key employees of the combined entity, the contingent payments may be profit-sharing arrangements (i.e., compensation). However, if such shareholders owned only a small number of the acquiree’s shares, and all selling shareholders received the same amount of contingent consideration on a per-share basis, the conditional payments may be contingent consideration.

When evaluating whether selling shareholders who become employees of the combined entity owned substantially all of the shares in the acquiree, entities also should consider preacquisition ownership interests held by parties related to the selling shareholders, such as family members. Entities may need to use judgment in determining which parties are considered “related to selling shareholders.”

6.2.3.3.6 Linkage to the Valuation

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<td><strong>55-25(f)</strong> 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.</td>
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Entities should consider whether the sum of the consideration transferred on the acquisition date and any anticipated contingent payments is consistent with the acquirer’s estimate of the acquiree’s fair value or whether that total exceeds the estimate. For example, an acquirer and acquiree may disagree on the specific fair value of the acquiree but agree on a related range of value. In such a scenario, the acquirer may agree to pay the seller (1) a fixed amount at the closing that would represent the low end of the range and (2) a contingent amount if earnings exceed a certain target that would represent the higher end of the range, in which case the contingent payments might be viewed as additional consideration. By contrast, if the sum of the fixed amount at the closing and any anticipated contingent payments exceeds the higher end of the range of the acquiree’s estimated fair value, the substance of the arrangement might be to provide compensation.
6.2.3.3.7 Formula for Determining Contingent Consideration

**ASC 805-10**

**55-25(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.

Payments based on multiples of earnings (e.g., EBITDA, EBIT, net income, or revenues) may be more likely to be contingent consideration than payments based on percentages of earnings, which are more likely to be profit-sharing arrangements that should be accounted for as compensation.

6.2.4 Other Arrangements

**ASC 805-10**

**55-25(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 recognize 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.

The acquirer and the selling shareholders may enter into other arrangements simultaneously with, or in close proximity to, the acquisition. If so, the acquirer should determine whether to attribute some or all of the contingent payments under the acquisition agreement to such other arrangements (e.g., in circumstances in which the other arrangement provides for no payment or a below-market payment). Amounts attributable to other arrangements should be accounted for separately from the business combination in accordance with their nature.

In addition, ASC 805-10-55-25(h) states that "the income tax treatment of contingent payments may indicate that contingent payments are attributable to something other than consideration for the acquiree." When assessing the substance of an arrangement, entities should evaluate any lack of symmetry between the accounting treatment and the tax treatment of contingent payments.

6.2.5 Selling Shareholders Share Proceeds With Specified Employees of the Acquiree

In some acquisitions, one or more of the selling shareholders may decide to share some of the proceeds that they are entitled to receive with one or more of the acquiree’s nonshareholder employees. Such arrangements may be structured in various ways. For example, the selling shareholders may decide to share a portion of the consideration that they are entitled to receive on the acquisition date or to share a portion of any future contingent payments that they are entitled to receive, or both. The selling shareholders may direct the acquirer to deliver the amounts directly to the specified employees or may pay the specified employees directly from their proceeds.
6.2.6 Disputes Arising From the Business Combination

After the completion of a business combination, a dispute may occur between an acquirer and the acquiree's sellers that sometimes results in payments between the parties after the acquisition date. Alternatively, an acquirer's shareholders may bring a claim against the acquirer for various reasons (e.g., overpayment for the acquiree — see discussion in Section 6.2.6.2).

6.2.6.1 Settlement of Disputes With the Sellers Over a Business Combination

When a dispute between the acquirer and the seller results in a transfer of amounts between the parties after the acquisition date, questions may arise about whether the acquirer, when accounting for such subsequent payments, should reflect the amount paid or received either (1) as an adjustment to the consideration transferred for the acquiree or (2) in its postacquisition income statement. At the 2003 AICPA Conference on Current SEC Developments, SEC OCA Professional Accounting Fellow Randolph Green indicated in prepared remarks that the SEC has “generally concluded that legal claims between an acquirer and the former owners of an acquired business should be reflected in the income statement when settled.” This view is based on the general belief that contingencies related to litigation about the business combination itself are not preacquisition contingencies. However, Mr. Green noted that an acquirer may be able to treat such payments as an adjustment to the consideration transferred for the acquisition if there is a “clear and direct link to the purchase price.” He gave the following example:

-Assume a purchase agreement explicitly sets forth the understanding that each “acquired customer” is worth $1,000, that not less than one thousand customers will be transferred as of the consummation date, and subsequent litigation determines that the actual number of acquired customers was only nine hundred. The effects of the litigation should properly be reflected as part of the purchase price. In contrast, if the purchase agreement obligates the seller to affect its best efforts to retain customers through the consummation date and litigation subsequently determines that the seller failed to do so, the effects are not clearly and directly linked to the purchase price and, accordingly, should be reflected in the income statement.

Even when an acquirer is able to establish “a clear and direct link” to the consideration transferred, we believe that it is only appropriate to adjust the consideration transferred if the measurement period is still open. If it is closed, entities should recognize such amounts in the income statement. In an alternative example, Mr. Green noted that “claims that assert one party [misled] the other or that a provision of the agreement is unclear are not unique to business combination agreements.” Therefore, such claims do not generally establish a clear and direct link to the consideration transferred and should be reflected in the income statement.

Mr. Green also noted that “[f]requently, claims seeking enforcement of an escrow or escrow-like arrangement also include claims of misrepresentation or otherwise constitute a mixed claim.” He went on to say that “[i]n order to reflect some or all of the settlement of such a [mixed] claim as an adjustment of the purchase price of the acquired business, the acquirer should be able to persuasively demonstrate that all or a specifically identified portion of the mixed claim is clearly and directly linked to the purchase price.”

Although not stated by Mr. Green, neither the acquirer’s legal costs to settle the dispute nor any settlement amounts used to reimburse the sellers for legal costs or other damages are clearly and directly linked to the consideration transferred. Thus, they should be reflected in the income statement.

While this SEC staff speech was given before Statement 141(R) was issued, we believe that the views expressed in it continue to apply.
6.2.6.2 Settlement of Disputes With the Acquirer's Shareholders Over a Business Combination

An acquirer's shareholders may bring a claim against the acquirer after the acquisition date for various reasons, such as the shareholders' assertion that the acquirer overpaid for the acquiree. The acquirer should recognize costs incurred for such disputes, including any settlement amounts if paid, in the income statement and not as part of the consideration transferred to the acquiree. This view is consistent with an additional statement by Mr. Green that, in reference to settlements of litigation over the consideration transferred, “the cost of litigation brought by the acquirer's shareholders should always be reflected in the income statement.”

6.3 Accounting for Arrangements Entered Into Concurrently With the Business Combination

An acquirer and seller may enter into one or more other agreements in close proximity to, or simultaneously with, the business combination. For example, an acquirer and seller may enter into a business combination transaction as well as execute an ongoing supply, distribution, collaboration, or licensing agreement. Such agreements may be transitional (e.g., for a few months) or more long term. The acquirer should account for individual agreements in accordance with their nature and should specifically consider whether each agreement's stated price reflects an amount that would be expected in the absence of a concurrent business combination. For example, the consideration for the business could be overstated while the pricing for the supply agreement could be understated or vice versa. Therefore, an entity may need to adjust the stated contractual amounts when recognizing each arrangement.

Example 6-15

Supply Agreement Entered Into Simultaneously With the Acquisition

Company B enters into an agreement with Company C to acquire C’s subsidiary, Subsidiary S. Subsidiary S has been supplying a specific raw material to C, and C wants to continue to receive it after the acquisition. Company B agrees to pay a fixed amount on the acquisition date and to provide a predetermined amount of raw materials to C at no cost for one year after the closing date.

In determining the consideration transferred in the business combination, B should include the value related to the amount of raw materials to be provided to C for no cost, because an arrangement to provide no-cost materials would be unexpected in the absence of the business combination.

6.4 Partial Acquisitions

A “partial acquisition” is a business combination in which an entity acquires a controlling interest, but less than 100 percent of the voting interests, in an entity. The ASC master glossary defines a noncontrolling interest (also known as a minority interest) as “[t]he portion of equity (net assets) in a subsidiary not attributable, directly or indirectly, to a parent.” Therefore, the portion of equity in the acquiree held by other parties is presented as a noncontrolling interest in the acquirer's consolidated financial statements.

An underlying premise of ASC 805 is that obtaining control of a business makes the acquirer accountable and responsible for all of the acquiree's assets and liabilities, regardless of the acquirer's ownership percentage. Therefore, in a partial acquisition, the acquirer recognizes in its consolidated financial statements the assets acquired, liabilities assumed, and noncontrolling interest at 100 percent of their values, measured in accordance with ASC 805 (generally at fair value). That is, even if the acquirer obtains a less than 100 percent interest in the acquiree, all of the assets and liabilities, including goodwill, are measured at 100 percent of their values, as calculated in accordance with ASC 805.
On the acquisition date of a partial acquisition, the acquirer only transfers consideration for the portion of the equity interests acquired in that transaction. Therefore, to determine the amounts to recognize for the assets acquired (including goodwill), liabilities assumed, and any noncontrolling interests, the acquirer must include in the calculation “the fair value of any noncontrolling interest,” in accordance with ASC 805-30-30-1. That guidance requires entities to measure goodwill in business combinations, including partial acquisitions, as follows:

The acquirer shall recognize 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, which generally requires acquisition-date fair value (see paragraph 805-30-30-7)
      2. The fair value of any noncontrolling interest in the acquiree
      3. In a business combination achieved in stages, 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. [Emphasis added]

Once an entity has control of a subsidiary, any subsequent acquisitions of some or all of the noncontrolling interests in that subsidiary are accounted for as equity transactions under ASC 810-10, as long as the acquirer maintains control. For more information about acquisitions of noncontrolling interests, see Deloitte’s A Roadmap to Consolidation — Identifying a Controlling Financial Interest.

Example 6-16

**Measuring Goodwill in a Partial Acquisition**

Company A acquires 80 percent of the equity interests in, and control of, Company B for $1,600. Company A had no prior ownership in B. The transaction meets the definition of a business combination. The fair value of the noncontrolling interest is $380. The fair value of B’s identifiable net assets as of the acquisition date is $1,500.

Company A should measure goodwill as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consideration transferred for A’s 80 percent interest in B</td>
<td>$ 1,600</td>
</tr>
<tr>
<td>Plus: Fair value of the noncontrolling interest in B (see ASC 805-30-30-1)</td>
<td>380*</td>
</tr>
<tr>
<td>Minus: Net identifiable assets recognized under ASC 805</td>
<td>(1,500)</td>
</tr>
<tr>
<td>Goodwill</td>
<td>$ 480</td>
</tr>
</tbody>
</table>

* The fair value of the noncontrolling interest in B includes a discount for lack of control for illustrative purposes. The amount of discount, if any, should be determined for each transaction on the basis of the facts and circumstances.
6.4.1 Measuring the Fair Value of a Noncontrolling Interest

ASC 805-20

Measuring the Fair Value of a Noncontrolling Interest in an Acquiree

30-7 Paragraph 805-20-30-1 requires the acquirer to measure a noncontrolling interest in the acquiree at its fair value at the acquisition date. An acquirer sometimes will be able to measure the acquisition-date fair value of a noncontrolling interest on the basis of a quoted price in an active market for the equity shares (that is, those not held by the acquirer). In other situations, however, a quoted price in an active market for the equity shares will not be available. In those situations, the acquirer would measure the fair value of the noncontrolling interest using another valuation technique.

30-8 The fair values of the acquirer’s interest in the acquiree and the noncontrolling interest on a per-share basis might differ. The main difference is likely to be the inclusion of a control premium in the per-share fair value of the acquirer’s interest in the acquiree or, conversely, the inclusion of a discount for lack of control (also referred to as a noncontrolling interest discount) in the per-share fair value of the noncontrolling interest if market participants would take into account such a premium or discount when pricing the noncontrolling interest.

ASC 805 requires an acquirer to determine the acquisition-date fair value of any noncontrolling interest in the acquiree. If there is an active market for the noncontrolling interest, it must be measured “on the basis of a quoted price in an active market for the equity shares (that is, those not held by the acquirer).” However, ASC 805 does not provide detailed guidance on valuing the noncontrolling interest when an active market does not exist, except to say that “the acquirer would measure the fair value of the noncontrolling interest using another valuation technique” and that the “main difference [in valuing the noncontrolling interests] is likely to be . . . the inclusion of a discount for lack of control.” The valuation techniques used by entities to measure the noncontrolling interest should be consistent with the fair value measurement principles in ASC 820.

Example 6-17

Impact of a Control Premium on the Fair Value of the Noncontrolling Interest

Company A acquires 60 percent (600,000 shares) of Company B for $6 million (or $10 per share). However, on the acquisition date, B’s shares are trading at $9.00 per share. The acquirer acknowledges that it is paying a premium over the market because it believes that it will derive synergies from integrating B with its own business.

Because A paid a premium over B’s market value per share, it may not be reasonable to conclude that the fair value of each share held by noncontrolling shareholders is $10.00.

Example 6-18

Determining the Fair Value of the Noncontrolling Interest

Company C acquired 75 percent (750,000 shares) of Company D, a privately held entity, for $15 million in cash (or $20 per share). An independent third-party valuation firm calculates the fair value of D as a whole (i.e., 100 percent) as $19 million by using valuation techniques in accordance with the guidance in ASC 820.

It may be appropriate for C to derive the fair value of the noncontrolling interest as $4 million (or $16 per share), calculated as the fair value of the entire business ($19 million) less the fair value of the consideration transferred by C ($15 million), which includes a control premium.
6.5 Business Combinations Achieved in Stages

**ASC 805-10**

**A Business Combination Achieved in Stages**

*25-9* An acquirer sometimes obtains control of an acquiree in which it held an equity interest immediately before the acquisition date. For example, on December 31, 20X1, Entity A holds a 35 percent noncontrolling equity interest in Entity B. On that date, Entity A purchases an additional 40 percent interest in Entity B, which gives it control of Entity B. This Topic refers to such a transaction as a business combination achieved in stages, sometimes also referred to as a step acquisition.

*25-10* 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 recognize the resulting gain or loss, if any, in earnings. In prior reporting periods, with respect to its previously held equity method investment, the acquirer may have recognized amounts in other comprehensive income in accordance with paragraph 323-10-35-18. If so, the amount that was recognized in other comprehensive income shall be reclassified and included in the calculation of gain or loss as of the acquisition date. If the business combination achieved in stages relates to a previously held equity method investment that is a foreign entity, the amount of accumulated other comprehensive income that is reclassified and included in the calculation of gain or loss shall include any foreign currency translation adjustment related to that previously held investment. For guidance on derecognizing foreign currency translation adjustments recorded in accumulated other comprehensive income, see Section 830-30-40.

As described in ASC 805-10-25-9, in a business combination achieved in stages, an acquirer “obtains control of an acquiree in which it held an equity interest immediately before the acquisition date.” Such transactions are also commonly called “step acquisitions.” Because, as stated previously, an acquirer is accountable and responsible for all of the acquiree's assets and liabilities regardless of the ownership percentage acquired on the acquisition date, the acquirer in a step acquisition recognizes in its consolidated financial statements the assets acquired, liabilities assumed, and noncontrolling interest at 100 percent of their values, measured in accordance with ASC 805 (generally at fair value).

However, on the acquisition date of a business combination achieved in stages, the acquirer only transfers consideration for the portion of the equity interests acquired in that transaction. Therefore, to determine the amounts to recognize for the assets acquired (including goodwill), liabilities assumed, and any noncontrolling interests, the acquirer must determine the fair value of the acquiree as a whole. To do so, the acquirer must remeasure its previously held equity interest in the acquiree as of its acquisition-date fair value and recognize the resulting gain or loss, if any, in earnings. The acquirer then measures the goodwill in accordance with the guidance in ASC 805-30-30-1 and accounts for the acquisition as if it had sold the previously held interest, recognized any gain or loss in current-period earnings, and then acquired a controlling interest in the acquiree. Paragraph B384 of the Basis for Conclusions of Statement 141(R) explains the FASB’s rationale for the accounting treatment:

> The Boards concluded that a change from holding a noncontrolling investment in an entity to obtaining control of that entity is a significant change in the nature of and economic circumstances surrounding that investment. That change warrants a change in the classification and measurement of that investment. Once it obtains control, the acquirer no longer is the owner of a noncontrolling investment asset in the acquiree. As in present practice, the acquirer ceases its accounting for an investment asset and begins reporting in its financial statements the underlying assets, liabilities, and results of operations of the acquiree. In effect, the acquirer exchanges its status as an owner of an investment asset in an entity for a controlling financial interest in all of the underlying assets and liabilities of that entity (acquiree) and the right to direct how the acquiree and its management use those assets in its operations.
In prior periods, the previously held interest may have been remeasured to fair value, with changes recognized in other comprehensive income. Alternatively, the investment may have been in a foreign entity for which the acquirer had recognized cumulative translation adjustments. In such cases, any amounts in accumulated comprehensive income related to the previously held interest should be reclassified and included in the calculation of the gain or loss.

Once the acquirer obtains control of the acquiree, subsequent increases or decreases in its ownership interest are accounted for as equity transactions in accordance with ASC 810-10 as long the acquirer retains control. For more information about acquisitions of noncontrolling interests, see Deloitte’s *A Roadmap to Consolidation — Identifying a Controlling Financial Interest*.

### Example 6-19

**Business Combination Achieved in Stages (Step Acquisition)**

Company A purchases a 35 percent interest in Company B, a publicly traded entity, for $2,000 on January 1, 20X8. (The deferred tax accounting implications are ignored in this example.) Company A accounts for its 35 percent interest in B by using the equity method of accounting.

On December 31, 20X9, A purchases the remaining 65 percent interest for $6,500 and obtains control of B. Company A accounts for the transaction as a business combination. Company B’s identifiable net assets are recognized at $8,000 under ASC 805, and the fair value of A’s 35 percent interest in B is $3,500. The book value of that interest is $2,500.

Company A should account for the acquisition of B as follows:

| Carrying value of previously held interest | $2,500 |
| Fair value of previously held interest on the acquisition date | $3,500 |
| Gain recognized in A’s earnings on remeasurement of previously held interest | $1,000 |

| Consideration transferred for 65 percent interest in B | $6,500 |
| Plus: Fair value of previously held interest (see ASC 805-30-30-1) | $3,500 |
| Minus: Net identifiable assets recognized under ASC 805 | $(8,000) |
| Goodwill | $2,000 |

### 6.5.1 Measuring the Fair Value of a Previously Held Interest

ASC 805 does not specify how to measure a previously held equity interest. For publicly traded interests, entities should measure fair value by using the market price on the acquisition date. However, some have questioned whether a previously held interest that is not publicly traded should be remeasured with or without a control premium.

Some have looked to ASC 805-30-30-1, which describes how to measure goodwill, as support for remeasuring a previously held interest without a control premium. That paragraph states:

> The acquirer shall recognize 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, which generally requires acquisition-date fair value (see paragraph 805-30-30-7)
2. The fair value of any noncontrolling interest in the acquiree

3. In a business combination achieved in stages, 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.

Proponents of this view believe that this guidance indicates that a previously held interest is its own unit of account. That is, in measuring the fair value of the acquiree, entities should separately measure (1) the consideration transferred for the interest that gave the acquirer control, (2) the fair value of any noncontrolling interest, and (3) the fair value of any previously held interest. Because there are three separate units of account, each is measured individually, and possibly differently, from the others. Entities should then look to ASC 805-20-30-8, which clarifies how a noncontrolling interest in a partial acquisition should be measured:

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

ASC 805-20-30-8 clarifies that a noncontrolling interest is a separate unit of account that should be measured differently from the acquirer's controlling interest. Thus, if the previously held interest is also a separate unit of account, it must also be measured independently, which suggests that no control premium should be included in the value of the previously held interest.

Alternatively, others believe that the acquirer's entire ownership interest (both the newly acquired and the previously held interest) in the acquiree should be measured as a single unit of account. This view could result in the inclusion of a control premium in the remeasurement of the previously held interest.

Supporters of this view also look to the guidance in ASC 805-20-30-8, but they interpret the words “the fair values of the acquirer's interest in the acquiree and the noncontrolling interest” to indicate that there are two units of account in the measurement of the acquiree's fair value: the acquirer's total interest (both the newly acquired and the previously held interest) and the noncontrolling interest, if any. They then read the words “inclusion of a control premium in the per-share fair value of the acquirer's interest in the acquiree” to indicate that the valuation of the acquirer's interest (both the newly acquired and the previously held interest) should include a control premium.

We understand that members of both the FASB's and IASB's staffs discussed this issue at the September 23, 2008, FASB Valuation Resource Group meeting. At that meeting, two staff members, one from each staff, expressed their belief that measuring a previously held interest without a control premium is consistent with both boards' intent in jointly developing Statement 141(R) (now ASC 805) and IFRS 3. However, we note that there has been no additional standard setting in response to the staff discussions. We also note that sometimes, such as in the case of a publicly traded acquiree, it would be appropriate to measure at the same per-share amount both the interest that gives the acquirer control and the previously held interest, which may include a control premium. We therefore believe that measuring a previously held interest requires the use of judgment and that different approaches may be reasonable under different circumstances.
### 6.6 Business Combinations Achieved Without the Transfer of Consideration

<table>
<thead>
<tr>
<th><strong>ASC 805-10</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>25-11</strong> An acquirer sometimes obtains control of an acquiree without transferring consideration. The acquisition method of accounting for a business combination applies to those combinations. Such circumstances include any of the following:</td>
</tr>
<tr>
<td>a. The acquiree repurchases a sufficient number of its own shares for an existing investor (the acquirer) to obtain control.</td>
</tr>
<tr>
<td>b. Minority veto rights lapse that previously kept the acquirer from controlling an acquiree in which the acquirer held the majority voting interest.</td>
</tr>
<tr>
<td>c. The acquirer and acquiree agree to combine their businesses by contract alone. The acquirer transfers no consideration in exchange for control of an acquiree and holds no equity interests in the acquiree, either on the acquisition date or previously. Examples of business combinations achieved by contract alone include bringing two businesses together in a stapling arrangement or forming a dual-listed corporation.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>ASC 805-30</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>55-2</strong> In a business combination achieved without the transfer of consideration, the acquirer must substitute the acquisition-date fair value of its interest in the acquiree for the acquisition-date fair value of the consideration transferred to measure goodwill or a gain on a bargain purchase (see paragraphs 805-30-30-1 through 30-4). Subtopic 820-10 provides guidance on using valuation techniques to measure fair value.</td>
</tr>
</tbody>
</table>

An acquirer may obtain control of an acquiree without transferring any consideration on the acquisition date. Even though no consideration is transferred, the acquirer must still account for the transaction by using the acquisition method. ASC 805-30-55-2 states that “[t]he acquirer must substitute the acquisition-date fair value of its interest in the acquiree for the acquisition-date fair value of the consideration transferred to measure goodwill or a gain on a bargain purchase.”

ASC 805-10-25-11 provides three examples of business combinations achieved without the transfer of consideration:

a. The acquiree repurchases a sufficient number of its own shares for an existing investor (the acquirer) to obtain control [see Section 6.6.1].

b. Minority veto rights lapse that previously kept the acquirer from controlling an acquiree in which the acquirer held the majority voting interest [see Section 6.6.2].

c. The acquirer and acquiree agree to combine their businesses by contract alone [see Section 6.6.3].

These are examples only, and there may be other transactions or events that qualify as business combinations achieved without the transfer of consideration.
6.6.1 Share Repurchases

A business combination can occur when an entity repurchases a sufficient number of its own shares from existing investors and another existing investor obtains control of the entity. In such cases, the acquiree transfers consideration to buy back its own shares, but the acquirer does not transfer any consideration to obtain control of its investee.

**Example 6-20**

**Share Repurchase**

Company A holds a 48 percent interest in Company B and accounts for it by using the equity method of accounting. The remaining 52 percent interest in B is widely held. Company B announces a share buyback program. Company A does not sell any of its interest. As a result of B's share buybacks, A's percent interest in B increases to greater than 50 percent of the outstanding shares, and A obtains control of B.

Company A should account for this event as a business combination (i.e., an acquisition achieved in stages, since A had a previously held interest). While A did not transfer consideration to obtain control of B, it did obtain control as a result of B's repurchase of its own shares.

6.6.2 Lapse of Minority Veto Rights or Substantive Participating Rights

A business combination can occur when minority veto rights or substantive participating rights held by one or more shareholders lapse, giving a majority shareholder control over an entity. While it is presumed under the guidance in ASC 810-10 that a voting interest entity is controlled by the holder of more than 50 percent of an entity's voting interest, noncontrolling interest holders sometimes have the right to either participate in or block certain significant financial and operating decisions that an entity makes in the ordinary course of business. In such situations, the majority investor cannot control the entity. However, if those minority veto rights or substantive participating rights lapse, the holder of the majority interest may obtain control of the entity and would account for that event as a business combination. For more information about minority veto rights and substantive participating rights, see Deloitte’s *A Roadmap to Consolidation — Identifying a Controlling Financial Interest*.

**Example 6-21**

**Lapse of Minority Veto Rights**

Company A holds a majority interest in Company X, and Company D holds both a noncontrolling interest and minority veto rights in X. The minority veto rights preclude A from exercising control over X, so A accounts for its interest in X by using the equity method of accounting. On the date that D's veto rights expire, A gains control over X.

Once A obtains control of X, it should account for this event as a business combination.

6.6.3 Control by Contract

A business combination can occur when an acquirer and acquiree agree to combine their businesses by contract alone (e.g., a stapling arrangement or dual-listed corporations). In such cases, one of the entities must be identified as the acquirer for accounting purposes, and the assets and liabilities of the entity determined to be the acquiree for accounting purposes are recognized by using the acquisition method, generally at the acquisition-date fair values. ASC 805-10-25-12 states, in part, that for business combinations achieved by contract alone, “the acquirer shall attribute to the equity holders of the acquiree the amount of the acquiree's net assets recognized.” In other words, the acquirer should consolidate the acquiree even if the acquirer owns little or none of the acquiree's outstanding equity. The acquirer should recognize in its postcombination financial statements a noncontrolling interest for
the equity in the acquiree owned by other parties even if the result is that the noncontrolling interest represents 100 percent of the acquiree’s net assets.

With the introduction of the VIE model, the relevance of the control by contract model has diminished. This is because a legal entity controlled by contract would most likely be a VIE since one of the conditions for exemption from the VIE model is that the equity investors at risk must control the legal entity’s most significant activities. However, in the rare instances in which such a legal entity is not a VIE, the guidance in ASC 810-10-15-20 through 15-22 applies. See Deloitte’s A Roadmap to Consolidation — Identifying a Controlling Financial Interest for more information about the control-by-contract model.

6.7 Recapitalization Transactions

A recapitalization is a type of reorganization designed to change an entity’s capital structure (e.g., the mix of debt and equity). Usually, these transactions involve new debt financing, issuing new shares, or repurchasing outstanding shares. In a leveraged recapitalization, new debt is issued, and the proceeds are used to redeem shares from existing shareholders as part of a series of steps that may also result in the establishment of a new majority shareholder. If the transaction results in a change in control of the entity undergoing the recapitalization, the new controlling entity would account for the entity that underwent the recapitalization (if it meets the definition of a business) as an acquiree in a business combination. In such a situation, an entity should evaluate all facts and circumstances in determining whether it has obtained control of a business as a result of an investee undergoing a recapitalization transaction.

**Example 6-22**

**Recapitalization Transaction Without a Change in Control**
Entities A, B, C, D, and E each own 20 percent of the issued and outstanding shares of Company X. Company X meets the definition of a business. None of the entities has control of X. Company X buys back all of E’s shares, and the ownership of A, B, C, and D increases to 25 percent each. However, no entity obtains control of X and thus a business combination has not occurred as a result of the recapitalization.

**Recapitalization Transaction With a Change in Control**
Entities A, B, and C own all of the issued and outstanding shares of Company X. Company X meets the definition of a business. Entity A owns 45 percent, B owns 40 percent, and C owns 15 percent. None of the entities has control of X. Company X buys back all of C’s shares, and A’s ownership increases to 53 percent. In the absence of evidence that A does not control X, a business combination between A and X has occurred as a result of the recapitalization.

6.7.1 Transaction Costs in a Recapitalization

Entities may incur costs related to structuring a recapitalization. An entity undergoing a recapitalization should account for its costs on the basis of their nature. For example:

- Costs related to issuing debt are capitalized as debt issuance costs and amortized over the life of the debt by using the effective interest method.
- Costs related to issuing equity and raising capital are recognized as a reduction to the total amount of equity raised. (See Section 5.7 of Deloitte’s A Roadmap to Initial Public Offerings for more information about offering costs and SAB Topic 5.A.)
- Direct and incremental costs (e.g., costs related to advisory or legal services) should be expensed as incurred.
If the costs are billed to the entity as a single amount, we believe that the entity should apply the guidance in the **Interpretive Response** to Question 1 of SAB Topic 2.A.6, which states, in part:

> When an investment banker provides services in connection with a business combination or asset acquisition and also provides underwriting services associated with the issuance of debt or equity securities, the total fees incurred by an entity should be allocated between the services received on a relative fair value basis. The objective of the allocation is to ascribe the total fees incurred to the actual services provided by the investment banker.

We believe that the amounts allocated to debt issuance costs should result in an effective interest rate on the debt that is consistent with the effective market interest rate and that the amounts allocated to equity issuance costs should be consistent with the fees an underwriter would charge.

Further, we believe that if the fees are incurred by a new investor, those costs should not be recognized in the financial statements of the entity undergoing the recapitalization unless they were incurred by the investor on the entity's behalf. We believe that entities should consider the guidance in SAB Topic 1.B and SAB Topic 5.T in determining whether such costs were incurred on behalf of, and for the benefit of, the entity.

### 6.8 Reverse Acquisitions

As discussed in Chapter 3, a reverse acquisition occurs when the entity that issues its shares or gives other consideration to effect the transaction is determined for accounting purposes to be the acquiree (also called the accounting acquiree or legal acquirer), while the entity whose shares are acquired is for accounting purposes the acquirer (also called the accounting acquirer or legal acquiree). The accounting acquiree/legal acquirer generally continues in existence as the legal entity whose shares represent the outstanding common shares of the combined company. While the accounting acquiree/legal acquirer continues to issue its own financial statements, those statements are often in the name of the accounting acquirer/legal acquiree because the legal acquirer often adopts the name of the legal acquiree. The financial reporting reflects the accounting acquirer's/legal acquiree's financial information, except for its equity, which is retroactively adjusted to reflect the equity of the accounting acquiree/legal acquirer.

**Example 6-23**

**Reverse Acquisition**

Company A, a public company with substantive operations and a December 31 year-end, has one million common shares outstanding as of June 30, 20X9. On July 1, 20X9, in a transaction accounted for as a business combination, A issues four million of its newly registered common shares to Company B, a private entity, in exchange for all of B's two million outstanding common shares (an exchange rate of 2:1). After the transaction, B controls A's voting rights through its 80 percent ownership interest (four million common shares held ÷ five million total common shares outstanding) and its ability to elect the majority of the combined entity's board members.

Although A issued common shares to effect the business combination, B would be considered the accounting acquirer under ASC 805, provided that there are no other existing pertinent facts and circumstances to the contrary after consideration of the factors in ASC 805-10-55-12 through 55-14.
6.8.1 Accounting Acquiree Must Meet the Definition of a Business

ASC 805-40-25-1 states that the guidance in ASC 805-40 on reverse acquisitions only applies if the accounting acquiree/legal acquirer meets the definition of a business in ASC 805 (see Section 2.4). Otherwise, the transaction is accounted for as either a reverse asset acquisition or a capital transaction, depending on the substance of the transaction. See Appendix C for more information about accounting for asset acquisitions.

6.8.2 Measuring Consideration Transferred

In a reverse acquisition, the accounting acquirer/legal acquirer typically issues its shares to the owners of the accounting acquirer/legal acquirer as consideration in the transaction. However, to apply the acquisition method of accounting, the accounting acquirer/legal acquirer must calculate the hypothetical amount of consideration that it would have transferred to acquire the accounting acquiree/legal acquirer and obtain the same percentage of ownership interest in the combined entity that results from the transaction. Accordingly, the fair value of the consideration transferred is determined on the basis of the number of equity interests that the accounting acquirer/legal acquirer would have had to issue to the accounting acquiree/legal acquirer's owners to provide the same ratio of ownership of equity interests in the combined entity as a result of the reverse acquisition. Generally, the fair value of the consideration transferred equals the fair value of the accounting acquiree/legal acquirer.

In some reverse acquisitions, the accounting acquiree/legal acquirer may issue cash or other consideration, as well as shares, to acquire the shares of the accounting acquirer/legal acquirer. The payment of cash to the shareholders of the accounting acquirer/legal acquirer should be considered a distribution of capital and, accordingly, a reduction of shareholders' equity of the accounting acquirer/legal acquirer.

For reverse acquisitions between a public company and a private company in which the public company is the accounting acquirer but is determined to be the accounting acquiree, the fair value of the public company's shares generally is more reliably determinable than the fair value of the private company's shares. Thus, the determination of the consideration transferred might be based on the fair value of the legal acquirer's shares rather than the fair value of the legal acquiree's shares.
6.8.3  Measuring the Accounting Acquiree’s Assets and Liabilities, Including Goodwill

ASC 805-40

30-1 All of the measurement principles applicable to business combinations in Subtopics 805-10, 805-20, and 805-30 apply to a reverse acquisition.

In a reverse acquisition accounted for as a business combination, the accounting acquiree’s/legal acquirer’s assets and liabilities are measured in accordance with the guidance in ASC 805 on business combinations. ASC 805-40-55-12 clarifies that an entity should measure goodwill in a reverse acquisition “as the excess of the fair value of the consideration effectively transferred” (emphasis added) by the accounting acquirer/legal acquiree divided by the fair value of the accounting acquiree’s/legal acquirer’s identifiable assets and liabilities. The consideration effectively transferred is calculated as described in Section 6.8.2.

In some reverse acquisitions, the accounting acquirer/legal acquiree owns shares of the accounting acquiree/legal acquirer before the transaction. To calculate the amount of goodwill to recognize, the accounting acquirer/legal acquiree must remeasure its previously held interest in the accounting acquiree/legal acquirer at its acquisition-date fair value and add it to the consideration transferred. See Section 6.5 for more information about the accounting for previously held interests.

If the accounting acquiree/legal acquirer does not meet the definition of a business and the acquisition is accounted for as a reverse asset acquisition, the accounting acquiree’s assets and liabilities are measured in accordance with the subsections in ASC 805-50 on the acquisition of assets rather than a business. See Appendix C for more information about accounting for asset acquisitions.

6.8.4  Noncontrolling Interests

ASC 805-40

25-2 In a reverse acquisition, some of the owners of the legal acquiree (the accounting acquirer) might not exchange their equity interests for equity interests of the legal parent (the accounting acquiree). Those owners are treated as a noncontrolling interest in the consolidated financial statements after the reverse acquisition. That is because the owners of the legal acquiree that do not exchange their equity interests for equity interests of the legal acquirer have an interest in only the results and net assets of the legal acquiree — not in the results and net assets of the combined entity. Conversely, even though the legal acquirer is the acquiree for accounting purposes, the owners of the legal acquirer have an interest in the results and net assets of the combined entity.

30-3 The assets and liabilities of the legal acquiree are measured and recognized in the consolidated financial statements at their precombination carrying amounts (see paragraph 805-40-45-2(a)). Therefore, in a reverse acquisition the noncontrolling interest reflects the noncontrolling shareholders’ proportionate interest in the precombination carrying amounts of the legal acquiree’s net assets even though the noncontrolling interests in other acquisitions are measured at their fair values at the acquisition date.

In some reverse acquisitions, some shareholders of the accounting acquirer/legal acquiree may not exchange their interests for interests in the accounting acquiree/legal acquirer, which results in noncontrolling interests in the combined entity. Because the noncontrolling interest holders own ownership interests in the entity determined to be the acquirer for accounting purposes, “the noncontrolling interest reflects the noncontrolling shareholders’ proportionate interest in the precombination carrying amounts of the legal acquiree’s net assets even though the noncontrolling interests in other acquisitions are measured at their fair values at the acquisition date.”
6.8.5 Presentation of the Combined Entity’s Financial Statements

In a reverse acquisition, the financial statements of the newly combined entity represent a continuation of the financial statements of the accounting acquirer/legal acquiree. As a result, the assets and liabilities of the accounting acquirer/legal acquiree are presented at their historical carrying values in the consolidated financial statements of the newly combined entity and the assets and liabilities of the accounting acquiree/legal acquirer are recognized on the acquisition date and measured by using the acquisition method. The results of the accounting acquiree’s/legal acquirer’s results of operations are included in the combined company’s financial statements beginning on the acquisition date.

<table>
<thead>
<tr>
<th>ASC 805-40</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>30-4</strong> Paragraph 805-40-45-1 provides guidance on required adjustments to the accounting acquirer’s legal capital to reflect the legal capital of the legal parent (accounting acquiree) in the consolidated financial statements following a reverse acquisition.</td>
</tr>
<tr>
<td><strong>45-1</strong> Consolidated financial statements prepared following a reverse acquisition are issued under the name of the legal parent (accounting acquiree) but described in the notes as a continuation of the financial statements of the legal subsidiary (accounting acquirer), with one adjustment, which is to retroactively adjust the accounting acquirer’s legal capital to reflect the legal capital of the accounting acquiree. That adjustment is required to reflect the capital of the legal parent (the accounting acquiree). Comparative information presented in those consolidated financial statements also is retroactively adjusted to reflect the legal capital of the legal parent (accounting acquiree).</td>
</tr>
<tr>
<td><strong>45-2</strong> 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:</td>
</tr>
<tr>
<td>a. The assets and liabilities of the legal subsidiary (the accounting acquirer) recognized and measured at their precombination carrying amounts.</td>
</tr>
<tr>
<td>b. The assets and liabilities of the legal parent (the accounting acquiree) recognized and measured in accordance with the guidance in this Topic applicable to business combinations.</td>
</tr>
<tr>
<td>c. The retained earnings and other equity balances of the legal subsidiary (accounting acquirer) before the business combination.</td>
</tr>
<tr>
<td>d. The amount recognized 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. However, the equity structure (that is, 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 acquiree) 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.</td>
</tr>
<tr>
<td>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 and illustrated in Example 1, Case B (see paragraph 805-40-55-18).</td>
</tr>
</tbody>
</table>
The following table summarizes the measurement basis for the combined entity’s financial statements at the time of a reverse acquisition:

<table>
<thead>
<tr>
<th>Statement of Financial Position Balance(s)</th>
<th>Measurement Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets and liabilities</td>
<td>Sum of (1) the accounting acquiree's/legal acquirer's assets and liabilities, measured by using the acquisition method under ASC 805, and (2) the accounting acquirer's/legal acquiree's assets and liabilities, measured at their carrying values.</td>
</tr>
<tr>
<td>Retained earnings and other equity balances</td>
<td>The accounting acquirer's/legal acquiree's precombination carrying amount, proportionately reduced by any noncontrolling interests.</td>
</tr>
<tr>
<td>Issued equity</td>
<td>Sum of (1) the accounting acquirer's/legal acquiree's issued equity immediately before the reverse acquisition, proportionately reduced by any noncontrolling interests, and (2) the fair value of the accounting acquiree/legal acquirer (i.e., the hypothetical consideration transferred). The equity structure (i.e., the number and type of equity interests issued) reflects the accounting acquiree's/legal acquirer's equity structure. However, the balance is adjusted to reflect the par value of the outstanding shares of the accounting acquiree/legal acquirer, including the number of shares issued in the reverse acquisition. Any difference is recognized as an adjustment to the APIC account.</td>
</tr>
<tr>
<td>APIC</td>
<td>The historical APIC account of the accounting acquirer/legal acquiree immediately before the reverse acquisition is carried forward and increased to reflect the additional fair value of the accounting acquiree/legal acquirer less the par value of the shares held by its preacquisition shareholders.</td>
</tr>
<tr>
<td>Noncontrolling interest</td>
<td>The noncontrolling interest's proportionate share of the accounting acquirer's/legal acquiree's precombination retained earnings, issued equity, and other equity balances.</td>
</tr>
<tr>
<td>Prior-period presentation</td>
<td>For periods before the reverse acquisition, the shareholders’ equity of the combined entity presented on the basis of the historical equity of the accounting acquirer/legal acquiree before the acquisition, retroactively recast to reflect the number of shares received in the acquisition.</td>
</tr>
</tbody>
</table>

### 6.8.6 EPS Calculation

In a reverse acquisition, the financial statements of the combined entity reflect the equity of the accounting acquiree/legal acquirer, including the equity interests issued as part of the reverse acquisition. As a result, EPS is calculated on the basis of the capital structure of the accounting acquiree/legal acquirer.
As noted in (d) in the preceding paragraph [ASC 805-40-45-2(d)], the equity structure in the consolidated financial statements following a reverse acquisition reflects the equity structure of the legal acquirer (the accounting acquiree), including the equity interests issued by the legal acquirer to effect the business combination.

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

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

The basic EPS 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 of the legal acquiree attributable to common shareholders in each of those periods

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

### 6.8.7 Illustrative Example

ASC 805-40-55-2 through 55-23 illustrate the guidance on accounting for reverse acquisitions:

The following Cases illustrate the guidance in this Subtopic on accounting for a reverse acquisition:

a. A reverse acquisition if all the shares of the legal subsidiary are exchanged (Case A)

b. A reverse acquisition if not all of the shares of the legal subsidiary are exchanged and a noncontrolling interest results (Case B).

In these Cases, Entity B, the legal subsidiary, acquires Entity A, the entity issuing equity instruments and therefore the legal parent, on September 30, 20X6. These Cases ignore the accounting for any income tax effects. Cases A and B share all of the following information and assumptions.
The statements of financial position of Entity A and Entity B immediately before the business combination are as follows.

<table>
<thead>
<tr>
<th></th>
<th>Entity A (Legal Parent, Accounting Acquiree)</th>
<th>Entity B (Legal Subsidiary, Accounting Acquirer)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current assets</td>
<td>$500</td>
<td>$700</td>
</tr>
<tr>
<td>Noncurrent assets</td>
<td>$1,300</td>
<td>$3,000</td>
</tr>
<tr>
<td>Total assets</td>
<td>$1,800</td>
<td>$3,700</td>
</tr>
<tr>
<td>Current liabilities</td>
<td>$300</td>
<td>$600</td>
</tr>
<tr>
<td>Noncurrent liabilities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total liabilities</td>
<td>$700</td>
<td>$1,700</td>
</tr>
<tr>
<td>Shareholders' equity</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Retained earnings</td>
<td>$800</td>
<td>$1,400</td>
</tr>
<tr>
<td>Issued equity</td>
<td></td>
<td></td>
</tr>
<tr>
<td>100 common shares</td>
<td>$300</td>
<td>$—</td>
</tr>
<tr>
<td>60 common shares</td>
<td>$—</td>
<td>$600</td>
</tr>
<tr>
<td>Total shareholders' equity</td>
<td>$1,100</td>
<td>$2,000</td>
</tr>
<tr>
<td>Total liabilities and shareholders' equity</td>
<td>$1,800</td>
<td>$3,700</td>
</tr>
</tbody>
</table>

On September 30, 20X6, Entity A issues 2.5 shares in exchange for each common share of Entity B. All of Entity B's shareholders exchange their shares in Entity B. Therefore, Entity A issues 150 common shares in exchange for all 60 common shares of Entity B.

The fair value of each common share of Entity B at September 30, 20X6, is $40. The quoted market price of Entity A's common shares at that date is $16.

The fair values of Entity A's identifiable assets and liabilities at September 30, 20X6, are the same as their carrying amounts, except that the fair value of Entity A's noncurrent assets at September 30, 20X6, is $1,500.

Case A: All the Shares of the Legal Subsidiary Are Exchanged

This Case illustrates the accounting for a reverse acquisition if all of the shares of the legal subsidiary, the accounting acquirer, are exchanged in a business combination. The accounting illustrated in this Case includes the calculation of the fair value of the consideration transferred, the measurement of goodwill and the calculation of earnings per share (EPS).

The calculation of the fair value of the consideration transferred follows.
**ASC 805-40 (continued)**

**55-10** As a result of the issuance of 150 common shares by Entity A (legal parent, accounting acquiree), Entity B’s shareholders own 60 percent of the issued shares of the combined entity, that is, 150 of 250 issued shares. The remaining 40 percent are owned by Entity A’s shareholders. If the business combination had taken the form of Entity B issuing additional common shares to Entity A’s shareholders in exchange for their common shares in Entity A, Entity B would have had to issue 40 shares for the ratio of ownership interest in the combined entity to be the same. Entity B’s shareholders would then own 60 of the 100 issued shares of Entity B — 60 percent of the combined entity. As a result, the fair value of the consideration effectively transferred by Entity B and the group’s interest in Entity A is $1,600 (40 shares with a per-share fair value of $40). The fair value of the consideration effectively transferred should be based on the most reliable measure. In this Case, the quoted market price of Entity A’s shares provides a more reliable basis for measuring the consideration effectively transferred than the estimated fair value of the shares in Entity B, and the consideration is measured using the market price of Entity A’s shares — 100 shares with a per-share fair value of $16.

**55-11** Goodwill is measured as follows.

**55-12** Goodwill is measured as the excess of the fair value of the consideration effectively transferred (the group’s interest in Entity A) over the net amount of Entity A’s recognized identifiable assets and liabilities, as follows.

<table>
<thead>
<tr>
<th></th>
<th>$</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Consideration effectively transferred</strong></td>
<td>1,600</td>
<td></td>
</tr>
<tr>
<td><strong>Net recognized values of Entity A’s identifiable assets and liabilities</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current assets</td>
<td>500</td>
<td></td>
</tr>
<tr>
<td>Noncurrent assets</td>
<td>1,500</td>
<td></td>
</tr>
<tr>
<td>Current liabilities</td>
<td>-300</td>
<td></td>
</tr>
<tr>
<td>Noncurrent liabilities</td>
<td>-400</td>
<td>-1,300</td>
</tr>
<tr>
<td>Goodwill</td>
<td></td>
<td>300</td>
</tr>
</tbody>
</table>
### ASC 805-40 (continued)

**55-13** The consolidated statement of financial position immediately after the business combination is as follows.

<table>
<thead>
<tr>
<th>Description</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current assets ($700 + $500)</td>
<td>1,200</td>
</tr>
<tr>
<td>Noncurrent assets ($3,000 + $1,500)</td>
<td>4,500</td>
</tr>
<tr>
<td>Goodwill</td>
<td>300</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>6,000</td>
</tr>
<tr>
<td>Current liabilities ($600 + $300)</td>
<td>900</td>
</tr>
<tr>
<td>Noncurrent liabilities ($1,100 + $400)</td>
<td>1,500</td>
</tr>
<tr>
<td><strong>Total liabilities</strong></td>
<td>2,400</td>
</tr>
<tr>
<td>Shareholders' equity</td>
<td></td>
</tr>
<tr>
<td>Retained earnings</td>
<td>1,400</td>
</tr>
<tr>
<td>Issued equity</td>
<td></td>
</tr>
<tr>
<td>250 common shares ($600 + $1,600)</td>
<td>2,200</td>
</tr>
<tr>
<td><strong>Total shareholders' equity</strong></td>
<td>3,600</td>
</tr>
<tr>
<td><strong>Total liabilities and shareholders' equity</strong></td>
<td>6,000</td>
</tr>
</tbody>
</table>

**55-14** In accordance with paragraph 805-40-45-2(c) through (d), the amount recognized as issued equity interests in the consolidated financial statements ($2,200) is determined by adding the issued equity of the legal subsidiary immediately before the business combination ($600) and the fair value of the consideration effectively transferred, measured in accordance with paragraph 805-40-30-2 ($1,600). However, the equity structure appearing in the consolidated financial statements (that is, the number and type of equity interests issued) must reflect the equity structure of the legal parent, including the equity interests issued by the legal parent to effect the combination.

**55-15** The calculation of EPS follows.
ASC 805-40 (continued)

55-16 Entity B's earnings for the annual period ended December 31, 20X5, were $600, and the consolidated earnings for the annual period ended December 31, 20X6, are $800. There was no change in the number of common shares issued by Entity B during the annual period ended December 31, 20X5, and during the period from January 1, 20X6, to the date of the reverse acquisition on September 30, 20X6. EPS for the annual period ended December 31, 20X6, is calculated as follows.

<table>
<thead>
<tr>
<th>Description</th>
<th>Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of shares deemed to be outstanding for the period from January 1, 20X6, to the acquisition date (that is, the number of common shares issued by Entity A [legal parent, accounting acquiree] in the reverse acquisition)</td>
<td>150</td>
</tr>
<tr>
<td>Number of shares outstanding from the acquisition date to December 31, 20X6</td>
<td>250</td>
</tr>
<tr>
<td>Weighted-average number of common shares outstanding</td>
<td>175</td>
</tr>
<tr>
<td>[(150 × 9 ÷ 12) + (250 × 3 ÷ 12)]</td>
<td></td>
</tr>
<tr>
<td>EPS (800 ÷ 175)</td>
<td>$4.57</td>
</tr>
</tbody>
</table>

55-17 Restated EPS for the annual period ending December 31, 20X5, is $4.00 (calculated as the earnings of Entity B of 600 divided by the 150 common shares Entity A issued in the reverse acquisition).

Case B: Not All the Shares of the Legal Subsidiary Are Exchanged

55-18 This Case illustrates the accounting for a reverse acquisition if not all of the shares of the legal subsidiary, the accounting acquirer, are exchanged in a business combination and a noncontrolling interest results.

55-19 Assume the same facts as in Case A except that only 56 of Entity B's 60 common shares are exchanged. Because Entity A issues 2.5 shares in exchange for each common share of Entity B, Entity A issues only 140 (rather than 150) shares. As a result, Entity B's shareholders own 58.3 percent of the issued shares of the combined entity (140 of 240 issued shares). The fair value of the consideration transferred for Entity A, the accounting acquiree, is calculated by assuming that the combination had been effected by Entity B's issuing additional common shares to the shareholders of Entity A in exchange for their common shares in Entity A. That is because Entity B is the accounting acquirer, and paragraphs 805-30-30-7 through 30-8 require the acquirer to measure the consideration exchanged for the accounting acquiree.

55-20 In calculating the number of shares that Entity B would have had to issue, the noncontrolling interest is ignored. The majority shareholders own 56 shares of Entity B. For that to represent a 58.3 percent equity interest, Entity B would have had to issue an additional 40 shares. The majority shareholders would then own 56 of the 96 issued shares of Entity B and, therefore, 58.3 percent of the combined entity. As a result, the fair value of the consideration transferred for Entity A, the accounting acquiree, is $1,600 (that is, 40 shares each with a fair value of $40). That is the same amount as when all 60 of Entity B's shareholders tender all 60 of its common shares for exchange. The recognized amount of the group's interest in Entity A, the accounting acquiree, does not change if some of Entity B's shareholders do not participate in the exchange.

55-21 The noncontrolling interest is represented by the 4 shares of the total 60 shares of Entity B that are not exchanged for shares of Entity A. Therefore, the noncontrolling interest is 6.7 percent. The noncontrolling interest reflects the noncontrolling shareholders' proportionate interests in the precombination carrying amounts of the net assets of Entity B, the legal subsidiary. Therefore, the consolidated statement of financial position is adjusted to show a noncontrolling interest of 6.7 percent of the precombination carrying amounts of Entity B's net assets (that is, $134 or 6.7 percent of $2,000).
Chapter 6 — Other Acquisition Method Guidance

ASC 805-40 (continued)

55-22 The consolidated statement of financial position at September 30, 20X6, reflecting the noncontrolling interest is as follows.

<table>
<thead>
<tr>
<th></th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current assets ($700 + $500)</td>
<td>1,200</td>
</tr>
<tr>
<td>Noncurrent assets ($3,000 + $1,500)</td>
<td>4,500</td>
</tr>
<tr>
<td>Goodwill</td>
<td>300</td>
</tr>
<tr>
<td>Total assets</td>
<td>6,000</td>
</tr>
<tr>
<td>Current liabilities ($600 + $300)</td>
<td>900</td>
</tr>
<tr>
<td>Noncurrent liabilities ($1,100 + $400)</td>
<td>1,500</td>
</tr>
<tr>
<td>Total liabilities</td>
<td>2,400</td>
</tr>
<tr>
<td>Shareholders' equity</td>
<td></td>
</tr>
<tr>
<td>Retained earnings ($1,400 × 93.3%)</td>
<td>1,306</td>
</tr>
<tr>
<td>Issued equity</td>
<td></td>
</tr>
<tr>
<td>240 common shares ($560 + $1,600)</td>
<td>2,160</td>
</tr>
<tr>
<td>Noncontrolling interest</td>
<td>134</td>
</tr>
<tr>
<td>Total shareholders' equity</td>
<td>3,600</td>
</tr>
<tr>
<td>Total liabilities and shareholders' equity</td>
<td>6,000</td>
</tr>
</tbody>
</table>

55-23 The noncontrolling interest of $134 has 2 components. The first component is the reclassification of the noncontrolling interest's share of the accounting acquirer's retained earnings immediately before the acquisition ($1,400 × 6.7% or $93.80). The second component represents the reclassification of the noncontrolling interest's share of the accounting acquirer's issued equity ($600 × 6.7% or $40.20).

6.8.8 Public Shell Corporations and SPACs

ASC 805-40

05-2 As one example of a reverse acquisition, a private operating entity may want to become a public entity but not want to register its equity shares. To become a public entity, the private entity will arrange for a public entity to acquire its equity interests in exchange for the equity interests of the public entity. In this situation, the public entity is the legal acquirer because it issued its equity interests, and the private entity is the legal acquiree because its equity interests were acquired. However, application of the guidance in paragraphs 805-10-55-11 through 55-15 results in identifying:

a. The public entity as the acquiree for accounting purposes (the accounting acquiree)
b. The private entity as the acquirer for accounting purposes (the accounting acquirer).
In some cases, a nonoperating public shell company legally acquires a private operating company by using cash, other assets, equity, or a combination thereof. A nonoperating public shell company is a registrant that has no or nominal operations and no or nominal assets (other than possibly cash). The owners and management of the private company generally have actual or effective operating control of the combined company after the transaction, and the private company gains access to the public market without going through an IPO. The SEC staff considers the acquisition of a private operating company by a nonoperating public shell company to be, in substance, a capital transaction rather than a business combination (or asset acquisition). That is, the transaction is a reverse recapitalization, equivalent to the issuance of shares by the private operating company for the net monetary assets of the public shell company accompanied by a recapitalization. The accounting is similar to that resulting from a reverse acquisition, except that no goodwill or other intangible assets are recognized.

In other cases, a SPAC, sometimes also called a "blank check" company, legally acquires a private operating company. A SPAC is a newly formed company that raises cash in an IPO and uses that cash, its equity, or a combination thereof to fund the acquisition of one or more private operating companies. After the IPO, the SPAC's management looks to complete an acquisition of a target company within the period specified in its governing documents (e.g., 24 months). If an acquisition cannot be completed within this time frame, the cash raised in the IPO must generally be returned to investors.

Because SPACs generally hold no assets other than cash or investments before completing their initial acquisition, they are public shell companies. However, unlike public shell companies that have no or nominal operations, SPACs engage in significant precombination activities (e.g., raising cash in public markets, identifying investment opportunities). Therefore, unlike transactions in which a nonoperating public shell company acquires an operating company that must be accounted for as a reverse recapitalization, entities must analyze transactions in which a SPAC acquires an operating company to determine whether the SPAC or the operating company is the acquirer for accounting purposes ("accounting acquirer").

The ASC master glossary defines an acquirer as follows:

> The entity that obtains control of the acquiree. However, in a business combination in which a variable interest entity (VIE) is acquired, the primary beneficiary of that entity always is the acquirer.

Entities must first consider the guidance in ASC 805-10-25-5, which states, in part, that “in a business combination in which a [VIE] is acquired, the primary beneficiary of that entity always is the acquirer. The determination of which party, if any, is the primary beneficiary of a VIE shall be made in accordance with the guidance in the Variable Interest Entities Subsections of Subtopic 810-10, not by applying either the guidance in the General Subsections of that Subtopic, relating to a controlling financial interest, or in paragraphs 805-10-55-11 through 55-15.” Consequently, entities must consider whether the legal acquiree (i.e., the operating company) is a VIE on the basis of the guidance in ASC 810-10-15-14.

To qualify as a VIE, a legal entity needs to have only one of the following characteristics:

- The legal entity does not have sufficient equity investment at risk (see Section 5.2 of Deloitte’s *A Roadmap to Consolidation — Identifying a Controlling Financial Interest*).
- The equity investors at risk, as a group, lack the characteristics of a controlling financial interest (see Section 5.3 of Deloitte’s *A Roadmap to Consolidation — Identifying a Controlling Financial Interest*). In this assessment, there are specific requirements for entities that are limited partnerships or similar legal entities such as limited liability companies with managing members. Some of these entities may be VIEs depending on what voting rights are provided to
limited partners in a limited partnership or to nonmanaging members for certain limited liability corporations (see Section 5.3.1.2 of Deloitte’s A Roadmap to Consolidation — Identifying a Controlling Financial Interest).

- The legal entity is structured with disproportionate voting rights, and substantially all of the activities are conducted on behalf of an investor with disproportionately few voting rights (see Section 5.4 of Deloitte’s A Roadmap to Consolidation — Identifying a Controlling Financial Interest).

If the legal acquiree is a voting interest entity rather than a VIE, entities should identify the acquirer by first considering the guidance in the general subsections of ASC 810-10 related to determining the existence of a controlling financial interest. If they cannot identify the acquirer on the basis of that guidance, they should consider the factors in ASC 805-10-55-11 through 55-15.

ASC 805-10-55-11 states that in an acquisition “effected primarily by transferring cash or other assets or by incurring liabilities, the acquirer usually is the entity that transfers the cash or other assets or incurs the liabilities.” Therefore, if the acquisition is effected primarily by the SPAC’s transfer of cash or other assets rather than its equity, the SPAC will usually be identified as the accounting acquirer.

ASC 805-10-55-12 states that in an acquisition “effected primarily by exchanging equity interests, the acquirer usually is the entity that issues its equity interests. However, in some business combinations, commonly called reverse acquisitions, the issuing entity is the acquiree.” That is, if the acquisition is effected primarily by exchanging equity interests, the SPAC is the entity that issues its equity interests to effect the transaction and is therefore the “legal acquirer.” Sometimes, the SPAC may also be identified as the accounting acquirer. However, in certain transactions, the operating company whose equity interests are acquired and is therefore the “legal acquiree” is determined to be the accounting acquirer. Entities should consider the following factors in ASC 805-10-55-12 and 55-13 when identifying the accounting acquirer in business combinations effected primarily by exchanging equity shares:

- “The relative voting rights in the combined entity after the business combination” (ASC 805-10-55-12(a)).
- “The existence of a large minority voting interest in the combined entity” (ASC 805-10-55-12(b)).
- “The composition of the governing body of the combined entity” (ASC 805-10-55-12(c)).
- “The composition of the senior management of the combined entity” (ASC 805-10-55-12(d)).
- “The terms of the exchange of equity interests” (ASC 805-10-55-12(e)).
- The “relative size (measured in, for example, assets, revenues, or earnings)” of the combining entities (ASC 805-10-55-13).

See Section 3.1 for more information about identifying the acquirer.

If the SPAC is determined to be the accounting acquirer, the entities must determine whether the operating company meets the definition of a business (see Section 2.4). If it does, the transaction is a business combination and the SPAC recognizes the operating company’s assets and liabilities in accordance with the guidance in ASC 805-10, ASC 805-20, and ASC 805-30, generally at fair value. If the operating company is determined to be a group of assets that does not meet the definition of a business, the transaction is an asset acquisition and the SPAC recognizes the operating company’s assets and liabilities in accordance with the guidance in ASC 805-50 at relative fair value (see Appendix C). By contrast, if the operating company is determined to be the accounting acquirer, generally the SPAC’s only precombination asset is the cash raised from its investors and the substance of the
transaction is a recapitalization of the operating company (i.e., a reverse recapitalization). Accordingly, the accounting for the transaction is similar to that of an acquisition of a private operating company by a nonoperating public shell company (as described above).

Because a reverse recapitalization is equivalent to the issuance of shares by the private operating company for the net monetary assets of the public shell company, the transaction costs incurred to effect the recapitalization may represent costs related to issuing equity and raising capital that are recognized as a reduction to the total amount of equity raised (i.e., reduction of APIC) rather than expensed as incurred.

See Section 5.7 of Deloitte’s A Roadmap to Initial Public Offerings for more information about offering costs, and see SAB Topic 5.A for more information about reporting considerations related to acquisitions by public shell companies and SPACs.
Chapter 7 — Disclosure

A business combination often results in a significant change in an acquirer’s assets, liabilities, and operations. ASC 805 describes the overall objectives for disclosing information that permits investors, creditors, and others to evaluate the financial effects of a business combination. ASC 805-10-50, ASC 805-20-50, and ASC 805-30-50 provide specific disclosure requirements that are intended to fulfill those objectives. However, if the information an acquirer discloses under those specific requirements or other GAAP is not sufficient for meeting the overall objectives in ASC 805, the acquirer must disclose whatever additional information is necessary to meet those objectives.

7.1 Disclosure Objectives

<table>
<thead>
<tr>
<th>ASC 805-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Business Combinations Occurring During a Current Reporting Period or After the Reporting Date but Before the Financial Statements Are Issued</strong></td>
</tr>
<tr>
<td><strong>50-1</strong> The acquirer shall disclose information that enables users of its financial statements to evaluate the nature and financial effect of a business combination that occurs either:</td>
</tr>
<tr>
<td>a. During the current reporting period</td>
</tr>
<tr>
<td>b. After the reporting date but before the financial statements are issued or are available to be issued (as discussed in Section 855-10-25).</td>
</tr>
<tr>
<td><strong>The Financial Effects of Adjustments That Relate to Business Combinations That Occurred in the Current or Previous Reporting Periods</strong></td>
</tr>
<tr>
<td><strong>50-5</strong> The acquirer shall disclose information that enables users of its financial statements to evaluate the financial effects of adjustments recognized in the current reporting period that relate to business combinations that occurred in the current or previous reporting periods.</td>
</tr>
<tr>
<td><strong>Other Disclosures</strong></td>
</tr>
<tr>
<td><strong>50-7</strong> If the specific disclosures required by this Subtopic and other generally accepted accounting principles (GAAP) do not meet the objectives set out in paragraphs 805-10-50-1 and 805-10-50-5, the acquirer shall disclose whatever additional information is necessary to meet those objectives.</td>
</tr>
</tbody>
</table>

Entities must provide separate disclosures for each material business combination that occurs during the reporting period. However, certain disclosures may be provided in the aggregate for immaterial business combinations that are material collectively (see Section 7.1.1).

The disclosure requirements apply to all acquirers, with the exception of the pro forma disclosures required by ASC 805-10-50-2(h), which apply only to public entities (see Section 7.9 for more information). Further, in accordance with ASC 270-10-50-5 and ASC 270-10-50-7(a), the disclosure requirements in ASC 805 also apply to interim financial reports.
7.1.1 Individually Immaterial Business Combinations That Are Material Collectively

Specific disclosures are required if an acquirer completes multiple immaterial business combinations in a reporting period that are material collectively. For such business combinations, ASC 805-10-50-3, ASC 805-20-50-2, and ASC 805-30-50-2 require entities to disclose, in the aggregate, the information required by the following:

- ASC 805-10-50-2 (e)–(h) (i.e., the disclosures in ASC 805-10-50-2 (a)–(d) are not required. See Section 7.2 below).
- ASC 805-20-50-1.
- ASC 805-30-50-1.

See Section 7.1.2 below for more information about assessing materiality.

7.1.2 Assessing Materiality

ASC 805 does not provide guidance on differentiating between material and immaterial business combinations or on evaluating when individually immaterial business combinations are material collectively, so entities need to apply judgment. Although SEC Regulation S-X, Rule 3-05, specifies thresholds for registrants related to significance (see Appendix D), those thresholds are generally higher than the materiality thresholds under ASC 805. Therefore, registrants must separately determine which financial statement disclosures are required under ASC 805 for an individually material business combination (or for individually immaterial business combinations that are material collectively) in the period presented.

We believe that in addition to the quantitative considerations involved in the assessment of materiality, entities should consider qualitative factors, such as the amount of discussion about a business combination in an entity’s MD&A, annual report, or press release.

Unless otherwise indicated, the following discussion of disclosure requirements applies to all material business combinations and individually immaterial business combinations that are material collectively occurring during the reporting period.

7.2 General Information to Be Disclosed

<table>
<thead>
<tr>
<th><strong>ASC 805-10</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>50-2</strong></td>
</tr>
<tr>
<td>a.</td>
</tr>
<tr>
<td>b.</td>
</tr>
<tr>
<td>c.</td>
</tr>
<tr>
<td>d.</td>
</tr>
</tbody>
</table>

Disclosure of the information provided in ASC 805-10-50-2(a)–(d) is not required for individually immaterial business combinations that are collectively material (see Section 7.1.1 above).
7.3 Assets Acquired and Liabilities Assumed

ASC 805-20

50-1 Paragraph 805-10-50-1 identifies one of the objectives of disclosures about a business combination. To meet that objective, the acquirer shall disclose all of the following information for each business combination that occurs during the reporting period:

c. The amounts recognized as of the acquisition date for each major class of assets acquired and liabilities assumed (see Example 5 [paragraph 805-10-55-37]).

The disclosures required by ASC 805-20-50-1(c) are often presented in a tabular format. See Section 7.14 for a disclosure example.

ASC 805-20-50-1 also includes specific disclosure requirements for certain acquired assets and liabilities. Those requirements are described in more detail below.

7.3.1 Indemnification Assets

ASC 805-20

50-1 Paragraph 805-10-50-1 identifies one of the objectives of disclosures about a business combination. To meet that objective, the acquirer shall disclose all of the following information for each business combination that occurs during the reporting period:

a. For indemnification assets, all of the following:
   1. The amount recognized as of the acquisition date
   2. A description of the arrangement and the basis for determining the amount of the payment
   3. An estimate of the range of outcomes (undiscounted) or, if a range cannot be estimated, that fact and the reasons why a range cannot be estimated. If the maximum amount of the payment is unlimited, the acquirer shall disclose that fact.

7.3.2 Receivables

ASC 805-20

50-1 Paragraph 805-10-50-1 identifies one of the objectives of disclosures about a business combination. To meet that objective, the acquirer shall disclose all of the following information for each business combination that occurs during the reporting period:

b. For acquired receivables not subject to the requirements of Subtopic 310-30, all of the following:
   1. The fair value of the receivables
   2. The gross contractual amounts receivable
   3. The best estimate at the acquisition date of the contractual cash flows not expected to be collected.

The disclosures shall be provided by major class of receivable, such as loans, direct financing leases in accordance with Subtopic 840-30, and any other class of receivables.
### Pending Content (Transition Guidance: ASC 842-10-65-1)

b. For acquired receivables not subject to the requirements of Subtopic 310-30, all of the following:

1. The fair value of the receivables (unless those receivables arise from sales-type leases or direct financing leases by the lessor for which the acquirer shall disclose the amounts recognized as of the acquisition date)
2. The gross contractual amounts receivable
3. The best estimate at the acquisition date of the contractual cash flows not expected to be collected.

   The disclosures shall be provided by major class of receivable, such as loans, net investment in sales-type or direct financing leases in accordance with Subtopic 842-30 on leases — lessor, and any other class of receivables.

### 7.3.3 Assets and Liabilities Arising From Contingencies

In addition to the requirements in ASC 805, SEC registrants should consider the disclosure requirements in SAB Topic 5.Y, which addresses disclosures related to loss contingencies.
7.3.4 Intangible Assets

While ASC 805-20-50-1(c) requires disclosure of “[t]he amounts recognized as of the acquisition date for each major class of assets acquired and liabilities assumed,” ASC 350-30-50-1 provides more specific disclosure requirements for acquired intangible assets:

**ASC 350-30**

**Disclosures in the Period of Acquisition**

**50-1** For intangible assets acquired either individually or as part of a group of assets (in either an asset acquisition, a business combination, or an acquisition by a not-for-profit entity), all of the following information shall be disclosed in the notes to financial statements in the period of acquisition:

a. For intangible assets subject to amortization, all of the following:
   1. The total amount assigned and the amount assigned to any major intangible asset class
   2. The amount of any significant residual value, in total and by major intangible asset class
   3. The weighted-average amortization period, in total and by major intangible asset class.

b. For intangible assets not subject to amortization, the total amount assigned and the amount assigned to any major intangible asset class.

c. The amount of research and development assets acquired in a transaction other than a business combination or an acquisition by a not-for-profit entity and written off in the period and the line item in the income statement in which the amounts written off are aggregated.

d. For intangible assets with renewal or extension terms, the weighted-average period before the next renewal or extension (both explicit and implicit), by major intangible asset class.

This information also shall be disclosed separately for each material business combination or acquisition by a not-for-profit entity or in the aggregate for individually immaterial business combinations or acquisitions by a not-for-profit entity that are material collectively if the aggregate fair values of intangible assets acquired, other than goodwill, are significant.

In addition, ASC 350-30-50-2 through 50-5 provide disclosure requirements for intangible assets in periods after their acquisition.

7.3.4.1 In-Process Research and Development

Other than the requirement in ASC 805-20-50-1(c) for acquirers to disclose “[t]he amounts recognized as of the acquisition date for each major class of assets acquired and liabilities assumed,” ASC 805 does not specifically address disclosures related to IPR&D. However, acquirers must comply with the fair value measurement disclosure requirements in ASC 820-10-50.
7.3.5 Goodwill

**ASC 805-30**

50-1 Paragraph 805-10-50-1 identifies one of the objectives of disclosures about a business combination. To meet that objective, the acquirer shall disclose all of the following information for each business combination that occurs during the reporting period:

a. A qualitative description of the factors that make up the goodwill recognized, such as expected synergies from combining operations of the acquiree and the acquirer, intangible assets that do not qualify for separate recognition, or other factors. . . .

d. The total amount of goodwill that is expected to be deductible for tax purposes.

e. If the acquirer is required to disclose segment information in accordance with Subtopic 280-10, the amount of goodwill by reportable segment. If the assignment of goodwill to reporting units required by paragraphs 350-20-35-41 through 35-44 has not been completed as of the date the financial statements are issued or are available to be issued (as discussed in Section 855-10-25), the acquirer shall disclose that fact. . . .

50-4 Paragraph 805-10-50-5 identifies the second objective of disclosures about the effects of business combinations that occurred in the current or previous reporting periods. To meet the objective in that paragraph, the acquirer shall disclose the following information for each material business combination or in the aggregate for individually immaterial business combinations that are material collectively: . . .

b. A reconciliation of the carrying amount of goodwill at the beginning and end of the reporting period as required by paragraph 350-20-50-1. . . .

Further, ASC 350-20 requires entities to provide a reconciliation of the carrying amounts of goodwill at the beginning and end of the reporting period:

**ASC 350-20**

50-1 The changes in the carrying amount of goodwill during the period shall be disclosed, showing separately (see Example 3 [paragraph 350-20-55-24]):

a. The gross amount and accumulated impairment losses at the beginning of the period

b. Additional goodwill recognized during the period, except goodwill included in a disposal group that, on acquisition, meets the criteria to be classified as held for sale in accordance with paragraph 360-10-45-9

c. Adjustments resulting from the subsequent recognition of deferred tax assets during the period in accordance with paragraphs 805-740-25-2 through 25-4 and 805-740-45-2

d. Goodwill included in a disposal group classified as held for sale in accordance with paragraph 360-10-45-9 and goodwill derecognized during the period without having previously been reported in a disposal group classified as held for sale

e. Impairment losses recognized during the period in accordance with this Subtopic

f. Net exchange differences arising during the period in accordance with Topic 830

g. Any other changes in the carrying amounts during the period

h. The gross amount and accumulated impairment losses at the end of the period.

Entities that report segment information in accordance with Topic 280 shall provide the above information about goodwill in total and for each reportable segment and shall disclose any significant changes in the allocation of goodwill by reportable segment. If any portion of goodwill has not yet been allocated to a reporting unit at the date the financial statements are issued, that unallocated amount and the reasons for not allocating that amount shall be disclosed.
## Pending Content (Transition Guidance: ASC 350-20-65-3)

### 50-1A
Entities that have one or more reporting units with zero or negative carrying amounts of net assets shall disclose those reporting units with allocated goodwill and the amount of goodwill allocated to each and in which reportable segment the reporting unit is included.

In addition, ASC 350-20-50 provides disclosure requirements for goodwill in periods after the business combination.

As discussed in Chapter 8, a private company and not-for-profit entity can elect an alternative to account for goodwill. In such a case, the entity is required to amortize goodwill over a 10-year period unless it can demonstrate that a shorter life is more appropriate. A private company or not-for-profit entity that elects the accounting alternative must provide disclosures as follows:

### ASC 350-20

#### 50-4
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, by major acquisition by a not-for-profit entity, or by reorganization event resulting in fresh-start reporting.
- b. The weighted-average amortization period in total and the amortization period by major business combination, by major acquisition by a not-for-profit entity, or by reorganization event resulting in fresh-start reporting.

#### 50-5
The following information shall be disclosed in the financial statements or the notes to financial statements for each period for which a statement of financial position is presented:

- a. The gross carrying amounts of goodwill, accumulated amortization, and accumulated impairment loss
- b. The aggregate amortization 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 derecognized during the period without having previously been reported in a disposal group classified as held for sale.

#### 50-6
For each goodwill impairment loss recognized, the following information shall be disclosed in the notes to financial statements that include the period in which the impairment loss is recognized:

- 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 or nonprofit activities, a present value or other valuation technique, or a combination of those methods)
- c. The caption in the income statement or statement of activities in which the impairment loss is included
- d. The method of allocating the impairment loss to the individual amortizable units of goodwill.

#### 50-7
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 or an acquisition by [a] not-for-profit entity.
7.4 Consideration Transferred, Including Contingent Consideration

ASC 805-30

50-1 Paragraph 805-10-50-1 identifies one of the objectives of disclosures about a business combination. To meet that objective, the acquirer shall disclose all of the following information for each business combination that occurs during the reporting period: . . .

b. The acquisition-date fair value of the total consideration transferred and the acquisition-date fair value of each major class of consideration, such as the following:
   1. Cash
   2. Other tangible or intangible assets, including a business or subsidiary of the acquirer
   3. Liabilities incurred, for example, a liability for contingent consideration
   4. Equity interests of the acquirer, including the number of instruments or interests issued or issuable and the method of determining the fair value of those instruments or interests.

c. For contingent consideration arrangements, all of the following:
   1. The amount recognized as of the acquisition date
   2. A description of the arrangement and the basis for determining the amount of the payment
   3. An estimate of the range of outcomes (undiscounted) or, if a range cannot be estimated, that fact and the reasons why a range cannot be estimated. If the maximum amount of the payment is unlimited, the acquirer shall disclose that fact. . . .

50-4 Paragraph 805-10-50-5 identifies the second objective of disclosures about the effects of business combinations that occurred in the current or previous reporting periods. To meet the objective in that paragraph, the acquirer shall disclose the following information for each material business combination or in the aggregate for individually immaterial business combinations that are material collectively:

a. For each reporting period after the acquisition date until the entity collects, sells, or otherwise loses the right to a contingent consideration asset, or until the entity settles a contingent consideration liability or the liability is cancelled or expires, all of the following:
   1. Any changes in the recognized amounts, including any differences arising upon settlement
   2. Any changes in the range of outcomes (undiscounted) and the reasons for those changes
   3. The disclosures required by Section 820-10-50. . . .

ASC 805-30-50-1 requires acquirers to disclose “[t]he acquisition-date fair value of the total consideration transferred and the acquisition-date fair value of each major class of consideration.” The consideration transferred from the acquirer to the seller is commonly in the form of cash, equity instruments of the acquirer, or a combination of both. However, the consideration can take other forms, such as noncash assets or liabilities incurred (e.g., contingent consideration or a seller note).

Connecting the Dots

Cash flows related to the acquisitions of businesses, PP&E, and other productive assets are presented as investing activities in the statement of cash flows. For a business combination, all cash paid to purchase a business is shown as a single line item, net of any cash acquired. After an acquisition, the cash flows of the acquirer and acquiree are combined and presented in a consolidated statement of cash flows.

An entity may also need to consider other financial reporting implications of a business combination, depending on the nature and terms of the transaction. For example, any noncash effects of an acquisition that involves noncash consideration must be disclosed in a narrative format or summarized in a schedule.
See Section 7.5 of Deloitte’s *A Roadmap to the Preparation of the Statement of Cash Flows* for more information about issues related to the presentation of cash flows in a business combination.

### 7.5 Bargain Purchase Gains

**ASC 805-30**

<table>
<thead>
<tr>
<th>50-1 Paragraph 805-10-50-1 identifies one of the objectives of disclosures about a business combination. To meet that objective, the acquirer shall disclose all of the following information for each business combination that occurs during the reporting period: . . .</th>
</tr>
</thead>
<tbody>
<tr>
<td>f. In a bargain purchase (see paragraphs 805-10-25-2 through 25-4), both of the following:</td>
</tr>
<tr>
<td>1. The amount of any gain recognized in accordance with paragraph 805-10-25-2 and the line item in the income statement in which the gain is recognized</td>
</tr>
<tr>
<td>2. A description of the reasons why the transaction resulted in a gain.</td>
</tr>
</tbody>
</table>

### 7.6 Partial Acquisitions and Noncontrolling Interests

**ASC 805-30**

<table>
<thead>
<tr>
<th>50-1 Paragraph 805-10-50-1 identifies one of the objectives of disclosures about a business combination. To meet that objective, the acquirer shall disclose all of the following information for each business combination that occurs during the reporting period: . . .</th>
</tr>
</thead>
<tbody>
<tr>
<td>e. For each business combination in which the acquirer holds less than 100 percent of the equity interests in the acquiree at the acquisition date, both of the following:</td>
</tr>
<tr>
<td>1. The fair value of the noncontrolling interest in the acquiree at the acquisition date</td>
</tr>
<tr>
<td>2. The valuation technique(s) and significant inputs used to measure the fair value of the noncontrolling interest.</td>
</tr>
</tbody>
</table>

In addition to meeting the requirement in ASC 805-20-50-1(e), entities must disclose under ASC 810-10-50-1A — either in the statement of changes in equity or in the notes to the consolidated financial statements — a reconciliation between the beginning and end of the period carrying amounts of total equity, equity attributable to the parent, and equity attributable to the noncontrolling interest. For further details on these required disclosure requirements, see Chapter 8 of Deloitte’s *A Roadmap to Accounting for Noncontrolling Interests*. 
7.7 Business Combinations Achieved in Stages

ASC 805-10

50-2 To meet the objective in the preceding paragraph [ASC 805-10-50-1], the acquirer shall disclose the following information for each business combination that occurs during the reporting period:

g. In a business combination achieved in stages, all of the following:
   1. The acquisition-date fair value of the equity interest in the acquiree held by the acquirer immediately before the acquisition date
   2. The amount of any gain or loss recognized as a result of remeasuring to fair value the equity interest in the acquiree held by the acquirer immediately before the business combination (see paragraph 805-10-25-10) and the line item in the income statement in which that gain or loss is recognized
   3. The valuation technique(s) used to measure the acquisition-date fair value of the equity interest in the acquiree held by the acquirer immediately before the business combination
   4. Information that enables users of the acquirer’s financial statements to assess the inputs used to develop the fair value measurement of the equity interest in the acquiree held by the acquirer immediately before the business combination.

7.8 Transactions That Are Separate From the Business Combination

ASC 805-10

50-2 To meet the objective in the preceding paragraph [ASC 805-10-50-1], the acquirer shall disclose the following information for each business combination that occurs during the reporting period:

e. For transactions that are recognized separately from the acquisition of assets and assumptions of liabilities in the business combination (see paragraph 805-10-25-20), all of the following:
   1. A description of each transaction
   2. How the acquirer accounted for each transaction
   3. The amounts recognized for each transaction and the line item in the financial statements in which each amount is recognized
   4. If the transaction is the effective settlement of a preexisting relationship, the method used to determine the settlement amount.

7.8.1 Acquisition-Related Costs

ASC 805-10

50-2 To meet the objective in the preceding paragraph [ASC 805-10-50-1], the acquirer shall disclose the following information for each business combination that occurs during the reporting period:

f. The disclosure of separately recognized transactions required in (e) [ASC 805-10-50-2(e)] shall include the amount of acquisition-related costs, the amount recognized as an expense, and the line item or items in the income statement in which those expenses are recognized. The amount of any issuance costs not recognized as an expense and how they were recognized also shall be disclosed.

Acquirers typically incur acquisition-related costs — such as third-party costs for finders’ fees — as well as advisory, legal, accounting, valuation, and other professional or consulting fees. ASC 805-10-25-23 states, in part, that “[t]he acquirer shall account for acquisition-related costs as expenses in the periods
in which the costs are incurred and the services are received, with one exception. The costs to issue debt or equity securities shall be recognized in accordance with other applicable GAAP (see Section 5.4.1). ASC 805-10-50-2(f) requires an entity to disclose:

- “[T]he amount of acquisition-related costs.”
- “[T]he amount recognized as an expense.”
- “[T]he line item or items in the income statement in which [the] expenses are recognized.”
- “The amount of any issuance costs not recognized as an expense and how they were recognized.”

While entities will often incur acquisition-related costs in the reporting periods before an acquisition, the disclosures specified in ASC 805-10-50-2 are required only for business combinations that occur during the current reporting period or after the reporting date but before financial statements are issued unless the initial accounting for the business combination is incomplete at the time the financial statements are issued or are available to be issued.

### 7.9 Supplemental Information for Public Entities

<table>
<thead>
<tr>
<th>ASC 805-10</th>
</tr>
</thead>
</table>

**50-2** To meet the objective in the preceding paragraph [ASC 805-10-50-1], the acquirer shall disclose the following information for each business combination that occurs during the reporting period: . . .

h. If the acquirer is a public entity, all of the following:

1. The amounts of revenue and earnings of the acquiree since the acquisition date included in the consolidated income statement for the reporting period.
2. If comparative financial statements are not presented, the revenue and earnings of the combined entity for the current reporting period as though the acquisition date for all business combinations that occurred during the year had been as of the beginning of the annual reporting period (supplemental pro forma information).
3. If comparative financial statements are presented, the revenue and earnings of the combined entity as though the business combination(s) that occurred during the current year had occurred as of the beginning of the comparable prior annual reporting period (supplemental pro forma information). For example, for a calendar year-end entity, disclosures would be provided for a business combination that occurs in 20X2, as if it occurred on January 1, 20X1. Such disclosures would not be revised if 20X2 is presented for comparative purposes with the 20X3 financial statements (even if 20X2 is the earliest period presented).
4. The nature and amount of any material, nonrecurring pro forma adjustments directly attributable to the business combination(s) included in the reported pro forma revenue and earnings (supplemental pro forma information).

If disclosure of any of the information required by (h) is impracticable, the acquirer shall disclose that fact and explain why the disclosure is impracticable. In this context, the term impracticable has the same meaning as in paragraph 250-10-45-9.

According to ASC 805-10-50-2(h)(1), an acquirer that meets the definition of a public entity is required to disclose “[t]he amounts of revenue and earnings of the acquiree since the acquisition date included in the consolidated income statement for the reporting period.” The FASB limited the period for this disclosure to the year of acquisition (i.e., the end of the annual reporting period that includes the acquisition date) because the Board believed that it might become impracticable for entities to obtain this information after the acquiree becomes more integrated into the acquirer’s operations.
In addition, ASC 805-10-50-2(h) requires public entities to disclose “supplemental pro forma information.” The requirements for this disclosure differ depending on whether comparative financial statements are presented:

- If an acquirer presents comparative financial statements, it is required to disclose “the revenue and earnings of the combined entity as though the business combination(s) that occurred during the current year had occurred as of the beginning of the comparable prior annual reporting period” (emphasis added).

- If an acquirer does not present comparative financial statements, it is required to disclose “the revenue and earnings of the combined entity for the current reporting period as though the acquisition date for all business combinations that occurred during the year had been as of the beginning of the annual reporting period” (emphasis added).

In addition, in accordance with ASC 805-10-50-2(h)(4), acquirers must disclose “[t]he nature and amount of any material, nonrecurring pro forma adjustments directly attributable to the business combination(s) included in the reported pro forma revenue and earnings.”

Entities must provide pro forma information for business combinations that occur (1) during the reporting period or (2) after the reporting date but before the financial statements are issued unless the initial accounting for the business combination is incomplete at the time the financial statements are issued or are available to be issued. In addition, if multiple immaterial business combinations occur that are material collectively, pro forma information should be disclosed in the aggregate for those business combinations.

The supplemental pro forma information required by ASC 805-10-50-2(h) (i.e., the revenue and earnings of the acquiree for the periods before the acquisition) does not need to be audited. Auditors, however, should perform the procedures required by PCAOB AU Section 558.

**SEC Considerations**

The SEC rules on pro forma financial information disclosures differ from the guidance in U.S. GAAP:

- ASC 805-10-50-2(h) requires pro forma financial information to be disclosed in the notes to the historical financial statements.
- SEC Regulation S-X, Article 11, requires pro forma financial information to be presented in certain SEC filings (e.g., Form 8-K, registration statements, and proxy statements).

The pro forma financial information disclosures required by ASC 805 are not sufficient to satisfy the more extensive presentation requirements of Article 11. We believe that since that the FASB does not provide detailed guidance on preparing the pro forma financial information, registrants preparing such information under ASC 805 may apply the same concepts they apply when preparing their pro forma information under Article 11 in the absence of guidance under ASC 805 (see Section D.8 for more information).
7.9.1 Definition of a Public Entity

The disclosures in ASC 805-10-50-2(h) apply to an acquirer that meets the following definition of a public entity in the ASC master glossary:

A business entity or a not-for-profit entity that meets any of the following conditions:

a. It has issued debt or equity securities or is a conduit bond obligor for conduit debt securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets).

b. It is required to file financial statements with the Securities and Exchange Commission (SEC).

c. It provides financial statements for the purpose of issuing any class of securities in a public market.

The ASC master glossary includes multiple definitions of a public entity, so entities should ensure that they are applying the correct one when determining whether ASC 805 pro forma disclosures are required. The definition of public entity in ASC 805-10-20 is the same as that in ASC 280-10-20 for segment reporting, but it is different from those in ASC 718-10-20 for share-based payment awards and ASC 740-10-20 for income taxes. In addition, the definition of a public entity is different from the definition of a PBE, which is used to determine whether an entity qualifies for the private company accounting alternatives as discussed in Chapter 8.

7.9.2 Periods to Be Presented

The objective of the disclosure requirements in ASC 805-10-50-2(h) is to give financial statement users a sense of what the acquirer's revenues and earnings would have been if the acquiree had been part of the acquirer's operations in the periods before the acquisition. However, ASC 805-10-50-2(h) requires disclosure of the supplemental pro forma information only for (1) the year of the acquisition and (2) the previous year if comparative financial statements are presented, even if the acquirer presents more than two years of income statements. For example, if an acquirer with a calendar year-end had a material business combination on July 1, 20X8, it would disclose the following in its December 31, 20X8, comparative financial statements:

- The revenue and earnings of the acquiree from July 1, 20X8, through December 31, 20X8.
- The revenue and earnings of the combined entity from January 1, 20X8, through December 31, 20X8.
- The revenue and earnings of the combined entity from January 1, 20X7, through December 31, 20X7.

In its December 31, 20X9, comparative financial statements, the acquirer would carry forward the disclosures from the prior year without revising them. It would not have to include additional pro forma information for 20X9 because the acquiree's results would be included in the consolidated financial statements.

Example 7-1

Company A acquires Company B in a business combination on April 30, 20X8. Company A has a calendar year-end, and the acquisition of B is material to A's financial statements. We believe that in its June 30, 20X8, interim financial statements, A should present supplemental pro forma financial information for the three months ended June 30, 20X8, and the six months ended June 30, 20X8. Even though the business combination did not occur in the first quarter of 20X8, we believe that A should present supplemental pro forma financial information for the three months ended March 31, 20X8, in its March 31, 20X9, financial statements because the comparative interim period does not include B's results.
7.9.3 Preparing Pro Forma Financial Information

ASC 805 does not provide specific guidance on the preparation of pro forma information. The objective of the ASC 805 pro forma disclosure requirements is to give the acquirer’s financial statement users a sense of what the acquirer’s revenues and earnings would have been if the business combination had occurred at the beginning of the current year (or previous year if comparative financial statements are presented). Typically, the acquiree’s revenues and earnings are added to those of the acquirer for the period of the year in which the acquiree was not owned by the acquirer. If the acquirer presents comparative financial statements, the acquiree’s revenues and earnings are added to those of the acquirer for the previous year. Pro forma information should be adjusted for the following:

- **Acquisition-related costs** — Costs related to the acquisition are included in earnings as of the beginning of the earliest period (i.e., the beginning of either the current year or the previous year if comparative financial statements are presented).
- **Fair value adjustments** — Income statement effects of fair value adjustments (e.g., depreciation or amortization) are shown as if those adjustments were recognized at the beginning of either the current year or the previous year if comparative financial statements are presented.
- **Income taxes** — Tax effects of the business combination are shown as if the acquiree had been part of the entity since the beginning of either the current year or the previous year if comparative financial statements are presented.
- **Financing** — Adjustments related to obtaining financing, such as new debt and additional interest expense, are presented as if the new debt had been obtained as of the beginning of either the current year or the previous year if comparative financial statements are presented.
- **Accounting policies** — An acquiree’s pro forma revenues and earnings are adjusted to reflect the accounting policies that will be applied by the acquiree after the business combination. See Section 4.16 for more information about conforming accounting policies.

In accordance with ASC 805-10-50-2(h)(4), acquirers must also disclose “[t]he nature and amount of any material, nonrecurring pro forma adjustments directly attributable to the business combination(s) included in the reported pro forma revenue and earnings.” However, acquirers should not include adjustments that are not objectively determinable, such as adjustments for costs savings or synergies resulting from the business combination.

7.9.4 Impracticability Exception

ASC 805-10-50-2 states that “[i]f disclosure of any of the information required by (h) [ASC 805-10-50-2(h)] is impracticable, the acquirer shall disclose that fact and explain why the disclosure is impracticable.”

ASC 250-10-45-9 clarifies the meaning of impracticability as follows:

It shall be deemed impracticable to apply the effects of a change in accounting principle retrospectively only if any of the following conditions exist:

a. After making every reasonable effort to do so, the entity is unable to apply the requirement.

b. Retrospective application requires assumptions about management’s intent in a prior period that cannot be independently substantiated.
c. Retrospective application requires significant estimates of amounts, and it is impossible to distinguish objectively information about those estimates that both:

1. Provides evidence of circumstances that existed on the date(s) at which those amounts would be recognized, measured, or disclosed under retrospective application
2. Would have been available when the financial statements for that prior period were issued.

Impracticability is viewed as a high hurdle. Because the ASC 805 pro forma disclosures do not typically need to include significant estimates or assumptions about management’s intent, it is unusual for entities to determine that it is impracticable to provide them.

7.10  **Fair Value Measurements**

The fair value measurement disclosures in ASC 820-10-50 are applicable to the assets and liabilities acquired in a business combination that are measured at fair value. ASC 820 also requires entities to disclose certain information if the assets or liabilities are remeasured to fair value on a recurring basis.

7.11  **Disclosures Required When the Initial Accounting for the Business Combination Is Incomplete (Measurement-Period Adjustments)**

| 50-4A | If the initial accounting for a business combination is incomplete (see paragraphs 805-10-25-13 through 25-14) for particular assets, liabilities, noncontrolling interests, or items of consideration and the amounts recognized in the financial statements for the business combination thus have been determined only provisionally, the acquirer shall disclose the following information for each material business combination or in the aggregate for individually immaterial business combinations that are material collectively to meet the objective in paragraph 805-10-50-5:
|       | a. The reasons why the initial accounting is incomplete
|       | b. The assets, liabilities, equity interests, or items of consideration for which the initial accounting is incomplete
|       | c. The nature and amount of any measurement period adjustments recognized during the reporting period in accordance with paragraph 805-10-25-17, including separately the amount of adjustment to current-period income statement line items relating to the income effects that would have been recognized in previous periods if the adjustment to provisional amounts were recognized as of the acquisition date. Alternatively, an acquirer may present those amounts separately on the face of the income statement.

During the measurement period, the acquirer has time to obtain the information needed to identify and measure the consideration transferred, the assets acquired, the liabilities assumed, and any previously held or noncontrolling interests. The objective of this period is to give the acquirer a reasonable amount of time in which to obtain the information necessary to enable it to complete the accounting for a business combination while maintaining normal reporting schedules. However, the measurement period cannot exceed one year from the acquisition date. Entities should disclose the assets, liabilities, and items of consideration for which the initial accounting is incomplete. See Section 6.1 for more information about the measurement period.
7.12 Disclosures Related to Business Combinations After the Balance Sheet Date

**ASC 805-10**

50-4 If the acquisition date of a business combination is after the reporting date but before the financial statements are issued or are available to be issued (as discussed in Section 855-10-25), the acquirer shall disclose the information required by paragraph 805-10-50-2 unless the initial accounting for the business combination is incomplete at the time the financial statements are issued or are available to be issued. In that situation, the acquirer shall describe which disclosures could not be made and the reason why they could not be made.

**ASC 805-20**

50-3 If the acquisition date of a business combination is after the reporting date but before the financial statements are issued or are available to be issued (as discussed in Section 855-10-25), the acquirer shall disclose the information required by paragraph 805-20-50-1 unless the initial accounting for the business combination is incomplete at the time the financial statements are issued or are available to be issued. In that situation, the acquirer shall describe which disclosures could not be made and the reason why they could not be made.

**ASC 805-30**

50-3 If the acquisition date of a business combination is after the reporting date but before the financial statements are issued or are available to be issued (as discussed in Section 855-10-25), the acquirer shall disclose the information required by paragraph 805-30-50-1 unless the initial accounting for the business combination is incomplete at the time the financial statements are issued or are available to be issued. In that situation, the acquirer shall describe which disclosures could not be made and the reason why they could not be made.

As indicated in ASC 805-10-50-4, entities are required to disclose the information included in ASC 805-10-50-2, ASC 805-20-50-1, and ASC 805-30-50-1 “[i]f the acquisition date of a business combination is after the reporting date but before the financial statements are issued or are available to be issued.” If the initial accounting for the business combination is incomplete when the financial statements are issued or are available to be issued, the acquirer should “describe which disclosures could not be made and the reason why they could not be made,” in accordance with ASC 805-20-50-3. In addition, as stated in ASC 805-20-50-4A, if an acquirer has recognized only provisional amounts for “particular assets, liabilities, noncontrolling interests, or items of consideration,” it should disclose the following, either “for each material business combination or in the aggregate for individually immaterial business combinations that are material collectively”:

- “The reasons why the initial accounting is incomplete.”
- “The assets, liabilities, equity interests, or items of consideration for which the initial accounting is incomplete.”
- “The nature and amount of any measurement period adjustments recognized during the reporting period in accordance with paragraph 805-10-25-17.”
7.13 Disclosures Related to Business Combinations That Occurred in Previous Reporting Periods

ASC 805-10-50-1 states, in part, that the “acquirer shall disclose information that enables users of its financial statements to evaluate the nature and financial effect of a business combination that occurs [during] the current [financial] reporting period.” Therefore, whenever financial statements include the period in which a business combination occurred, the required disclosures for the acquisition should be provided. For example, if an entity completed a business combination in 20X0 and presents three years of income statements in its financial statements, it should include the disclosures related to the 20X0 business combination in its 20X1 and 20X2 financial statements.

7.14 Illustrative Example

The following example is reproduced from ASC 805-10-55-37 through 55-50 and illustrates some of the disclosure requirements of ASC 805.

<table>
<thead>
<tr>
<th>ASC 805-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Example 5: Illustration of Disclosure Requirements</strong></td>
</tr>
<tr>
<td>55-37 This Example illustrates some of the disclosure requirements established in the several Subtopics of this Topic; it is not based on an actual transaction. The Example assumes that Acquirer is a public entity and that Target is a private entity. The illustration presents the disclosures in a tabular format that refers to the specific disclosure requirements illustrated. An actual note to financial statements might present many of the disclosures illustrated in a simple narrative format.</td>
</tr>
<tr>
<td>55-38 Paragraph 805-10-50-2(a) through (d)</td>
</tr>
<tr>
<td>On June 30, 20X0, Acquirer acquired 15 percent of the outstanding common shares of Target. On June 30, 20X2, Acquirer acquired 60 percent of the outstanding common shares of Target. Target is a provider of data networking products and services in Canada and Mexico. As a result of the acquisition, Acquirer is expected to be the leading provider of data networking products and services in those markets. It also expects to reduce costs through economies of scale.</td>
</tr>
<tr>
<td>55-39 Paragraph 805-30-50-1(a) and 805-30-50-1(e)</td>
</tr>
<tr>
<td>The goodwill of $2,500 arising from the acquisition consists largely of the synergies and economies of scale expected from combining the operations of Acquirer and Target. All of the goodwill was assigned to Acquirer’s network segment.</td>
</tr>
<tr>
<td>55-40 Paragraph 805-30-50-1(d)</td>
</tr>
<tr>
<td>None of the goodwill recognized is expected to be deductible for income tax purposes.</td>
</tr>
</tbody>
</table>
The following table summarizes the consideration paid for Target and the amounts of the assets acquired and liabilities assumed recognized at the acquisition date, as well as the fair value at the acquisition date of the noncontrolling interest in Target.

At June 30, 20X2

<table>
<thead>
<tr>
<th>Refer to Paragraph(s)</th>
<th>Consideration</th>
</tr>
</thead>
<tbody>
<tr>
<td>805-30-50-1(b)</td>
<td></td>
</tr>
<tr>
<td>805-30-50-1(b)(1)</td>
<td>Cash</td>
</tr>
<tr>
<td>805-30-50-1(b)(4)</td>
<td>Equity instruments (100,000 common shares of Acquirer)</td>
</tr>
<tr>
<td>805-30-50-1(b)(3), 805-30-50-1(c)(1)</td>
<td>Contingent consideration arrangement</td>
</tr>
</tbody>
</table>

**Fair value of total consideration transferred**

<table>
<thead>
<tr>
<th>805-10-50-2(g)(1)</th>
<th>Fair value of Acquirer’s equity interest in Target held before the business combination</th>
<th>2,000</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td><strong>Acquisition-related costs (including in selling, general, and administration expenses in Acquirer’s income statement for the year ending December 31, 20X2)</strong></td>
<td>1,250</td>
</tr>
<tr>
<td></td>
<td><strong>Recognized amounts of identifiable assets acquired and liabilities assumed</strong></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Financial assets</td>
<td>3,500</td>
</tr>
<tr>
<td></td>
<td>Inventory</td>
<td>1,000</td>
</tr>
<tr>
<td></td>
<td>Property, plant, and equipment</td>
<td>10,000</td>
</tr>
<tr>
<td></td>
<td>Identifiable intangible assets</td>
<td>3,300</td>
</tr>
<tr>
<td></td>
<td>Financial liabilities</td>
<td>(4,000)</td>
</tr>
<tr>
<td></td>
<td>Liability arising from a contingency</td>
<td>(1,000)</td>
</tr>
<tr>
<td></td>
<td>Total identifiable net assets</td>
<td>12,800</td>
</tr>
<tr>
<td></td>
<td><strong>Noncontrolling interest in Target</strong></td>
<td>(3,300)</td>
</tr>
<tr>
<td></td>
<td><strong>Goodwill</strong></td>
<td>2,500</td>
</tr>
<tr>
<td></td>
<td><strong>Total</strong></td>
<td>12,000</td>
</tr>
</tbody>
</table>

**Paragraph 805-30-50-1(b)(4)**

The fair value of the 100,000 common shares issued as part of the consideration paid for Target ($4,000) was determined on the basis of the closing market price of Acquirer’s common shares on the acquisition date.
The contingent consideration arrangement requires Acquirer to pay the former owners of Target 5 percent of the revenues of an unconsolidated equity investment, referred to as Investee, owned by Target, in excess of $7,500 for 20X3, up to a maximum amount of $2,500 (undiscounted). The potential undiscounted amount of all future payments that Acquirer could be required to make under the contingent consideration arrangement is between $0 and $2,500. The fair value of the contingent consideration arrangement of $1,000 was estimated by applying the income approach. That measure is based on significant inputs that are not observable in the market, which Section 820-10-35 refers to as Level 3 inputs. Key assumptions include a discount rate range of 20 percent to 25 percent and a probability-adjusted level of revenues in Investee between $10,000 and $20,000. As of December 31, 20X2, the amount recognized for the contingent consideration arrangement, the range of outcomes, and the assumptions used to develop the estimates had not changed.

The fair value of the financial assets acquired includes receivables under sales-type leases or direct financing leases of data networking equipment with a fair value of $2,000. The gross amount due under the contracts is $3,100, of which $450 is expected to be uncollectible.

The fair value of the noncontrolling interest in Target, a private entity, was estimated by applying the income approach and a market approach. This fair value measurement is based on significant inputs that are not observable in the market and thus represents a fair value measurement categorized within Level 3 of the fair value hierarchy as described in Section 820-10-35. Key assumptions include a discount rate range of 20 percent to 25 percent, a terminal value based on a range of terminal earnings before interest, taxes, depreciation, and amortization multiples between 3 and 5 (or, if appropriate, based on long-term sustainable growth rates ranging between 3 percent and 6 percent), financial multiples of entities deemed to be similar to Target, and adjustments because of the lack of control or lack of marketability that market participants would consider when measuring the fair value of the noncontrolling interest in Target.
**ASC 805-10 (continued)**

**55-48** Paragraph 805-10-50-2(g)(2)

Acquirer recognized a gain of $500 as a result of remeasuring to fair value its 15 percent equity interest in Target held before the business combination. The gain is included in other income in Acquirer’s income statement for the year ending December 31, 20X2.

**55-49** Paragraph 805-10-50-2(h)(1) through (h)(3)

The amounts of Target’s revenue and earnings included in Acquirer’s consolidated income statement for the year ended December 31, 20X2, and the revenue and earnings of the combined entity had the acquisition date been January 1, 20X2 (if comparative financial statements are not presented), and January 1, 20X1 (if comparative financial statements are presented), are as follows.

<table>
<thead>
<tr>
<th>Refer to Paragraph</th>
<th>Revenue</th>
<th>Earnings</th>
</tr>
</thead>
<tbody>
<tr>
<td>805-10-50-2(h)(1)</td>
<td>$ 4,090</td>
<td>$ 1,710</td>
</tr>
<tr>
<td>805-10-50-2(h)(2)</td>
<td>$27,670</td>
<td>$12,870</td>
</tr>
<tr>
<td>805-10-50-2(h)(3)</td>
<td>$27,670</td>
<td>$14,770</td>
</tr>
<tr>
<td>20X1 supplemental pro forma from 1/1/20X1−12/31/20X1</td>
<td>$26,985</td>
<td>$12,325</td>
</tr>
</tbody>
</table>

**55-50** Paragraph 805-10-50-2(h)(4)

20X2 supplemental pro forma earnings were adjusted to exclude $1,250 of acquisition-related costs incurred in 20X2 and $650 of nonrecurring expense related to the fair value adjustment to acquisition-date inventory. 20X1 supplemental pro forma earnings were adjusted to include these charges.
Chapter 8 — Private-Company and Not-for-Profit Entity Accounting Alternatives

In 2012, the Financial Accounting Foundation, which oversees the FASB, established the Private Company Council (PCC) to improve the process of setting accounting standards for private companies. As the primary advisory body to the FASB on private-company matters, the PCC uses the private-company decision-making framework to guide the FASB on the appropriate accounting treatment for private companies for items under active consideration on the FASB’s technical agenda. The framework focuses on user relevance and cost-benefit considerations for private companies as potential justifications for establishing alternative guidance. Any proposed changes to GAAP must be endorsed by the FASB.

In 2014, the FASB issued ASUs 2014-02 and 2014-18, which offered entities other than PBEs and not-for-profit entities simplified accounting alternatives for certain identifiable intangible assets acquired in a business combination and the subsequent accounting for goodwill. The alternatives were initially developed by the PCC on the basis of feedback from private companies and their stakeholders about the costs and complexity associated with the accounting for certain identifiable intangible assets and the goodwill impairment test.

When the Board issued ASUs 2014-02 and 2014-18, it was aware that the issues addressed in them were not limited to private companies but decided not to extend the alternatives to PBEs or not-for-profit entities at that time. The Board received feedback from not-for-profit stakeholders that “questioned the relevance of an impairment-only approach to goodwill as well as input that the benefits of the current accounting for goodwill and identifiable intangible assets acquired in an acquisition by a not-for-profit entity do not justify the related costs.” Accordingly, it added a project to its agenda to determine whether to extend the private-company alternatives to not-for-profit entities. In May 2019, the Board issued ASU 2019-06, which gives not-for-profit entities the option to elect the same alternative approaches to account for certain identifiable intangible assets acquired in a business combination and goodwill. The guidance in ASU 2019-06 became effective upon its issuance. A not-for-profit entity should apply the goodwill accounting alternative, if elected, prospectively for all existing goodwill and for all new goodwill generated in acquisitions. It should apply the intangible assets accounting alternative, if elected, prospectively upon the occurrence of the first transaction within the scope of the alternative.
Changing Lanes
The FASB has an active project on its agenda to revisit the accounting for certain identifiable intangible assets and the subsequent accounting for goodwill broadly for all entities. The staff plans to (1) explore adding amortization to the goodwill impairment model, including the amortization method and period; (2) explore other changes to the goodwill impairment model; (3) consider the accounting for identifiable intangible assets; and (4) address matters related to presentation, disclosure, and transition. Practitioners should monitor the project for any developments that might change the current accounting.

8.1 Definition of a PBE and Private Company

The first step in determining whether an entity can apply the accounting alternatives is to ensure that the entity is not a PBE. An entity that meets the definition of a PBE cannot apply any of the private-company accounting alternatives.

In December 2013, the FASB issued ASU 2013-12 to incorporate the definition of a PBE into the ASC master glossary and clarify which entities qualify for private-company financial accounting and reporting alternatives. The ASU was issued, in part, because the previous guidance in U.S. GAAP contained several definitions of “nonpublic entity” and “public entity,” which resulted in diversity in practice.

The ASC master glossary defines a PBE as follows:

A public business entity is a business entity meeting any one of the criteria below. Neither a not-for-profit entity nor an employee benefit plan is a business entity.

a. It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing).

b. It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC.

c. It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer.

d. It has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market.

e. It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including notes) and make them publicly available on a periodic basis (for example, interim or annual periods). An entity must meet both of these conditions to meet this criterion.

An entity may meet the definition of a public business entity solely because its financial statements or financial information is included in another entity’s filing with the SEC. In that case, the entity is only a public business entity for purposes of financial statements that are filed or furnished with the SEC.

The definition of a PBE excludes not-for-profit entities within the scope of ASC 958 and employee benefit plans within the scope of ASC 960 through ASC 965 on plan accounting. It does not affect any existing ASC requirements.

The ASC master glossary defines a private company as “[a]n entity other than a public business entity, a not-for-profit entity, or an employee benefit plan within the scope of Topics 960 through 965 on plan accounting.”
8.1.1 Entities That File or Furnish Financial Statements With or to a Regulator, and Entities That Have Publicly Traded Securities

The FASB determined in ASU 2013-12 that financial statement users of entities that issue publicly traded securities generally have less access to management than users of private-company financial information, and they are typically a broader group with more diverse needs. The Board therefore concluded that entities should be considered PBEs if they (1) file or furnish financial statements with or to the SEC or another regulatory agency or (2) issue or trade securities. Further, an entity is considered a PBE if its financial statements or financial information, such as the following, is required to be or is included in a registrant's SEC filing:

- Financial statements of significant acquired or to be acquired businesses under SEC Regulation S-X, Rule 3-05.
- Financial statements of significant equity method investees under SEC Regulation S-X, Rule 3-09.
- Summarized financial information of equity method investees under SEC Regulation S-X, Rule 4-08(g).

To ensure that the definition of a PBE encompassed entities that prepare U.S. GAAP financial statements in other jurisdictions, the FASB included both foreign and domestic regulators in it. However, the Board indicated that if an entity is considered a PBE only because its financial information is included in the financial information of another entity that furnishes or files financial statements to or with the SEC, the entity is considered a PBE only for the financial statements filed with the SEC; the entity can apply the private-company accounting alternatives in its stand-alone financial statements.

Similarly, the FASB concluded that private companies that are consolidated subsidiaries of PBEs are not considered PBEs for stand-alone reporting purposes and are therefore able to apply private-company accounting alternatives in their stand-alone financial statements. This is because the information they provide may be useful to the users of the stand-alone financial statements.

The FASB also decided that a private company that controls a public subsidiary should not be considered a PBE. According to ASU 2013-12, "the financial reporting requirements of a public subsidiary should not preclude a privately held entity from applying financial accounting and reporting alternatives for private companies in its own financial statements."

8.1.2 Conduit Bond Obligors

Conduit bond obligors indirectly access the public debt markets. In ASU 2013-12, the FASB noted that users of such entities' financial statements may have less access to management and related financial information than most other private-company financial statement users do and that these entities have a broad base of financial statement users; therefore, their users' information needs may be similar to those of the financial statements of public companies. Consequently, the FASB concluded that conduit bond obligors should be considered PBEs for financial accounting and reporting purposes.

8.1.3 Employee Benefit Plans

The FASB concluded in ASU 2013-12 that the needs of the financial statement users of employee benefit plans are more focused than those of the financial statement users of public or private companies.
Further, the accounting guidance applied by employee benefit plans is often tailored to the plans. Accordingly, the Board excluded employee benefit plans from the definition of a PBE. Instead, the FASB decided to consider, “on a standard-by-standard basis, whether all, none, or some employee benefit plans should be permitted to apply financial accounting and reporting alternatives under U.S. GAAP, using factors such as user needs and resources.”

8.1.4 Not-for-Profit Entities

The ASC master glossary defines a not-for-profit entity as:

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.

The amendments in ASU 2019-06 apply to all not-for-profit entities as defined in the ASC master glossary, including those that are conduit bond obligors. Paragraph BC14 of ASU 2019-06 notes that “[t]he Board chose not to distinguish between public not-for-profit entities and nonpublic not-for-profit entities because the informational needs of users of financial statements of both not-for-profit entity types are the same.”

8.2 Accounting Alternatives for Private Companies and Not-for-Profit Entities

The paragraphs below discuss the accounting alternatives for certain intangible assets and goodwill. Entities do not need to perform a preferability assessment the first time they elect such alternatives; however, any later change to an accounting policy election requires justification that the change is preferable under ASC 250.

Connecting the Dots

Before electing the private-company accounting alternatives, a private company should consider whether it might become a PBE in the future (e.g., the entity may file an IPO or may be required to have its financial statements included in a registrant’s filing under SEC Regulation S-X, Rule 3-05). Neither the FASB nor the SEC has provided relief or transition guidance for private companies that have elected the private-company accounting alternatives and later become PBEs; thus, private companies that might become PBEs should be cautious about electing them. Private companies that do apply the accounting alternatives and later become PBEs would need to retrospectively remove the effects of the accounting alternatives in any financial statements filed with, or furnished to, the SEC. The removal of such effects could become increasingly complex as more time passes.
8.2.1 Accounting Alternative for Intangible Assets

ASC 805-20

Accounting Alternative

15-1A Paragraphs 805-20-15-2 through 15-4 and 805-20-25-29 through 25-33 provide guidance for an entity electing the accounting alternative in this Subtopic. See paragraph 805-20-65-2 for transition guidance for private companies and not-for-profit entities on applying the accounting alternative in this Subtopic.

15-2 A private company or not-for-profit entity may make an accounting policy election to apply the accounting alternative in this Subtopic. The guidance in the Accounting Alternative Subsections of this Subtopic applies when a private company or not-for-profit entity is required to recognize or otherwise consider the fair value of intangible assets as a result of any one of the following transactions:
   a. Applying the acquisition method (as described in paragraph 805-10-05-4 for all entities and Subtopic 958-805 for additional guidance for not-for-profit entities)
   b. Assessing the nature of the difference between the carrying amount of an investment and the amount of underlying equity in net assets of an investee when applying the equity method of accounting in accordance with Topic 323 on investments — equity method and joint ventures
   c. Adopting fresh-start reporting in accordance with Topic 852 on reorganizations.

15-3 An entity that elects the accounting alternative shall apply all of the related recognition requirements upon election. The accounting alternative, once elected, shall be applied to all future transactions that are identified in paragraph 805-20-15-2.

15-4 An entity that elects this accounting alternative must adopt the accounting alternative for amortizing goodwill in the Accounting Alternative Subsections of Topic 350-20 on intangibles — goodwill and other. If the accounting alternative for amortizing goodwill was not adopted previously, it should be adopted on a prospective basis as of the adoption of the accounting alternative in this Subtopic. For example, upon adoption, existing goodwill should be amortized on a straight-line basis over 10 years, or less than 10 years if the entity demonstrates that another useful life is more appropriate. However, an entity that elects the accounting alternative for amortizing goodwill is not required to adopt the accounting alternative in this Subtopic.

To achieve comparability, an entity should apply the accounting alternative to all eligible intangible assets. That is, if an entity adopts the accounting alternative for intangible assets, it cannot choose to recognize the customer-related intangible assets within its scope but subsume noncompetition agreements into goodwill. Furthermore, an entity that elects the accounting alternative for intangible assets must also adopt the accounting alternative for amortizing goodwill (see Section 8.2.2). “However, an entity that elects the accounting alternative for amortizing goodwill is not required to adopt the accounting alternative” for intangible assets.

If elected, the accounting alternative would be applied prospectively to (1) all intangible assets arising from business combinations occurring after adoption and (2) future transactions in which fresh-start reporting is adopted. In addition, when determining basis differences, an entity would apply it prospectively to all equity method investments acquired after adoption. The accounting alternative cannot be applied to previously recognized intangible assets (e.g., the option would not affect intangible assets recognized from previous business combinations).
### 8.2.1.1 Customer-Related Intangible Assets

| ASC 805-20 |  
|---|---|
| **25-30** | An intangible asset is identifiable if it meets either the separability criterion or the contractual-legal criterion described in the definition of identifiable. However, under the accounting alternative, an acquirer shall not recognize separately from goodwill the following intangible assets:  
  a. Customer-related intangible assets unless they are capable of being sold or licensed independently from other assets of a business  
  b. Noncompetition agreements. |
| **25-31** | Customer-related intangible assets often would not meet criterion (a) in paragraph 805-20-25-30 for recognition. Customer-related intangible assets that would meet that criterion for recognition under this accounting alternative are those that are capable of being sold or licensed independently from the other assets of a business. Examples of customer-related intangible assets are listed in paragraph 805-20-55-20. Many of the customer-related intangible assets that would meet criterion (a) for recognition also would be considered contract-based intangible assets as described in paragraph 805-20-55-31. Customer-related intangible assets that may meet that criterion for recognition include but are not limited to:  
  a. Mortgage servicing rights  
  b. Commodity supply contracts  
  c. Core deposits  
  d. Customer information (for example, names and contact information). |

Before the issuance of ASU 2014-18, many stakeholders indicated that separately recognizing customer-related intangible assets does not provide decision-useful information unless the contract giving rise to the asset could be sold separately from the other assets of the business. As a result, the PCC and FASB concluded that the benefits of recognizing customer-related intangible assets separately may not justify the related costs. Consequently, ASC 805-20-25-30 gives private companies the option to subsume into goodwill customer-related intangible assets unless they are capable of being sold or licensed independently from other assets of a business. While many customer-related intangible assets would meet that criterion, ASC 805-20-25-31 provides examples of such assets that generally could be sold separately, including, but not limited to, mortgage servicing rights, commodity supply contracts, core deposits, and customer information (e.g., names and contact information).

Under this accounting alternative, favorable customer contracts would be included in goodwill, but unfavorable customer contracts would not because they are liabilities and not within the alternative’s scope. However, in paragraph BC20 of ASU 2014-18, the FASB noted that “the concept of ‘at market’ is a broad range and customer contracts generally are considered to fall within the range that is considered ‘at market.’ Therefore, most customer contracts do not fall under the favorable-unfavorable contract guidance.” Paragraph BC20 of ASU 2014-18 also states, in part:

> Subsuming a significant favorable contract into goodwill will not necessarily create subsequent impairment issues. FASB Accounting Standards Update No. 2014-02, **Intangibles — Goodwill and Other (Topic 350): Accounting for Goodwill,** allows reporting entities to choose a life for goodwill that is less than 10 years. The PCC and the Board concluded that significant favorable contracts with a life shorter than 10 years may justify a shorter useful life for goodwill. As a result, the PCC and the Board concluded that favorable customer contracts will be included within the scope of this Update.
8.2.1.2 **Noncompetition Agreements**

Noncompetition agreements represent another category of intangible assets that are not separately recognized under this accounting alternative. In response to comments by stakeholders that noncompetition agreements are among the most subjective and difficult intangible assets to measure and that their value is disregarded by many users, the FASB determined that the benefits of recognizing them separately may not justify the related costs. Furthermore, the FASB indicates in paragraph BC19 of ASU 2014-18 that the “PCC and the Board chose not to require an assessment of whether a noncompetition agreement is capable of being sold or licensed separately from the other assets of a business because, in their view, noncompetition agreements will seldom, if ever, meet the criteria for recognition.”

8.2.1.3 **Contract Assets**

<table>
<thead>
<tr>
<th>ASC 805-20</th>
</tr>
</thead>
<tbody>
<tr>
<td>25-32 Contract assets, as used in Topic 606 on revenue from contracts with customers, are not considered to be customer-related intangible assets for purposes of applying this accounting alternative. Therefore, contract assets are not eligible to be subsumed into goodwill and shall be recognized separately.</td>
</tr>
</tbody>
</table>

The ASC master glossary defines a contract asset as “[a]n entity’s right to consideration in exchange for goods or services that the entity has transferred to a customer when that right is conditioned on something other than the passage of time (for example, the entity’s future performance).” Contract assets are not eligible for this accounting alternative. In paragraph BC21 of ASU 2014-18, the FASB elaborates on this decision as follows:

The PCC and the Board decided that contract assets as defined in the Master Glossary and used in Topic 606, Revenue from Contracts with Customers, are not considered intangible assets eligible to be subsumed into goodwill and therefore are not within the scope of this Update. In certain situations, an entity satisfies a performance obligation but does not have an unconditional right to consideration, for example, because it first needs to satisfy another performance obligation in the contract. That leads to recognition of a contract asset. Once an entity has an unconditional right to consideration, it should present that right as a receivable separately from the contract asset and account for it in accordance with other guidance (for example, Topic 310, Receivables). As a result, the PCC and the Board concluded that it is inappropriate to classify a contract asset as a customer-related intangible asset at the acquisition date when the contract asset will eventually be reclassified as a receivable.

8.2.1.4 **Leases**

<table>
<thead>
<tr>
<th>ASC 805-20</th>
</tr>
</thead>
<tbody>
<tr>
<td>25-33 A lease is not considered to be a customer-related intangible asset for purposes of applying this accounting alternative. Therefore, favorable and unfavorable leases are not eligible to be subsumed into goodwill and shall be recognized separately.</td>
</tr>
</tbody>
</table>

ASU 2014-18 clarifies that leases are not considered to be customer-related intangible assets. Therefore, favorable and unfavorable leases must be recognized separately from goodwill.
8.2.1.5 Disclosures

There are no incremental disclosure requirements associated with this accounting alternative. As discussed in the Background Information and Basis for Conclusions of ASU 2014-18, the PCC and FASB determined that the disclosure requirements already in ASC 805 were sufficient for intangible assets that do not require separate recognition and that requiring additional disclosures could potentially offset any cost savings associated with an entity's adoption of the accounting alternative.

8.2.2 Goodwill Accounting Alternative

<table>
<thead>
<tr>
<th>ASC 350-20</th>
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</thead>
<tbody>
<tr>
<td><strong>Accounting Alternative</strong></td>
</tr>
<tr>
<td>05-5 The Accounting Alternative Subsections of this Subtopic provide guidance for an entity within the scope of paragraph 350-20-15-4 that elects the accounting alternative for goodwill. If elected, the accounting alternative allows an eligible entity to amortize goodwill and test that goodwill for impairment upon a triggering event.</td>
</tr>
<tr>
<td>05-5A The accounting alternative guidance can be found in the following paragraphs:</td>
</tr>
<tr>
<td>c. Derecognition — paragraphs 350-20-40-8 through 40-9</td>
</tr>
<tr>
<td>d. Other Presentation Matters — paragraphs 350-20-45-4 through 45-7</td>
</tr>
<tr>
<td>e. Disclosure — paragraphs 350-20-50-4 through 50-7</td>
</tr>
<tr>
<td>05-6 An entity should continue to follow the applicable requirements in Topic 350 for other accounting and reporting matters related to goodwill that are not addressed in the Accounting Alternative Subsections of this Subtopic.</td>
</tr>
</tbody>
</table>

Entities that elect the goodwill accounting alternative (1) amortize goodwill on a straight-line basis over a useful life of 10 years, or less than 10 years if they can demonstrate that a shorter useful life is more appropriate, (2) test goodwill for impairment only when a triggering event occurs instead of having to perform the test at least annually, and (3) test goodwill for impairment at either the entity level or the reporting-unit level. In addition, entities would be required to comply with the accounting alternative's requirements related to subsequent measurement and disclosures.

ASC 350-20 provides the following guidance related to the goodwill accounting alternative:

<table>
<thead>
<tr>
<th>ASC 350-20</th>
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</thead>
<tbody>
<tr>
<td>35-62 The following guidance for goodwill applies to entities within the scope of paragraph 350-20-15-4 that elect the accounting alternative for the subsequent measurement of goodwill.</td>
</tr>
<tr>
<td>35-63 Goodwill relating to each business combination, acquisition by a not-for-profit entity, or reorganization event resulting in fresh-start reporting (amortizable unit of goodwill) shall be amortized on a straight-line basis over 10 years, or less than 10 years if the entity demonstrates that another useful life is more appropriate.</td>
</tr>
<tr>
<td>35-64 An entity may revise the remaining useful life of goodwill upon the occurrence of events and changes in circumstances that warrant a revision to the remaining period of amortization. However, the cumulative amortization period for any amortizable unit of goodwill cannot exceed 10 years. If the estimate of the remaining useful life of goodwill is revised, the remaining carrying amount of goodwill shall be amortized prospectively on a straight-line basis over that revised remaining useful life.</td>
</tr>
</tbody>
</table>
Upon adoption of this accounting alternative, an entity shall make an accounting policy election to test goodwill for impairment at the entity level or the reporting unit level. An entity that elects to perform its impairment tests at the reporting unit level shall refer to paragraphs 350-20-35-33 through 35-38 and paragraphs 350-20-55-1 through 55-9 to determine the reporting units of an entity.

Goodwill of an entity (or a reporting unit) shall be tested for impairment if an event occurs or circumstances change that indicate that the fair value of the entity (or the reporting unit) may be below its carrying amount (a triggering event). Paragraph 350-20-35-3C(a) through (g) includes examples of those events or circumstances. Those examples are not all-inclusive, and an entity shall consider other relevant events and circumstances that affect the fair value or carrying amount of the entity (or of a reporting unit) in determining whether to perform the goodwill impairment test. If an entity determines that there are no triggering events, then further testing is unnecessary.

The Goodwill Impairment Test

Upon the occurrence of a triggering event, an entity may assess qualitative factors to determine whether it is more likely than not (that is, a likelihood of more than 50 percent) that the fair value of the entity (or the reporting unit) is less than its carrying amount, including goodwill. Paragraph 350-20-35-3C(a) through (g) includes examples of those qualitative factors.

Because the examples included in paragraph 350-20-35-3C(a) through (g) are not all-inclusive, an entity shall consider other relevant events and circumstances that affect the fair value or carrying amount of the entity (or of the reporting unit) in determining whether to perform the quantitative goodwill impairment test. An entity shall consider the extent to which each of the adverse events and circumstances identified could affect the comparison of its fair value with its carrying amount (or of the reporting unit’s fair value with the reporting unit’s carrying amount). An entity should place more weight on the events and circumstances that most affect its fair value or the carrying amount of its net assets (or the reporting unit’s fair value or the carrying amount of the reporting unit’s net assets). An entity also should consider positive and mitigating events and circumstances that may affect its determination of whether it is more likely than not that its fair value is less than its carrying amount (or the fair value of the reporting unit is less than the carrying amount of the reporting unit). If an entity has a recent fair value calculation (or recent fair value calculation for the reporting unit), it also should include that calculation as a factor in its consideration of the difference between the fair value and the carrying amount in reaching its conclusion about whether to perform the quantitative goodwill impairment test.

An entity shall evaluate, on the basis of the weight of evidence, the significance of all identified events and circumstances in the context of determining whether it is more likely than not that the fair value of the entity (or the reporting unit) is less than its carrying amount. None of the individual examples of events and circumstances included in paragraph 350-20-35-3C(a) through (g) are intended to represent standalone events or circumstances that necessarily require an entity to perform the quantitative goodwill impairment test. Also, the existence of positive and mitigating events and circumstances is not intended to represent a rebuttable presumption that an entity should not perform the quantitative goodwill impairment test.

An entity has an unconditional option to bypass the qualitative assessment described in paragraphs 350-20-35-67 through 35-69 and proceed directly to a quantitative calculation by comparing the entity’s (or the reporting unit’s) fair value with its carrying amount (see paragraphs 350-20-35-72 through 35-78). An entity may resume performing the qualitative assessment upon the occurrence of any subsequent triggering events.

If, after assessing the totality of events or circumstances such as those described in paragraph 350-20-35-3C(a) through (g), an entity determines that it is not more likely than not that the fair value of the entity (or the reporting unit) is less than its carrying amount, further testing is unnecessary.
ASC 350-20 (continued)

35-72 If, after assessing the totality of events or circumstances such as those described in paragraph 350-20-35-3C(a) through (g), an entity determines that it is more likely than not that the fair value of the entity (or the reporting unit) is less than its carrying amount or if the entity elected to bypass the qualitative assessment in paragraphs 350-20-35-67 through 35-69, the entity shall determine the fair value of the entity (or the reporting unit) and compare the fair value of the entity (or the reporting unit) with its carrying amount, including goodwill. A goodwill impairment loss shall be recognized if the carrying amount of the entity (or the reporting unit) exceeds its fair value.

35-73 A goodwill impairment loss, if any, shall be measured as the amount by which the carrying amount of an entity (or a reporting unit) including goodwill exceeds its fair value. A goodwill impairment loss shall not exceed the entity’s (or the reporting unit’s) carrying amount of goodwill.

Pending Content (Transition Guidance: ASC 350-20-65-3)

35-73 A goodwill impairment loss, if any, shall be measured as the amount by which the carrying amount of an entity (or a reporting unit) including goodwill exceeds its fair value, limited to the total amount of goodwill of the entity (or allocated to the reporting unit). Additionally, an entity shall consider the income tax effect from any tax deductible goodwill on the carrying amount of the entity (or the reporting unit), if applicable, in accordance with paragraph 350-20-35-8B when measuring the goodwill impairment loss. See Example 2A in paragraph 350-20-55-23A for an illustration.

35-74 The guidance in paragraphs 350-20-35-22 through 35-27 shall be considered in determining the fair value of the entity (or the reporting unit).

35-75 The guidance in paragraphs 350-20-35-39 through 35-44 shall be considered in assigning acquired assets (including goodwill) and assumed liabilities to the reporting unit when determining the carrying amount of a reporting unit.

35-76 For an entity subject to the requirements of Topic 740 on income taxes, when determining the carrying amount of an entity (or a reporting unit), deferred income taxes shall be included in the carrying amount of an entity (or the reporting unit), regardless of whether the fair value of the entity (or the reporting unit) will be determined assuming it would be bought or sold in a taxable or nontaxable transaction.

35-77 The goodwill impairment loss, if any, shall be allocated to individual amortizable units of goodwill of the entity (or the reporting unit) on a pro rata basis using their relative carrying amounts or using another reasonable and rational basis.

35-78 After a goodwill impairment loss is recognized, the adjusted carrying amount of goodwill shall be its new accounting basis, which shall be amortized over the remaining useful life of goodwill. Subsequent reversal of a previously recognized goodwill impairment loss is prohibited.
Appendix A — Pushdown Accounting

A.1 Overview of Pushdown Accounting

When an entity obtains control of a business, a new basis of accounting is established in the acquirer's financial statements for the assets acquired and liabilities assumed. ASC 805-10, ASC 805-20, and ASC 805-30 provide guidance on accounting for an acquisition of a business in the acquirer's consolidated financial statements. Sometimes the acquiree will prepare separate financial statements after its acquisition. An acquiree in a business combination has the option of whether to use the parent's basis of accounting or the acquiree's historical carrying amounts for the assets acquired and liabilities assumed in the acquiree's separate financial statements. Use of the acquirer's basis of accounting in the preparation of an acquiree's separate financial statements is called “pushdown accounting.”

Under previous guidance, entities applied the pushdown accounting guidance in SAB Topic 5J, EITF Topic D-97, and comments made by the SEC observer at EITF meetings. In addition, certain accounting practices developed on the basis of SEC staff speeches; the AICPA's October 30, 1979, issues paper on pushdown accounting; and the FASB's December 18, 1991, discussion memorandum on this topic. However, such guidance was complicated and incomplete, only applied to SEC registrants, and was based on bright lines that provided opportunities for structuring and misapplication. To address those concerns, the FASB issued ASU 2014-17, which gave an acquiree the option to apply pushdown accounting in its separate financial statements when it has undergone a change in control.

ASU 2014-17 became effective on November 18, 2014, its date of issuance. The guidance in ASU 2014-17 was codified in the “Pushdown Accounting” subsections of ASC 805-50. An acquiree may elect to apply that guidance to (1) any future transaction or event in which an acquirer obtains control of the acquiree or (2) a past transaction or event in which an acquirer obtains control of the acquiree “when the financial statements of the reporting period that contains the acquisition date have not been issued” (conduit bond obligors or SEC filers) or have not been made available to be issued (all other entities). If the financial statements for the period that includes the most recent event in which an acquirer obtained control of the acquiree already have been issued or made available to be issued, the entity may still apply pushdown accounting; however, in such cases, the event must be accounted for as a change in accounting principle.

In response to the issuance of ASU 2014-17, the SEC staff issued SAB 115 to rescind the guidance in SAB Topic 5J, and the FASB issued ASU 2015-08 to rescind the remaining guidance on pushdown accounting and collaborative groups in ASC 805-50-S99. As a result, all authoritative guidance related to the application of pushdown accounting is now in the “Pushdown Accounting” subsections of ASC 805-50.
A.2 Scope

<table>
<thead>
<tr>
<th>ASC 805-50</th>
</tr>
</thead>
<tbody>
<tr>
<td>05-9 The guidance in the Pushdown Accounting Subsections addresses whether and at what threshold an acquiree that is a business or nonprofit activity can apply pushdown accounting in its separate financial statements.</td>
</tr>
<tr>
<td>15-10 The guidance in the Pushdown Accounting Subsections applies to the separate financial statements of an acquiree and its subsidiaries.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>ASC 805-10</th>
</tr>
</thead>
<tbody>
<tr>
<td>15-4 The guidance in the Business Combinations Topic does not apply to any of the following:</td>
</tr>
<tr>
<td>a. The formation of a joint venture</td>
</tr>
<tr>
<td>b. The acquisition of an asset or a group of assets that does not constitute a business or a nonprofit activity</td>
</tr>
<tr>
<td>c. A combination between entities, businesses, or nonprofit activities under common control (see paragraph 805-50-15-6 for examples)</td>
</tr>
<tr>
<td>d. An acquisition by a not-for-profit entity for which the acquisition date is before December 15, 2009 or a merger of not-for-profit entities (NFPs)</td>
</tr>
<tr>
<td>e. A transaction or other event in which an NFP obtains control of a not-for-profit entity but does not consolidate that entity, as described in paragraph 958-810-25-4. The Business Combinations Topic also does not apply if an NFP that obtained control in a transaction or other event in which consolidation was permitted but not required decides in a subsequent annual reporting period to begin consolidating a controlled entity that it initially chose not to consolidate.</td>
</tr>
<tr>
<td>f. Financial assets and financial liabilities of a consolidated variable interest entity that is a collateralized financing entity within the scope of the guidance on collateralized financing entities in Subtopic 810-10.</td>
</tr>
</tbody>
</table>

The pushdown accounting subsections in ASC 805-50 address when an acquiree may elect to apply pushdown accounting. ASC 805-50-15-10 indicates that the scope of pushdown accounting includes “the separate financial statements of an acquiree and its subsidiaries” that meet the definition of a business in ASC 805-10, as indicated in ASU 2014-17, or a nonprofit activity “upon the occurrence of an event in which an acquirer (an individual or an entity) obtains control of the [acquiree].” The scope includes both public and nonpublic entities.

The EITF considered whether the scope of the pushdown accounting subsections in ASC 805-50 should be limited to transactions in which an entity becomes substantially wholly owned rather than applying to all transactions or events in which an acquirer obtains control of a business or nonprofit activity. The Task Force ultimately decided that the scope of the guidance should be broader and should be consistent with the scope of ASC 805-10, ASC 805-20, and ASC 805-30, which apply to all transactions or events in which an acquirer obtains control of a business or nonprofit activity. As indicated in the Background Information and Basis for Conclusions of ASU 2014-17, the Task Force reasoned that the FASB had already decided in ASC 805-10, ASC 805-20, and ASC 805-30 that obtaining control of a business is a significant event for which a new basis of accounting is required “for the net assets acquired and, in the absence of another distinct threshold that is conceptually grounded in GAAP, change-in-control events also could serve as the basis for establishing a new basis in an [acquiree’s] separate financial statements.” The Task Force also decided that a change-in-control threshold for
pushdown accounting could reduce the complexity of the pushdown accounting guidance by eliminating the need to reconsider or develop collaborative group guidance, under which a group of investors may be regarded as a single investor in some circumstances.

An acquiree may only elect pushdown accounting if another entity or individual (i.e., an acquirer) has obtained control of the acquiree. Certain transactions are not within the scope of the pushdown accounting subsections of ASC 805-50 because they are not transactions in which an acquirer obtains control of a business or nonprofit activity (i.e., they are not within the scope of ASC 805-10, ASC 805-20, and ASC 805-30). Such transactions include the formation of a joint venture; combinations between entities, businesses, or nonprofit activities under common control; and mergers of not-for-profit entities. For example, the pushdown accounting election does not apply to the formation of a joint venture because, while an entity loses control of a subsidiary in such a transaction, no other individual or entity obtains control of it.

A.3 Option to Apply Pushdown Accounting Upon a Change in Control

<table>
<thead>
<tr>
<th>ASC 805-50</th>
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<tbody>
<tr>
<td><strong>25-4</strong> An acquiree shall have the option to apply pushdown accounting in its separate financial statements when an acquirer — an entity or individual — obtains control of the acquiree. An acquirer might obtain control of an acquiree in a variety of ways, including any of the following:</td>
</tr>
<tr>
<td>a. By transferring cash or other assets</td>
</tr>
<tr>
<td>b. By incurring liabilities</td>
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<tr>
<td>c. By issuing equity interests</td>
</tr>
<tr>
<td>d. By providing more than one type of consideration</td>
</tr>
<tr>
<td>e. Without transferring consideration, including by contract alone as discussed in paragraph 805-10-25-11.</td>
</tr>
</tbody>
</table>

**25-5** The guidance in the General Subsections of Subtopic 810-10 on consolidation, related to determining the existence of a controlling financial interest shall be used to identify the acquirer. If a business combination has occurred but applying that guidance does not clearly indicate which of the combining entities is the acquirer, the factors in paragraphs 805-10-55-11 through 55-15 shall be considered in identifying the acquirer. However, if the acquiree is a variable interest entity (VIE), the primary beneficiary of the acquiree always is the acquirer. The determination of which party, if any, is the primary beneficiary of a VIE shall be made in accordance with the guidance in the Variable Interest Entities Subsections of Subtopic 810-10, not by applying the guidance in the General Subsections of that Subtopic relating to a controlling financial interest or the guidance in paragraphs 805-10-55-11 through 55-15.

**25-6** The option to apply pushdown accounting may be elected each time there is a change-in-control event in which an acquirer obtains control of the acquiree. An acquiree shall make an election to apply pushdown accounting before the financial statements are issued (for a Securities and Exchange Commission (SEC) filer and a conduit bond obligor for conduit debt securities that are traded in a public market) or the financial statements are available to be issued (for all other entities) for the reporting period in which the change-in-control event occurred. If the acquiree elects the option to apply pushdown accounting, it must apply the accounting as of the acquisition date.
An acquiree can elect to apply pushdown accounting in its separate financial statements each time another entity or individual obtains control of it. The decision of whether to apply pushdown accounting upon a change in control is not an accounting policy election. For example, an acquiree may elect to apply pushdown accounting upon its acquisition in one year and, if it is acquired again in a subsequent year, may elect not to apply pushdown accounting at that time. An acquiree that elects to apply pushdown accounting must do so in its separate financial statements as of the date on which the acquirer obtains control of the acquiree (i.e., the acquisition date). ASC 805-10-25-6 and 25-7 provide guidance on identifying the acquisition date.

The term “control” is used in both the business combinations guidance and the pushdown accounting guidance and has the same meaning as the term “controlling financial interest” in ASC 810-10. ASC 810-10 indicates that a controlling financial interest generally results when one entity obtains, either directly or indirectly, more than 50 percent of the outstanding shares of another entity. However, control can also be obtained in other ways, such as through a contractual arrangement or when an entity becomes the primary beneficiary of a VIE. See Deloitte’s A Roadmap to Consolidation — Identifying a Controlling Financial Interest for more information about determining whether an acquiree has undergone a change in control.

As noted in the Background Information and Basis for Conclusions of ASU 2014-17, the Task Force considered whether pushdown accounting should be required or optional. The Task Force ultimately decided that requiring pushdown accounting may not be beneficial for some users and could be costly for preparers, since such a requirement would cause many more entities to apply pushdown accounting and may result in more frequent application of pushdown accounting by the same entity. The Task Force also noted that users’ views on the benefits and relevance of pushdown accounting differed, with some indicating that they “prefer not to distort historical trends by establishing a new basis of accounting for each change-in-control event” and others stressing that they “would prefer a new basis and consider an [acquiree’s] financial information in the context of its parent.” The Task Force acknowledged that giving entities an option reduces comparability in this area but decided that “allowing entities to apply judgment on the basis of their unique set of facts and circumstances” was more important than achieving such comparability. Before deciding whether to elect pushdown accounting, entities should consider the information needs and preferences of their financial statement users. When pushdown accounting is not elected, no adjustment is made to the acquiree’s financial records in connection with the acquisition. Therefore, in such cases, the acquiree will need to maintain accounting records that are separate from those of the parent to track items such as depreciation and amortization and will need to perform separate impairment analyses. It will be more difficult to maintain two sets of accounting records if multiple entities are acquired at different times. However, entities may prefer to carry over the acquiree’s historical basis for financial reporting purposes if carryover basis is being used for tax reporting purposes (i.e., when there is no tax “step-up”). Thus, entities should consider the burden of record keeping and their particular facts and circumstances when deciding whether to apply pushdown accounting.
Appendix A — Pushdown Accounting

Example A-1

**Loss of Control of a Subsidiary**

Company A has a wholly owned subsidiary, X. Company A sells 80 percent of its shares in X to the public in an initial public offering. The public shareholders are widely dispersed, and no individual shareholder acquires more than 3 percent of X's shares. Company A concludes that it no longer controls X.

Company A loses control of X upon the sale of X's shares to the public. Because no entity or individual obtains control of X, a new basis of accounting cannot be established in X's separate financial statements.

If a new legal entity is established to effect an acquisition, one must determine whether that newly formed entity (commonly called a “newco”) should be identified as the acquirer or whether it should be disregarded for accounting purposes. If the newco is identified as the acquirer, acquisition accounting, rather than pushdown accounting, would be applied to establish a new basis of accounting for the acquiree's assets and liabilities in the newco's financial statements. See Section 3.1.5 for further discussion.

A.4 **Common-Control Transactions May Trigger Pushdown Accounting**

In a common-control transaction, the receiving entity recognizes the transferred assets and liabilities at their carrying amounts on the date of transfer. However, sometimes the carrying amounts of the assets and liabilities transferred in the parent's consolidated financial statements differ from those in the transferring entity's separate financial statements (e.g., if the transferring entity had not applied pushdown accounting). ASC 805-50-30-5 states that, in such cases, the receiving entity's financial statements must “reflect the transferred assets and liabilities at the historical cost of the parent of the entities under common control.” While ASU 2014-17 made it optional to apply pushdown accounting in the acquiree's separate financial statements, it did not amend the guidance in ASC 805-50-30-5.

A.5 **Subsequent Election to Apply Pushdown Accounting**

<table>
<thead>
<tr>
<th>ASC 805-50</th>
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<tbody>
<tr>
<td>25-7 If the acquiree does not elect to apply pushdown accounting upon a change-in-control event, it can elect to apply pushdown accounting to its most recent change-in-control event in a subsequent reporting period as a change in accounting principle in accordance with Topic 250 on accounting changes and error corrections. Pushdown accounting shall be applied as of the acquisition date of the change-in-control event.</td>
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</tbody>
</table>
An acquiree that does not elect to apply pushdown accounting before the financial statements are issued (SEC filer) or are available to be issued (other entities) may subsequently elect to apply pushdown accounting to its most recent change-in-control event in a later reporting period. However, such a later election is a change in accounting principle and the acquiree would be required to apply the guidance on a change in accounting principle in ASC 250 in such circumstances, including all relevant disclosure requirements. We believe that an election to apply pushdown accounting would generally be preferable. ASC 250-10-45-5 requires that an entity “report a change in accounting principle through retrospective application . . . to all prior periods,” unless doing so would be impracticable. We would expect entities that elect pushdown accounting on a later date to apply it retroactively to the acquisition date since the parent generally would be expected to have maintained the records for all prior periods.

An SEC registrant that elects a voluntary change in accounting principle must file a preferable letter with the SEC (i.e., a letter from the entity's independent accountant indicating why the new accounting principle is preferable). Such a letter must be included in the registrant's first filing under the Securities Exchange Act of 1934 (i.e., Form 10-Q or Form 10-K) after the date of the accounting change.

### A.6 Election to Apply Pushdown Accounting Is Irrevocable

<table>
<thead>
<tr>
<th>ASC 805-50</th>
</tr>
</thead>
<tbody>
<tr>
<td>25-9 The decision to apply pushdown accounting to a specific change-in-control event if elected by an acquiree is irrevocable.</td>
</tr>
</tbody>
</table>

While an entity can elect to apply pushdown accounting in a subsequent reporting period, it cannot reverse the application of pushdown accounting in financial statements that have been issued (SEC filer) or are available to be issued (other entities). In addition, if an acquiree elects to apply pushdown accounting and that acquiree is subsequently acquired by another entity, the historical cost basis of the acquiree is based on the “pushed down” amounts. The new acquirer cannot revert to the acquiree’s historical cost basis that existed before the election to apply pushdown accounting.

According to the Background Information and Basis for Conclusions of ASU 2014-17, the Task Force decided that an entity should be allowed to apply pushdown accounting on a later date if, for example, the investor mix changes significantly and “pushdown accounting would be more relevant to the current investors.” Nonetheless, the Task Force decided that entities should be prohibited from subsequently reversing the application of pushdown accounting. Because an acquirer applies acquisition accounting to establish a new basis of accounting in its consolidated financial statements and subsequently accounts for the related assets and liabilities under GAAP, the acquiree would generally have the information to apply pushdown accounting on a later date. However, once a new basis is established in the acquiree’s separate financial statements, the historical cost basis for the acquiree’s assets and liabilities would often not be available.

### A.7 Subsidiary’s Election to Apply Pushdown Accounting

<table>
<thead>
<tr>
<th>ASC 805-50</th>
</tr>
</thead>
<tbody>
<tr>
<td>25-8 Any subsidiary of an acquiree also is eligible to make an election to apply pushdown accounting to its separate financial statements in accordance with the guidance in paragraphs 805-50-25-4 through 25-7 irrespective of whether the acquiree elects to apply pushdown accounting.</td>
</tr>
</tbody>
</table>
A subsidiary of an acquiree is not constrained by the acquiree’s or a higher-level subsidiary’s decision of whether to apply pushdown accounting upon a change-in-control event. If multiple entities are acquired in a business combination, the acquiree and any of its subsidiaries independently have the option to apply pushdown accounting in their separate financial statements.

The Background Information and Basis for Conclusions of ASU 2014-17 points out that the Task Force “considered, but ultimately rejected, a view in which an [acquiree] must elect to apply pushdown accounting in order for its subsidiaries to be able to elect the option to apply pushdown accounting” because “subsidiaries should reflect their parent’s basis.” The Task Force rejected that view on the basis that “each entity has different users and their perspectives may be different from one another.” Therefore, each entity within the group of acquired entities “should be allowed to separately evaluate whether pushdown accounting applies to their separate financial statements.”

### Example A-2

**Subsidiary’s Elections to Apply Pushdown Accounting**

- **Company A**
- **Company B**
- **Subsidiary X — Reporting Entity**
  - **Subsidiary X1**
  - **Subsidiary X2**
- **Subsidiary Y**
  - **Subsidiary Y1**
  - **Subsidiary Y2 — Reporting Entity**

Company A obtains control of Company B in a transaction accounted for as a business combination, and B becomes a subsidiary of A. Company B has two wholly owned subsidiaries, Subsidiary X and Subsidiary Y, each of which has two subsidiaries. Subsidiary X and Subsidiary Y2 each issue separate financial statements, and each may independently elect to apply pushdown accounting irrespective of whether B, Y, or any other acquired entity elects to do so. In addition, X’s or Y2’s ability to elect pushdown accounting does not depend on whether B issues separate financial statements.
A.8 Specific Initial Recognition and Measurement Guidance in an Acquiree’s Separate Financial Statements

ASC 805-50

30-10 If an acquiree elects the option in this Subtopic to apply pushdown accounting, the acquiree shall reflect in its separate financial statements the new basis of accounting established by the acquirer for the individual assets and liabilities of the acquiree by applying the guidance in other Subtopics of Topic 805. If the acquirer did not establish a new basis of accounting for the individual assets and liabilities of the acquiree because it was not required to apply Topic 805 (for example, if the acquirer was an individual or an investment company — see Topic 946 on investment companies), the acquiree shall reflect in its separate financial statements the new basis of accounting that would have been established by the acquirer had the acquirer applied the guidance in other Subtopics of Topic 805.

If an acquiree elects to apply pushdown accounting, the carrying amounts of its assets and liabilities in its separate financial statements are adjusted to reflect the amounts recognized in the acquirer’s consolidated financial statements as of the date on which control was obtained. As discussed in the paragraphs below, ASC 805-50 contains guidance on the initial recognition and measurement of certain assets, liabilities, and gains in an acquiree’s separate financial statements. For assets, liabilities, gains, and losses not specifically addressed in ASC 805-50, we believe that an acquiree should apply the recognition and measurement guidance in ASC 805-20 and ASC 805-30 that the acquirer applies.

An acquiree that elects pushdown accounting must apply it in its entirety; the acquiree cannot pick or choose which assets or liabilities to recognize in its separate financial statements. However, assets or liabilities that are the legal right or obligation of the parent or acquirer, rather than the acquiree, should not be pushed down unless they must be recognized in the acquiree’s financial statements in accordance with other GAAP (see Section A.11). In addition, expenses are not part of the acquirer’s basis in the assets acquired and liabilities assumed. Expenses incurred by the acquirer should not be pushed down to the acquiree’s separate financial statements unless the acquirer incurred such expenses on behalf of, or for the benefit of, the acquiree (see Section A.12).

An acquirer sometimes is not required to apply ASC 805-10, ASC 805-20, and ASC 805-30 to the acquiree’s assets acquired or liabilities assumed (e.g., the acquirer is an individual or an investment company). In such cases, the acquiree may nonetheless elect to apply pushdown accounting by recognizing in its separate financial statements the basis the acquirer would have recognized had it applied ASC 805-10, ASC 805-20, and ASC 805-30.

A.9 Subsequent Measurement Guidance

ASC 805-50

35-2 An acquiree shall follow the subsequent measurement guidance in other Subtopics of Topic 805 and other applicable Topics to subsequently measure and account for its assets, liabilities, and equity instruments, as applicable.

ASC 805-50 contains no specific subsequent-measurement guidance related to an acquiree’s separate financial statements. An acquiree that elects pushdown accounting should apply the subsequent-measurement guidance in ASC 805-20 and ASC 805-30 and other applicable GAAP to subsequently measure and account for its assets, liabilities, and equity instruments.
A.10 Goodwill and Bargain Purchase Gains

An acquiree that applies pushdown accounting must recognize the goodwill related to the acquisition in its separate financial statements. Certain items, such as liabilities that are not the legal obligation of the acquiree or bargain purchase gains, are not pushed down to the acquiree. Because these items are not pushed down to the acquiree's financial statements on the acquisition date, there will be an adjustment to the acquiree's APIC rather than to goodwill. However, a bargain purchase gain recognized by the acquirer is not recognized in the acquiree's separate income statement even if the acquiree elects to apply pushdown accounting. An acquiree that elects to apply pushdown accounting recognizes a bargain purchase gain as an adjustment to APIC (or net assets of a not-for-profit acquiree) in its separate financial statements.

ASC 350-20 requires that an acquirer assign all goodwill acquired in a business combination on the acquisition date to the acquirer's reporting units “that are expected to benefit from the synergies of the combination.” Such an allocation could result in a difference between the amount of goodwill recognized in the acquiree's separate financial statements and the amount of goodwill assigned to the acquiree in the parent's consolidated financial statements if some of the goodwill is assigned to one or more reporting units that do not include the assets or liabilities of the acquiree.

[Example A-3 has been deleted.]

A.11 Acquisition-Related Liabilities

ASC 805-50 provides guidance on applying pushdown accounting to acquisition-related liabilities that the acquirer (or acquiree) incurs at the time of the acquisition (e.g., acquisition-related debt or contingent consideration). Such liabilities differ from liabilities assumed, which were liabilities of the acquiree before the acquisition that the acquirer assumes as part of the acquisition.

In discussing the requirement cited in ASC 805-50-30-12 above, the Task Force referred to the definition of a liability in FASB Concepts Statement 6, which states that “[l]iabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.” The Background Information and Basis for Conclusions of ASU 2014-17 notes that the Task Force concluded that an acquiree should “recognize a liability incurred by the acquirer only if that obligation is the [acquiree’s] liability” (i.e., the liability is the acquiree's legal obligation even if the acquirer incurred the liability on behalf of the acquiree). The Background Information and Basis for Conclusions also cites the guidance in ASC 405-40, which applies to obligations related to joint-and-several liability arrangements for which the
total amount under the arrangement is fixed as of the reporting date. ASC 405-40-30-1 requires entities to recognize and measure liabilities resulting from joint-and-several liability arrangements as the sum of the following:

a. The amount the reporting entity agreed to pay on the basis of its arrangement among its co-obligors.
b. Any additional amount the reporting entity expects to pay on behalf of its co-obligors. If some amount within a range of the additional amount the reporting entity expects to pay is a better estimate than any other amount within the range, that amount shall be the additional amount included in the measurement of the obligation. If no amount within the range is a better estimate than any other amount, then the minimum amount in the range shall be the additional amount included in the measurement of the obligation.

### A.11.1 Acquisition-Related Debt

Acquisition-related liabilities include debt incurred at the time of the acquisition. Under ASC 805-50-30-12, an acquiree must recognize any acquisition-related debt in its separate financial statements only if it is required to do so under other GAAP. Thus, acquisition-related debt should be recognized in the acquiree’s separate financial statements only if (1) the debt is the legal obligation of the acquiree or (2) the acquirer and acquiree are joint and severally liable and the criteria in ASC 405-40 are met. We believe that if the acquiree recognizes the acquisition-related debt in its separate financial statements, it should also recognize the related interest expense and debt issue costs.

An acquiree may be required to recognize acquisition-related debt and liabilities in its separate financial statements as a result of other GAAP even if it does not elect to apply pushdown accounting. For example, if the acquirer incurs debt to finance the acquisition but the acquiree is named as the legal obligor, that debt would need to be recognized in the acquiree’s separate financial statements even if the acquiree does not apply pushdown accounting. This could lead to the acquiree’s presentation of negative equity in its financial statements if pushdown accounting is not elected.

Before being rescinded by SAB 115, SAB Topic 5.J expressed the SEC staff’s views on the pushdown of acquisition-related debt to the acquiree’s separate financial statements. SAB Topic 5.J stated that the parent’s acquisition-related debt, related interest expense, and allocable debt issue costs should be included in a subsidiary’s financial statements in any of the following circumstances:

- The subsidiary was 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 were to be “used to retire all or a part of [the parent’s] debt.”
- The subsidiary guaranteed or pledged “its assets as collateral for [the parent’s] debt.”

Because an acquiree’s assets are often pledged as collateral against an acquirer’s debt, we believe that the rescission of SAB Topic 5.J will result in fewer instances in which acquisition-related debt is recognized in the acquiree’s separate financial statements.

### A.11.2 Contingent Consideration

ASC 805-10-20 defines contingent consideration as follows:

Usually an obligation of the acquirer to transfer additional assets or equity interests to the former owners of an acquiree as part of the exchange for control of the acquiree if specified future events occur or conditions are met. However, contingent consideration also may give the acquirer the right to the return of previously transferred consideration if specified conditions are met.
ASC 805-30-25-5 requires that an acquirer recognize any contingent consideration at fair value on the acquisition date “as part of the consideration transferred in exchange for the acquiree.”

ASC 805-50 does not specify whether contingent consideration should be pushed down to the acquiree's separate financial statements. We believe that the general principles for acquisition-related liabilities incurred by the acquirer apply and that contingent consideration should be recognized in the acquiree's separate financial statements only if it is the acquiree's legal obligation to pay (or legal right to receive) the contingent consideration. If contingent consideration is not pushed down to the acquiree's separate financial statements, the acquiree would not recognize any changes in the fair value of the contingent consideration in its separate statement of operations.

A.12 Acquisition-Related Costs

ASC 805-10-25-23 states:

Acquisition-related costs are costs the acquirer incurs to effect a business combination. Those costs include finder's fees; advisory, legal, accounting, valuation, and other professional or consulting fees; general administrative costs, including the costs of maintaining an internal acquisitions department; and costs of registering and issuing debt and equity securities. The acquirer shall account for acquisition-related costs as expenses in the periods in which the costs are incurred and the services are received, with one exception. The costs to issue debt or equity securities shall be recognized in accordance with other applicable GAAP.

We believe that the acquirer's direct expenses for acquisition-related costs should not be recognized in the acquiree's separate financial statements unless the acquirer incurred such costs on behalf of, or for the benefit of, the acquiree. SAB Topic 1.B states that “[i]n general, the staff believes that the historical income statements of a registrant should reflect all of its costs of doing business. Therefore, in specific situations, the staff has required the subsidiary to revise its financial statements to include certain expenses incurred by the parent on its behalf.” Similarly, SAB Topic 5.T discusses the concept of reflecting costs incurred by a shareholder on behalf of a company in the company's financial statements. SAB Topic 5.T states that a transaction in which “a principal stockholder pays an expense for the company, unless the stockholder's action is caused by a relationship or obligation completely unrelated to his position as a stockholder or such action clearly does not benefit the company,” should be reflected as an expense in the company's financial statements, with a corresponding credit to APIC. While the guidance in SAB Topic 1.B and SAB Topic 5.T applies to public companies, we believe that private companies should also apply this guidance when evaluating the recognition of acquisition-related costs.

An acquiree will most likely incur acquisition-related costs associated with the business combination, such as legal fees or sell-side due diligence costs. The acquiree should recognize those costs in its separate financial statements in the periods in which the services are received. An acquirer may sometimes pay the liabilities of the acquiree on, or in close proximity to, the acquisition date. In such cases, it is necessary to determine whether the cash distributed should be reported as consideration transferred to effect the acquisition or as cash paid to settle a liability assumed in the acquisition. (See Section 4.12.1 for more information about making this determination.) If it is determined to be a liability assumed, and if the acquiree is the legal obligor for those costs, the liability should be recognized in the acquiree's separate postacquisition financial statements regardless of whether it elects pushdown accounting.
A.13 Income Taxes

Although the application of pushdown accounting is optional under ASC 805-50, ASC 740-10-30-5 states that deferred taxes must be "determined separately for each tax-paying component . . . in each tax jurisdiction." Therefore, to properly determine the temporary differences and to apply ASC 740 accurately, an entity must push down, to each tax-paying component, the amounts assigned to the individual assets and liabilities for financial reporting purposes. That is, because the cash inflows from assets acquired or cash outflows from liabilities assumed will be reflected on the tax return of the respective tax-paying component, the acquirer has a taxable or deductible temporary difference related to the entire amount recorded under the acquisition method (compared with its tax basis), regardless of whether such acquisition-method adjustments are actually pushed down and reflected in the acquiree's separate financial statements.

An entity can either record the amounts in its subsidiary's books (i.e., actual pushdown accounting) or maintain the records necessary to adjust the consolidated amounts to what they would have been had the amounts been recorded on the subsidiary's books (i.e., notional pushdown accounting). In many instances, the latter method can make record keeping more complex.

Further, the entire amount recorded under the acquisition method for a particular asset or liability must be converted to the currency in which the tax-paying component files its tax return (the "tax currency") to properly determine the temporary difference associated with the particular asset or liability and the corresponding deferred tax asset or deferred tax liability (i.e., deferred taxes are calculated in the tax currency and then translated or remeasured in accordance with ASC 830).

See Deloitte's A Roadmap to Accounting for Income Taxes for more information.

A.14 Foreign Currency Translation

ASC 830-30-45-11 states that “[a]fter a business combination, the amount assigned at the acquisition date to the assets acquired and the liabilities assumed (including goodwill or the gain recognized for a bargain purchase in accordance with Subtopic 805-30) shall be translated in conformity with the requirements of this Subtopic [ASC 830].” This requirement applies regardless of whether the entity elects to apply pushdown accounting.

See Deloitte's A Roadmap to Foreign Currency Transactions and Translations for more information.

A.15 Disclosures

<table>
<thead>
<tr>
<th>ASC 805-50</th>
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<tbody>
<tr>
<td><strong>50-5</strong> If an acquiree elects the option to apply pushdown accounting in its separate financial statements, it shall disclose information in the period in which the pushdown accounting was applied (or in the current reporting period if the acquiree recognizes adjustments that relate to pushdown accounting) that enables users of financial statements to evaluate the effect of pushdown accounting. To meet this disclosure objective, the acquiree shall consider the disclosure requirements in other Subtopics of Topic 805.</td>
</tr>
</tbody>
</table>
Appendix A — Pushdown Accounting

ASC 805-50 (continued)

50-6 Information to evaluate the effect of pushdown accounting may include the following:

a. The name and a description of the acquirer and a description of how the acquirer obtained control of the acquiree.
b. The acquisition date.
c. The acquisition-date fair value of the total consideration transferred by the acquirer.
d. The amounts recognized by the acquiree as of the acquisition date for each major class of assets and liabilities as a result of applying pushdown accounting. If the initial accounting for pushdown accounting is incomplete for any amounts recognized by the acquiree, the reasons why the initial accounting is incomplete.
e. A qualitative description of the factors that make up the goodwill recognized, such as expected synergies from combining operations of the acquiree and the acquirer, or intangible assets that do not qualify for separate recognition, or other factors. In a bargain purchase (see paragraphs 805-30-25-2 through 25-4), the amount of the bargain purchase recognized in additional paid-in capital (or net assets of a not-for-profit acquiree) and a description of the reasons why the transaction resulted in a gain.
f. Information to evaluate the financial effects of adjustments recognized in the current reporting period that relate to pushdown accounting that occurred in the current or previous reporting periods (including those adjustments made as a result of the initial accounting for pushdown accounting being incomplete [see paragraphs 805-10-25-13 through 25-14]).

The information in this paragraph is not an exhaustive list of disclosure requirements. The acquiree shall disclose whatever additional information is necessary to meet the disclosure objective set out in paragraph 805-50-50-5.

The disclosures that an entity applying pushdown accounting is required to provide under ASC 805-50 are generally based on the disclosures that an acquirer is required to provide for a business combination under ASC 805-10, ASC 805-20, and ASC 805-30. However, the ASC 805-50 requirements exclude certain disclosures that would only be relevant to users of the acquirer’s consolidated financial statements. For example, an acquiree is not required to disclose items such as the percentage of voting equity interests acquired by the acquirer, any transactions the acquirer recognized separately from the acquisition, and supplemental pro forma information. In subsequent reporting periods, the acquiree would need to provide any required disclosures for items such as goodwill and intangible assets.

There are no disclosure requirements for an acquiree that does not elect to apply pushdown accounting. Therefore, an acquiree would not be required to disclose that it was acquired or that it elected not to apply pushdown accounting.

[Section A.16 has been deleted.]

A.17 Financial Statement Presentation

The application of pushdown accounting and the presentation of a new basis of accounting in a subsidiary’s separate financial statements are akin to the termination of an old reporting entity and the creation of a new reporting entity. Therefore, it is not appropriate to combine preacquisition and postacquisition periods in a single set of financial statements. In both the financial statements and any footnote disclosures presented in tabular format, the preacquisition and postacquisition periods are separated by a vertical “black line.” The periods before the acquisition are labeled as the “predecessor” periods and the periods after the acquisition and the application of pushdown accounting are labeled as the “successor” periods. Since the application of pushdown accounting is akin to the creation of a new reporting entity, the predecessor entity’s equity structure is not carried forward and the new equity structure is presented in the successor period. The footnotes to the financial statements should
include separate footnote disclosures for the preacquisition and postacquisition periods. In addition, the footnote disclosures should include a description of the acquisition to alert users that pushdown accounting was applied and that, accordingly, the acquiree’s results of operations and cash flows in the predecessor and successor periods are not comparable.

A.17.1 Recognizing Expenses on the “Black Line”

In a speech at the 2014 AICPA Conference on Current SEC and PCAOB Developments, an SEC staff member (Carlton Tartar) discussed whether it is appropriate for an entity that is applying pushdown accounting to exclude, from both the predecessor and successor income statement periods, certain expenses triggered by the consummation of a business combination that were incurred by the acquiree. Examples of such expenses include investment banking fees paid by the acquiree that are contingent on the closing of the acquisition and share-based compensation awards with a preexisting provision that accelerated their vesting upon a change in control. While the staff acknowledged that a registrant needs to consider its specific facts and circumstances, it observed that registrants sometimes exclude expenses that are contingent on a change-in-control event from the predecessor and successor periods and record those expenses on the “black line” separating the two periods (i.e., neither the predecessor’s nor the successor’s financial statements would report the contingent payments as expenses). The staff encouraged “registrants to evaluate whether it is appropriate to record expenses that are related to the business combination in either the predecessor or successor periods as appropriate, based on the specific facts and circumstances underlying each individual transaction.” However, the staff also noted that it would not object to black line presentation “provided that transparent and disaggregated disclosure of the nature and amount of such expenses was made.”

This view is supported by analogy to the guidance in ASC 805-20-55-51, which prohibits entities from recognizing a liability for contractual termination benefits and curtailment losses under employee benefit plans that will be triggered by a business combination until the business combination is consummated. Similarly, the argument in support of recognizing expenses on the black line is that any expenses that do not become payable until the change in control should not be recognized until consummation occurs and should not be recognized in the period before the business combination (i.e., the predecessor period).

Another acceptable view is that all of the acquiree’s acquisition expenses, even those that are contingent on a change in control, should be recognized in the period in which they were incurred. Because the financial statements present the acquiree’s results of operations for the period up to the acquisition date, there is no longer a risk that the business combination will not occur. Thus, recognition of the expenses in the predecessor period is appropriate.

We believe that either alternative is acceptable provided that an acquiree recognizes all expenses triggered by a change in control consistently, either in the predecessor period or on the black line.

A.17.2 Reflecting Changes by the Successor in the Predecessor Period

Because the application of pushdown accounting is akin to the termination of an old reporting entity and the creation of a new reporting entity, the successor’s changes in accounting principle, adoption of new accounting standards that require retrospective application, reorganizations, or changes in segment reporting are not “pushed back” into the predecessor period. However, Section 13210.2 of the SEC’s Financial Reporting Manual (FRM) does require that the predecessor financial statements be retrospectively recast to reflect the successor’s discontinued operations. It states:

Predecessor financial statements are required to be retrospectively reclassified to reflect the impact of a successor’s discontinued operations. Registrants should contact the staff if unusual facts and circumstances may prohibit the company’s ability to reclassify predecessor fiscal periods.
A.18 Identifying When a Newly Formed Entity to Effect an Acquisition Is the Acquirer

While ASU 2014-17 simplified the application of pushdown accounting, it did not resolve certain long-standing practice issues related to whether a newly formed entity (commonly called a “newco”) should be identified as the acquirer in a business combination. Entities will often establish a newco to effect the acquisition of a business. If the newco is identified as the acquirer and is the reporting entity, it would apply acquisition accounting, rather than pushdown accounting. Therefore, recognizing a new basis for the assets acquired and liabilities assumed in the newco’s financial statements would not be optional.

ASC 805-10-55-15 provides limited guidance on whether a newco should be identified as the accounting acquirer and states:

A new entity formed to effect a business combination is not necessarily 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 paragraphs 805-10-55-10 through 55-14. In contrast, a new entity that transfers cash or other assets or incurs liabilities as consideration may be the acquirer.

Entities must use judgment in determining whether a newco should be identified as the acquirer. See Section 3.1.5 for more information about identifying a newco as the acquirer in a business combination.

A.18.1 Newco and Acquisition-Related Costs

If the newco is identified as the acquirer, the buyer’s acquisition-related costs should generally be reflected in the newco’s financial statements in accordance with SAB Topic 1.B and SAB Topic 5.T. If the newco’s parent incurred costs on the newco’s behalf, such costs should generally be recognized as an expense in the newco’s financial statements, with a corresponding credit to APIC. See Section A.12 for more information.

A.19 Recapitalization Transactions

A recapitalization is a type of reorganization designed to change an entity’s capital structure (i.e., mix of debt and equity). Usually, these transactions involve new debt financing, issuing new shares, or repurchasing outstanding shares. These transactions sometimes result in a change in control of the entity undergoing the recapitalization and may or may not result in a new basis of accounting at the entity level.

**Example A-4**

Recapitalization Transaction Without a Change in Control

Entities A, B, C, D, and E each own 20 percent of Company X’s issued and outstanding shares. None of the entities has control of X. Company X buys back all of E’s shares, and the ownership of A, B, C, and D increases to 25 percent each. However, no entity obtains control of X. The transaction is a recapitalization transaction for X, but there is no change in control over X.
Example A-5

Recapitalization Transaction With a Change in Control

Entities A, B, and C own all of Company X’s issued and outstanding shares. Entity A owns 45 percent, B owns 40 percent, and C owns 15 percent. None of the entities has control of X. Company X buys back all of C’s shares. Entity A’s ownership increases to 53 percent. In the absence of evidence that A does not control X, a business combination has occurred between A and X. Company X elects not to apply pushdown accounting. The transaction is a recapitalization transaction for X and, since X elects not to apply pushdown accounting, the basis of X’s assets or liabilities does not change when A obtains control of X.

A.19.1 Transaction Costs in a Recapitalization

Entities may incur costs related to structuring a recapitalization. An entity undergoing a recapitalization should account for its costs on the basis of the nature of those costs. For example, costs related to issuing debt are capitalized as debt issuance costs and amortized over the life of the debt by using the effective interest method, costs related to issuing equity and raising capital are recognized as a reduction to the total amount of equity raised, and costs related to advisory or legal services should be expensed as incurred.

If the costs are billed to the entity as a single amount, we believe that the entity should apply the guidance in paragraph 6 of SAB Topic 2.A, which states, in part:

When an investment banker provides services in connection with a business combination or asset acquisition and also provides underwriting services associated with the issuance of debt or equity securities, the total fees incurred by an entity should be allocated between the services received on a relative fair value basis. The objective of the allocation is to ascribe the total fees incurred to the actual services provided by the investment banker.

We believe that the amounts allocated to debt issuance costs should result in an effective interest rate on the debt that is consistent with an effective market interest rate and that the amounts allocated to equity issuance costs should be consistent with fees an underwriter would charge.

Further, we believe that if the fees are incurred by a new investor, those costs should not be recognized in the financial statements of the entity undergoing the recapitalization unless they were incurred by the investor on the entity’s behalf. We believe that entities should consider the guidance in SAB Topic 1.B and SAB Topic 5.T in determining whether such costs were incurred on behalf of, and for the benefit of, the entity. See Section A.12 for more information.
Appendix B — Accounting for Common-Control Transactions

B.1 Overview and Scope

B.1.1 Overview of Common-Control Transactions

A common-control transaction is typically a transfer of net assets or an exchange of equity interests between entities under the control of the same parent. While a common-control transaction is similar to a business combination for the entity that receives the net assets or equity interests, such a transaction does not meet the definition of a business combination because there is no change in control over the net assets. Therefore, the accounting and reporting for a transaction between entities under common control is outside the scope of the business combinations guidance in ASC 805-10, ASC 805-20, and ASC 805-30 and is addressed in the “Transactions Between Entities Under Common Control” subsections of ASC 805-50. Since there is no change in control over the net assets from the parent’s perspective, there is no change in basis in the net assets. ASC 805-50 requires that the receiving entity recognize the net assets received at their historical carrying amounts, as reflected in the parent’s financial statements. ASC 805-50 does not specifically address the accounting by the transferring entity. In the absence of guidance, certain practices have developed regarding the reporting by the transferring entity in its separate financial statements.

A common-control transaction has no effect on the parent’s consolidated financial statements. The net assets are derecognized by the transferring entity and recognized by the receiving entity at their historical carrying amounts. Any difference between the proceeds transferred or received and the carrying amounts of the net assets is recognized in equity in the transferring and receiving entities’ separate financial statements and eliminated in consolidation. Therefore, the guidance in the “Transactions Between Entities Under Common Control” subsections of ASC 805-50 and the following sections of this appendix applies only to the separate financial statements of an entity that engages in a common-control transaction.

ASC 805-50 also provides guidance addressing whether the receiving entity should report the net assets received prospectively from the date of the transfer or retrospectively for all periods presented. If the recognition of the net assets results in a “change in the reporting entity,” the receiving entity presents the transfer in its separate financial statements retrospectively, similarly to a pooling of interests. If not, the receiving entity presents the transfer in its separate financial statements prospectively from the date of the transfer. ASC 805-50 does not specifically address the reporting by the transferring entity; however, the transferring entity usually presents the transfer as a disposal on the date of the transfer in its separate financial statements.
B.1.2 Scope

<table>
<thead>
<tr>
<th>ASC 805-50</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>05-4</strong> As noted in paragraph 805-10-15-4(c), the guidance related to business combinations does not apply to combinations between entities or businesses under common control.</td>
</tr>
<tr>
<td><strong>15-5</strong> The guidance in the Transactions Between Entities Under Common Control Subsections applies to all entities.</td>
</tr>
<tr>
<td><strong>15-6A</strong> The guidance in the Transactions between Entities under Common Control Subsections does not apply to the initial measurement by a primary beneficiary of the assets, liabilities, and noncontrolling interests of a VIE if the primary beneficiary of a VIE and the VIE are under common control. Guidance for such a VIE is provided in Section 810-10-30.</td>
</tr>
<tr>
<td><strong>15-6B</strong> Mergers and acquisitions between or among two or more NFPs, all of which benefit a particular group of citizens, shall not be considered common control transactions solely because those entities benefit a particular group. The mission, operations, and historical sources of support of two or more NFPs may be closely linked to benefiting a particular group of citizens. However, that group neither owns nor controls the NFPs.</td>
</tr>
</tbody>
</table>

The guidance in the “Transactions Between Entities Under Common Control” subsections of ASC 805-50 applies to the separate financial statements of an entity that engages in a common-control transaction. However, ASC 810-10-30-1 addresses how a primary beneficiary of a VIE should initially measure the VIE's assets, liabilities, and noncontrolling interests when the primary beneficiary and the VIE are under common control. That guidance, which states as follows, is similar to that in ASC 805-50:

> 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 noncontrolling interests 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 [GAAP]).

B.2 Identifying Common-Control Transactions

B.2.1 Meaning of the Term “Common Control”

The term “control” has the same meaning as the term “controlling financial interest” in ASC 810-10-15-8, which states:

> For legal entities other than limited partnerships, the usual condition for a controlling financial interest is ownership of a majority voting interest, and, therefore, as a general rule ownership by one reporting entity, directly or indirectly, of more than 50 percent of the outstanding voting shares of another entity is a condition pointing toward consolidation. The power to control may also exist with a lesser percentage of ownership, for example, by contract, lease, agreement with other stockholders, or by court decree.

In determining control, an entity cannot consider only voting interests. Control may be established in other ways, such as:

- Variable interests (see the “Variable Interest Entities” subsections of ASC 810-10 and Deloitte’s *A Roadmap to Consolidation — Identifying a Controlling Financial Interest*).
- Contractual arrangements (see the “Consolidation of Entities Controlled by Contract” subsections of ASC 810-10).
While “common control” is not defined, we often think of the term as encompassing situations in which separate entities were consolidated by the same parent both before and after the transfer (or would have been consolidated by the same parent if the parent prepared consolidated financial statements).

**Example B-1**

**Entities Under Common Control**

Parent controls Subsidiary A with its 60 percent voting equity interest and Subsidiary B with its 100 percent voting equity interest. Because Parent controls both A and B, they are under the common control of Parent.

![Diagram showing Parent controlling Subsidiary A with 60% and Subsidiary B with 100%]

ASC 805-50-15-6 gives examples of other common-control transactions:

**ASC 805-50**

**Transactions**

15-6 The guidance in the Transactions between Entities under Common Control Subsections applies to combinations between entities or businesses under common control. The following are examples of those types of transactions:

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

b. A parent transfers the net assets of a wholly owned subsidiary into the parent and liquidates the subsidiary. That transaction is a change in legal organization but not a change in the reporting entity.

c. A parent transfers its controlling interest in several partially owned subsidiaries to a new wholly owned subsidiary. That also is a change in legal organization but not in the reporting entity.

d. 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.

e. 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.

f. A limited liability company is formed by combining entities under common control.

g. Two or more not-for-profit entities (NFPs) that are effectively controlled by the same board members transfer their net assets to a new entity, dissolve the former entities, and appoint the same board members to the newly combined entity.

**Changing Lanes**

In October 2018, the FASB issued ASU 2018-17, which amends the related-party guidance in ASC 810 to add an elective private-company scope exception to the VIE guidance for entities under common control. For more information, see Deloitte’s *A Roadmap to Consolidation — Identifying a Controlling Financial Interest*.
EITF Issue 02-5 also provides examples of common-control transactions. Although EITF Issue 02-5 was nullified by FASB Statement 141(R), which was codified in ASC 805-10, ASC 805-20, and ASC 805-30, we believe that the guidance provided by that Issue remains applicable to both public and private companies because of a lack of other authoritative guidance on this topic. While no consensus was reached, the SEC observer stated that the SEC staff believes 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.
- Immediate family members 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).
  1. Immediate family members include a married couple and their children, but not the married couple’s grandchildren.
  2. Entities might be owned in varying combinations among living siblings and their children. Those situations would require careful consideration regarding the substance of the ownership and voting relationships.
- 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.

We understand that the guidance about immediate family members should not be extended to other family relationships such as shares held by in-laws, cousins, or divorced couples. In addition, we understand that the SEC staff has objected to assertions that different companies owned by individuals that are not members of an immediate family are under common control unless there was written evidence of an agreement in place at the time of the transaction to vote a majority of an entity’s shares together.

A downstream merger is another example of a common-control transaction. In a downstream merger, a partially owned subsidiary exchanges its common shares for the outstanding voting common shares of its parent. As a result, the consolidated net assets are owned by both the former shareholders of the parent and the former shareholders of the noncontrolling interest in the subsidiary. Regardless of its legal form, a downstream merger is accounted for as if the parent acquired the shares of its subsidiary. Therefore, the reporting for a downstream merger is similar to that for a reverse acquisition without a change in basis for the assets and liabilities. The parent is treated as the ongoing reporting entity from an accounting perspective. The consolidated financial statements of the surviving entity are those of the parent, even though the subsidiary is the surviving legal entity. The shareholders’ equity of the surviving entity is adjusted to reflect the shareholders’ equity of the former parent, after effect is given to the acquisition of the noncontrolling interest, which is accounted for as an equity transaction in accordance with ASC 810-10-45-23.

In some cases, judgment must be used in the determination of whether entities are under common control. An entity should consider all facts and circumstances in making this determination.
B.2.2 Transactions Between Entities With Common Ownership

Common ownership exists when two or more entities have the same shareholders but no one shareholder controls all of the entities. Transfers of net assets or equity interests among entities that have common ownership are not common-control transactions. However, they may be accounted for similarly to common-control transactions if the transfer lacks economic substance. In prepared remarks at the 1997 Annual Conference on Current SEC Developments, Donna Coallier, then professional accounting fellow in the SEC’s OCA, addressed transactions between entities with a high degree of common ownership, stating:

When there is a transaction between entities with a high degree of common ownership, but that are not under common control, the staff assesses the transaction to determine whether the transaction lacks substance. FTB 85-5 provides an example of a similar assessment in an exchange between a parent and a minority shareholder in one of the parent’s partially owned subsidiaries. Paragraph 6 of FTB 85-5 states, in part:

}[I]f the minority interest does not change and if in substance the only assets of the combined entity after the exchange are those of the partially owned subsidiary prior to the exchange, a change in ownership has not taken place, and the exchange should be accounted for based on the carrying amounts of the partially owned subsidiary’s assets and liabilities.

Similarly, in a transfer or exchange between entities with a high degree of common ownership, the staff compares the percentages owned by shareholders in the combined company to the percentages owned in each of the combining companies before the transaction. When the percentages have changed or the owned interests are not in substance the same before and after the transaction, the staff believes a substantive transaction has occurred and has objected to historical cost accounting.

FASB Statement 141(R) nullified FASB Technical Bulletin 85-5. However, in the absence of other authoritative guidance, we believe that it continues to provide relevant guidance on assessing whether a transaction lacks economic substance. On the basis of the guidance in paragraph 6 of Technical Bulletin 85-5 and the prepared remarks of the SEC staff, for a transaction between entities with common ownership to be accounted for in a manner consistent with a common-control transaction, entities are expected to have identical owners and the ownership percentages would need to be very similar both before and after the transaction to demonstrate that the transaction lacks economic substance. Such fact patterns are unusual.

Example B-2

Transfer Between Entities With Common Ownership That Lacks Economic Substance

Investors A and B each have a 35 percent interest and Investor C has a 30 percent interest in Companies A, B, and C. No individual investor controls any of the companies. The investors agree to merge the three companies. Further, the investors exchange their shares in each of the three companies for shares of the new, merged company, Company ABC. After the transaction, A and B each have a 35 percent interest and C has a 30 percent interest in ABC.
Example B-2 (continued)

Before transfer:

<table>
<thead>
<tr>
<th>Investor A 35%</th>
<th>Investor B 35%</th>
<th>Investor C 30%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Company A</td>
<td>Company B</td>
<td>Company C</td>
</tr>
</tbody>
</table>

After transfer:

<table>
<thead>
<tr>
<th>Investor A 35%</th>
<th>Investor B 35%</th>
<th>Investor C 30%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Company ABC</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Because A’s, B’s, and C’s ownership interests in the underlying assets are the same before and after the merger, the transaction lacks economic substance. Thus, the transaction would be accounted for in a manner consistent with a common-control transaction in accordance with ASC 805-50. As the receiving entity, Company ABC would recognize the assets and liabilities of A, B, and C at their historical carrying amounts.

Example B-3

Transfer Between Entities With Common Ownership That Has Economic Substance

Investors A, B, C, and D together own Companies A and B. No individual investor controls both A and B. The investors agree to merge A and B. Further, the investors exchange their shares in each of the two companies for share of the new, merged company. The number of shares received is based on the relative fair values of the share held in A and B before the merger.

<table>
<thead>
<tr>
<th>Company A</th>
<th>Company B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investor A</td>
<td>80%</td>
</tr>
<tr>
<td>Investor B</td>
<td>10%</td>
</tr>
<tr>
<td>Investor C</td>
<td>5%</td>
</tr>
<tr>
<td>Investor D</td>
<td>5%</td>
</tr>
</tbody>
</table>

Company A is significantly larger than B such that after the merger the ownership in Company AB is as follows:

<table>
<thead>
<tr>
<th>Company B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investor A</td>
</tr>
<tr>
<td>Investor B</td>
</tr>
<tr>
<td>Investor C</td>
</tr>
<tr>
<td>Investor D</td>
</tr>
</tbody>
</table>

Although A and B had identical owners before the merger, given the resulting change in relative ownership, it would not be appropriate to account for the transaction in a manner consistent with a common-control transaction.
B.3 Measurement

B.3.1 Measurement by the Receiving Entity

<table>
<thead>
<tr>
<th>ASC 805-50</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Transfer Date Recognition</strong></td>
</tr>
<tr>
<td>25-2 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 shall initially recognize the assets and liabilities transferred at the date of transfer. See the Transactions Between Entities Under Common Control Subsection of Section 805-50-45 for guidance on the presentation of financial statements for the period of transfer and comparative financial statements for prior years.</td>
</tr>
<tr>
<td><strong>Transfer Date Measurement</strong></td>
</tr>
<tr>
<td>30-5 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 shall initially measure the recognized assets and liabilities transferred at their carrying amounts in the accounts of the transferring entity at the date of 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 shall reflect the transferred assets and liabilities at the historical cost of the parent of the entities under common control.</td>
</tr>
</tbody>
</table>

Under ASC 805-50-30-5, there is no change in basis for the net assets received because there is no change in control over the net asset or equity interests from the parent's perspective. A difference between any proceeds transferred and the carrying amounts of the net assets received is recognized in equity (generally APIC) in the receiving entity's separate financial statements.

**B.3.1.1 Difference in Carrying Amounts Between the Parent and Transferring Entity**

Sometimes, the carrying amounts of the net assets in the transferring entity's financial statements differ from those in the parent's consolidated financial statements. This can occur, for example, if the net assets being transferred were acquired in a business combination but the transferring entity did not apply pushdown accounting at the time of their acquisition. Under ASC 805-50-30-5, “the financial statements of the receiving entity shall reflect the transferred assets and liabilities at the historical cost of the parent of the entities under common control.” As a result, the receiving entity effectively applies pushdown accounting in its separate financial statements. (See Appendix A for more information about the application of pushdown accounting.) Therefore, the amounts of the net assets derecognized by the transferring entity will not be consistent with the amounts of the net assets recognized by the receiving entity.
Example B-4

Common-Control Transfer That Triggers Pushdown Accounting

Parent transfers its ownership interest in one of its subsidiaries, Subsidiary B, to another of its subsidiaries, Subsidiary A, in exchange for additional shares of A. The carrying value of B's net assets in Parent's consolidated financial statements is $1,000, and the carrying value of B's net assets in its separate financial statements is $500. The carrying value of B's net assets differs in Parent's consolidated financial statements and in B's separate financial statements because B did not apply pushdown accounting in its separate financial statements when Parent acquired control of B.

Before transfer:

Before transfer:

After transfer:

After transfer:

Subsidiary A's separate financial statements should reflect B's net assets at their carrying values, as presented in Parent's consolidated financial statements. The nature of the transfer is that Parent is transferring its investment in B to A.

B.3.1.2 Conforming Accounting Principles

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 shall be applied retrospectively, and financial statements presented for prior periods shall be adjusted unless it is impracticable to do so. Section 250-10-45 provides guidance if retrospective application is impracticable.
While we generally expect subsidiaries of a common parent to apply the same accounting principles to similar assets or liabilities, in limited circumstances it is acceptable for the accounting policies of subsidiaries of a common parent to differ. For example, one subsidiary of a parent may apply the last-in, first-out method to account for inventory while another of its subsidiaries may use a different method for similar inventories. Therefore, in some cases, the receiving entity and the transferring entity may use different accounting methods to account for certain assets or liabilities. ASC 805-50-30-6 states that in a common-control transaction, “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.” Thus, if the receiving entity applies a different accounting principle and elects to adopt that accounting principle for the assets or liabilities received, it must determine that the method it applies is preferable to the method applied by the transferring entity and must apply the change in accounting principle retrospectively in all periods presented, unless it is impracticable to do so, in accordance with the guidance in ASC 250. We believe that, in situations in which the accounting principle applied by the receiving entity is not preferable, the receiving entity has two options: (1) to continue to account for the transferred assets and liabilities using the accounting principle applied by the transferring entity or (2) to voluntarily adopt for its assets or liabilities the preferable accounting principle the transferring entity applies in accordance with ASC 250.

B.3.2 Measurement by the Transferring Entity

ASC 805-50 provides measurement guidance for the receiving entity but not for the transferring entity. Because of this lack of authoritative guidance, practice has developed such that the transferring entity's measurement generally follows the receiving entity's. That is, the transferring entity derecognizes the net assets transferred at their carrying amounts and generally recognizes no gains or losses. A difference between any proceeds received and the carrying amounts of the net assets transferred is recognized in equity (generally APIC) in the transferring entity's separate financial statements.

However, in certain circumstances, the transferring entity must remeasure certain assets to fair value and recognize any gains or losses before they are transferred to the receiving entity. As discussed below, such circumstances represent exceptions to the principle that assets and liabilities should be transferred at their historical carrying amounts.

B.3.2.1 Exception for Transfers of Financial Assets

ASC 860-10-55-78 states, in part, that “a transfer [of financial assets] from one subsidiary (the transferor) to another subsidiary (the transferee) of a common parent would be accounted for as a sale in each subsidiary's separate-entity financial statements” if (1) all the conditions in ASC 860-10-40-5 are met and (2) the receiving entity is not consolidated by the transferring entity. ASC 860-10-40-4 also indicates that “[i]n a transfer between two subsidiaries of a common parent, the [transferring entity] shall not consider parent involvements with the transferred financial assets in applying paragraph 860-10-40-5.” Therefore, if those conditions are met, the transferring entity recognizes a gain or loss on a sale of financial assets to the receiving entity in its separate financial statements. However, any gain or loss would be eliminated in the parent's consolidated financial statements.

The guidance in ASC 860-10-40-5 does not apply to transfers of financial assets between a parent and its subsidiaries, only to transfers between subsidiaries of a common parent. Entities should consider the guidance in ASC 860-10-55-17D if the transfer of financial assets is between a parent and its subsidiary.
We believe that the guidance in ASC 860-10 applies to transfers of financial assets regardless of whether the nature of such transfers is recurring or nonrecurring. That is, if a transfer's nature is consistent with that of a transfer of financial assets, entities should apply the guidance in ASC 860-10 rather than the guidance in the “Transactions Between Entities Under Common Control” subsections of ASC 805-50 or the exception for recurring transactions discussed in Section B.3.2.2 below. In addition, the guidance in ASC 860-10 does not apply to a transfer of shares or an interest in a subsidiary unless the subsidiary primarily consists of financial assets (i.e., the transfer is essentially a transfer of financial assets). In some cases, an entity may need to use judgment to determine the nature of the transfer (i.e., financial assets or net assets).

**B.3.2.2 Exception for Recurring Transactions for Which Valuation Is Not in Question, Such as Those Involving Inventory**

A transfer of net assets between entities under common control is typically nonrecurring. However, for recurring transfers of assets (rather than net assets) whose valuation is not in question, such as routine inventory transfers in the ordinary course of business, the transferring entity typically recognizes a gain in its separate financial statements, and the receiving entity recognizes the assets at their stepped-up values in its separate financial statements. The accounting for routine transfers between entities under common control was addressed in EITF Issue 85-21, which states, in part:

> The SEC Observer stated that the SEC staff's views on carrying over historical cost to record, in the separate financial statements of each entity, transfers between companies under common control or between a parent and its subsidiary run primarily to transfers of net assets (as in a business combination) or long-lived assets. Those views would not normally apply to recurring transactions for which valuation is not in question (such as routine transfers of inventory) in the separate financial statements of each entity that is a party to the transaction. [Emphasis added]

Although the EITF did not reach a consensus on this issue, the above guidance continues to be applied in practice. Any gain recognized in the transferring entity's separate financial statements is eliminated in the parent's consolidated financial statements unless the sale is to a regulated affiliate and the criteria in ASC 980-810-45-1 and 45-2 are met.

As described in the SEC Observer's comments on EITF Issue 85-21, the SEC staff's views apply to routine transfers of assets rather than transfers of “net assets (as in a business combination) or long-lived assets." In some cases, an entity may need to use judgment to determine whether a transfer represents a transfer of net assets.

**B.3.2.3 Goodwill**

If the net assets or equity interest transferred in a common-control transaction constitute a business in accordance with ASC 805-10 (see Section 2.4), the transferring entity will need to determine how much goodwill to include with the net assets transferred. If the net assets or equity interest transferred do not constitute a business, no goodwill would be transferred to the receiving entity.

An entity must often use judgment in determining the amount of goodwill to include with the net assets transferred. Sometimes this goodwill amount may be specifically identified, while other times it may be based fully or partially on a relative fair value allocation, in which case the entity would be expected to consider the guidance in ASC 350-20-40-1 through 40-7. For example, an entity may specifically identify the goodwill to be included in the net assets transferred when the net assets consist entirely of a subsidiary previously acquired in a business combination. In this scenario, an entity typically would identify the goodwill related to the prior acquisition as included in the net assets transferred, regardless of whether the subsidiary had previously applied pushdown accounting. However, an entity may need to use greater judgment when assessing transferred assets that do not entirely constitute a subsidiary
previously acquired in a business combination. For example, an entity may transfer a subsidiary that was acquired in a prior business combination and other businesses that were not. In this scenario, the entity may specifically identify the goodwill for the subsidiary that was previously acquired and may use a relative fair value allocation for the rest of the transferred businesses. Alternatively, the entity may determine that using a relative fair value allocation for the entire transfer is appropriate.

A common-control transfer may also result in a reorganization of reporting structure in the receiving entity’s, transferring entity’s, or parent’s financial statements. Such a reorganization could result in changes in operating segments and reporting units (see Section B.3.3.2 below).

B.3.3 Other Issues That May Affect the Receiving or Transferring Entities

B.3.3.1 Income Taxes

Paragraphs 270–272 of FASB Statement 109 had provided guidance on accounting for income taxes in a business combination accounted for as a pooling of interests. Because FASB Statement 141 eliminated the pooling-of-interests method, the guidance in Statement 109 was nullified and was not codified. However, we believe it is appropriate to continue to apply that guidance to a common-control transfer. That guidance stated:

270. The separate financial statements of combining enterprises for prior periods are restated on a combined basis when a business combination is accounted for by the pooling-of-interests method. [Footnote omitted] For restatement of periods prior to the combination date, a combining enterprise’s operating loss carryforward does not offset the other enterprise’s taxable income because consolidated tax returns cannot be filed for those periods. However, provisions in the tax law may permit an operating loss carryforward of either of the combining enterprises to offset combined taxable income subsequent to the combination date.

271. If the combined enterprise expects to file consolidated tax returns, a deferred tax asset is recognized for either combining enterprise’s operating loss carryforward in a prior period. A valuation allowance is necessary to the extent it is more likely than not that a tax benefit will not be realized for that loss carryforward through offset of either (a) the other enterprise’s deferred tax liability for taxable temporary differences that will reverse subsequent to the combination date or (b) combined taxable income subsequent to the combination date. Determined in that manner, the valuation allowance may be less than the sum of the valuation allowances in the separate financial statements of the combining enterprises prior to the combination date. That tax benefit is recognized as part of the adjustment to restate financial statements on a combined basis for prior periods. The same requirements apply to deductible temporary differences and tax credit carryforwards.

272. A taxable business combination may sometimes be accounted for by the pooling-of-interests method. The increase in the tax basis of the net assets acquired results in temporary differences. The deferred tax consequences of those temporary differences are recognized and measured the same as for other temporary differences. As of the combination date, recognizable tax benefits attributable to the increase in tax basis are allocated to contributed capital. Tax benefits attributable to the increase in tax basis that become recognizable after the combination date (that is, by elimination of a valuation allowance) are reported as a reduction of income tax expense.

For more information about income tax issues related to common-control transactions, see Deloitte’s A Roadmap to Accounting for Income Taxes.

B.3.3.2 Reorganization of Reporting Structure and Goodwill Impairment Testing

A common-control transfer may result in a reorganization of the reporting structure in the receiving entity’s, the transferring entity’s, or the parent’s financial statements. Thus, if any of the entities involved (i.e., the receiving entity, the transferring entity, or the parent) in the common-control transfer is an SEC registrant, it must assess whether the common-control transfer causes a change in the composition of its reportable segments. Under ASC 280-10-50-34, “[i]f a public entity changes the structure of its internal organization in a manner that causes the composition of its reportable segments to change, the corresponding information for earlier periods, including interim periods, shall be restated unless it is impracticable to do so.”
Similarly, entities must also assess whether the common-control transfer results in a change in reporting units. ASC 350-20-35-45 states that “[w]hen an entity reorganizes its reporting structure in a manner that changes the composition of one or more of its reporting units, the guidance in paragraphs 350-20-35-39 through 35-40 shall be used to reassigned assets and liabilities to the reporting units affected [but] goodwill shall be reassigned to the reporting units affected using a relative fair value allocation approach similar to that used when a portion of a reporting unit is to be disposed of (see paragraphs 350-20-40-1 through 40-7).” ASC 350-20-40-1 through 40-7 provide guidance on allocating goodwill when a portion of a reporting unit is disposed of.

We do not believe that the receiving entity, the transferring entity, or the parent needs to retrospectively test goodwill for impairment in the historical periods before the date of the transfer. However, ASC 350-20-40-7 requires that when a portion of a reporting unit is disposed of, an entity must test for impairment any “goodwill remaining in the portion of the reporting unit to be retained.” Therefore, if the transferred net assets represent a business and only a portion of a reporting unit of the transferring entity, the transferring entity must test the remaining portion of the goodwill in the reporting unit for impairment as of the date of the transfer. Similarly, if the transferred net assets represent a business and only a portion of a reporting unit of the parent, the parent must test the remaining portion of the goodwill in the reporting unit for impairment as of the date of the transfer. In addition, we believe that the receiving entity should consider whether, as of the date of the transfer, it is more likely than not that the fair value of any of its reporting units is below its carrying amount as a result of the transfer. If so, the receiving entity should test the reporting unit for impairment on the date of the transfer in accordance with ASC 350-20.

**B.3.3.3 Noncontrolling Interests in a Common-Control Transaction**

The ASC master glossary defines a noncontrolling interest (which is sometimes called a “minority interest”) as “[t]he portion of equity (net assets) in a subsidiary not attributable, directly or indirectly, to a parent.”

If there is an outstanding noncontrolling interest in either the receiving entity or the transferring entity, the effect of the transfer on the noncontrolling interest should be accounted for in accordance with ASC 810-10. Any changes in the parent’s ownership interest in a subsidiary while it maintains control of the subsidiary are accounted for as an equity transaction. The carrying amount of the noncontrolling interest is adjusted to reflect its change in ownership in the subsidiary. See the implementation guidance in ASC 810-10-55 for examples illustrating how to account for a change in the parent’s ownership interest in a subsidiary. Also see Deloitte’s *A Roadmap to Accounting for Noncontrolling Interests*.

**B.4 Presentation**

**B.4.1 Change in the Reporting Entity**

<table>
<thead>
<tr>
<th>ASC 805-50</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>05-5</strong> Some transfers of net assets or exchanges of shares between entities under common control result in a change in the reporting entity. In practice, the method that many entities have used to account for those transactions is similar to the pooling-of-interests method. The Transactions Between Entities Under Common Control Subsections provide guidance on preparing financial statements and related disclosures for the entity that receives the net assets.</td>
</tr>
</tbody>
</table>
The presentation of a common-control transfer in the receiving entity’s separate financial statements differs depending on whether the transfer results in a change in the reporting entity. If the nature of the net assets transferred does not result in a change in the reporting entity, the receiving entity presents the net assets received in its separate financial statements prospectively from the date of the transfer. If the nature of the net assets transferred results in a change in the reporting entity, the receiving entity presents the net assets received in its separate financial statements retrospectively for all periods during which the entities or net assets were under common control, similarly to a pooling of interests under APB Opinion 16.

ASC 250-10-20 provides guidance on accounting for a change in the reporting entity. It defines a “change in the reporting entity” as:

A change that results in financial statements that, in effect, are those of a different reporting entity. A change in the reporting entity is limited mainly to the following:

a. Presenting consolidated or combined financial statements in place of financial statements of individual entities
b. Changing specific subsidiaries that make up the group of entities for which consolidated financial statements are presented
c. Changing the entities included in combined financial statements.

Neither a business combination accounted for by the acquisition method nor the consolidation of a variable interest entity (VIE) pursuant to Topic 810 is a change in reporting entity.

Because the guidance in ASC 250-10 is limited, entities must use judgment in determining whether the receiving entity has undergone a change in the reporting entity. The guidance focuses on combining entities or subsidiaries; however, we believe that entities should assess the substance of the transfer rather than its legal form. Typically, the transfer of an asset or a group of similar assets will not result in a change in the reporting entity. For example, the transfer of one or several parcels of land with no other assets or liabilities or any related operations would not be expected to result in a change in the reporting entity. Similarly, if an asset or a group of similar assets constitutes the only assets in a legal entity and the receiving entity receives the shares of that legal entity as a result of a common-control transfer, we believe that entities should assess the nature of the assets transferred rather than the fact that they were transferred as part of a legal entity. We do not believe that an entity should come to a different conclusion solely on the basis of how the transfer is structured (exchange of shares versus a transfer of net assets).

We understand that some believe that if the net assets transferred meet the definition of a business in either ASC 805-10 or SEC Regulation S-X, Article 11, the transfer represents a change in the reporting entity. If the net assets transferred constitute a business, the transfer may be more likely to result in a change in the reporting entity. However, we believe that, in such circumstances, entities should use judgment and should consider all relevant facts and circumstances, including the significance of the transfer to the receiving entity’s separate financial statements.

### B.4.2  Financial Statement Presentation by the Receiving Entity

<table>
<thead>
<tr>
<th>ASC 805-50</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>45-1</strong> Paragraph 805-50-25-2 establishes that the assets and liabilities transferred between entities under common control are to be initially recognized by the receiving entity at the transfer date. This Subsection provides guidance on the presentation of financial statements for the period of transfer and comparative financial statements for prior years.</td>
</tr>
</tbody>
</table>
**ASC 805-50 (continued)**

**Financial Statement Presentation in Period of Transfer**

45-2 The financial statements of the receiving entity shall 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 shall be eliminated to the extent possible.

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.

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.

**Comparative Financial Statement Presentation for Prior Years**

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.

If the common-control transaction does not result in a change in the reporting entity, the receiving entity begins reporting the net assets transferred in its separate financial statements prospectively from the date of the transfer. If the common-control transaction results in a change in the reporting entity, the receiving entity begins reporting the net assets transferred in its separate financial statements on the date of the transfer and retrospectively adjusts its historical financial statements to include the net assets received and related operations for all periods during which the entities were under common control. Regardless of whether the common-control transaction results in a change in the reporting entity, the receiving entity cannot begin reporting the net assets or operations of the transferring entity before the transfer date even if it is probable that the transfer will occur.

The requirement in ASC 805-50 to retrospectively adjust the receiving entity’s historical financial statements is consistent with the guidance in ASC 250-10 on reporting a change in the reporting entity. ASC 250-10-45-21 states:

> When an accounting change results in financial statements that are, in effect, the statements of a different reporting entity, the change shall be retrospectively applied to the financial statements of all prior periods presented to show financial information for the new reporting entity for those periods. Previously issued interim financial information shall be presented on a retrospective basis. However, the amount of interest cost previously capitalized through application of Subtopic 835-20 shall not be changed when retrospectively applying the accounting change to the financial statements of prior periods.
**B.4.2.1 Pooling-of-Interests Method**

The method used to present a common-control transaction that results in a change in the reporting entity is similar to a pooling of interests. A pooling of interests was a method of accounting for a merger of two businesses. The assets and liabilities and operations of the two businesses were combined at their historical carrying amounts, and all historical periods were adjusted as if the businesses had always been combined. Similarly, in a common-control transaction, the receiving entity retrospectively adjusts its financial statements to include the transferred net assets and any related operations for all periods for which the entities or net assets were under common control. If the entities were not under common control for the entire period being reported on, the receiving entity’s financial statements are adjusted only retrospectively to the date on which the entities became under common control.

The accounting and reporting guidance on a pooling of interests was established in APB Opinion 16. However, FASB Statement 141 eliminated the pooling-of-interests method of accounting for business combinations and nullified the related guidance. While the guidance in APB Opinion 16 was eliminated, we believe that it continues to provide relevant guidance on presenting common-control transactions that result in a change in the reporting entity. The following bullets summarize how the receiving entity should report the transferred net assets if a change in the reporting entity has occurred and are based on the former guidance in APB Opinion 16 on accounting for a pooling of interests:

- The receiving entity recognizes the transferred net assets at their historical carrying amounts in the parent's consolidated financial statements. No new goodwill is recognized. The carrying values of the transferred net assets are added to the carrying values of the receiving entity's net assets. If the receiving entity and transferring entity applied different accounting principles and the transferred assets or liabilities are adjusted to reflect the method of accounting applied by the receiving entity, the change in accounting principle should be applied retroactively for all periods presented (see Section B.3.1.2).

- The equity accounts of the separate entities are combined:
  - If the receiving entity issues shares to effect the combination, the par value of the shares issued by the receiving entity is credited to the receiving entity's common-stock account. The entity may need to make adjustments to properly reflect the par value of the receiving entity's common stock. Any adjustments should first be made to combined APIC and then to combined retained earnings.
  - The retained earnings (or deficit) of the transferring entity are added to the retained earnings of the receiving entity.
  - Any difference between consideration given by the receiving entity and the carrying amounts of the net assets received is recognized in equity (i.e., as a dividend paid or received).

- The receiving and transferring entities' results of operations are combined in the period in which the transfer occurs as though the entities had been combined as of the beginning of the period (or from the date the entities became under common control if they were not under common control for the entire period).

- Intercompany balances and transactions between the receiving and transferring entities are eliminated.

- Comparative financial statements are retrospectively adjusted as if the receiving and transferring entities had always been combined (or from the date the entities became under common control if they were not under common control for the entire period).
### Example B-5

**Pooling of Interests**

Subsidiary A and Subsidiary B are wholly owned and under the common control of Parent. On January 1, 20X6, A issues 100 of its common shares for all of the outstanding common shares of B. The par value of A’s common stock is $2 per share. The first two columns summarize the financial information of A and B before the common-control transfer, and the last three columns illustrate combining the assets, liabilities, and shareholders’ equity of A and B and the adjustments necessary to state the common stock of the combined entity at its par value.

<table>
<thead>
<tr>
<th></th>
<th>Subsidiary A</th>
<th>Subsidiary B</th>
<th>Combined Before Adjustments</th>
<th>Adjustments</th>
<th>Combined After Adjustments</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td>$600</td>
<td>$300</td>
<td>$900</td>
<td>—</td>
<td>$900</td>
</tr>
<tr>
<td><strong>Liabilities</strong></td>
<td>$(100)</td>
<td>$(50)</td>
<td>$(150)</td>
<td>—</td>
<td>$(150)</td>
</tr>
<tr>
<td><strong>Shareholders’ equity</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Common stock</td>
<td>(200)</td>
<td>(50)</td>
<td>(250)</td>
<td>(150)*</td>
<td>(400)</td>
</tr>
<tr>
<td>APIC</td>
<td>(50)</td>
<td>(50)</td>
<td>(100)</td>
<td>100 *</td>
<td>—</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>(250)</td>
<td>(150)</td>
<td>(400)</td>
<td>50 *</td>
<td>(350)</td>
</tr>
<tr>
<td>Total shareholders’ equity</td>
<td>(500)</td>
<td>(250)</td>
<td>(750)</td>
<td>—</td>
<td>(750)</td>
</tr>
<tr>
<td><strong>Total liabilities and shareholders’ equity</strong></td>
<td>$(600)</td>
<td>$(300)</td>
<td>$(900)</td>
<td>—</td>
<td>$(900)</td>
</tr>
</tbody>
</table>

* Subsidiary A issued 100 shares of its $2 par value common stock to effect the combination. After the transaction, A has 200 shares of its common stock outstanding. Because the common-stock account cannot exceed the par value of the common stock outstanding, or $400, adjustments must be made within shareholders’ equity of the combined entity. The adjustment to reflect the par value of A’s common stock outstanding is made first to reduce APIC to zero, then to retained earnings.

#### B.4.2.2 Identifying the Predecessor in Certain Common-Control Transactions

For common-control transactions that result in a change in the reporting entity and for which both the receiving entity and the transferring entity were not under common control during the entire reporting period, it is necessary to determine which entity is the predecessor. The predecessor is the reporting entity deemed to be the receiving entity for accounting purposes in a common-control transaction. The predecessor is not always the entity that legally receives the net assets or equity interests transferred. If the entities were under common control during the entire reporting period, it is not necessary to determine which entity is the predecessor because the entities are combined from the beginning of the earliest period presented.
In prepared remarks at the 2006 AICPA Conference on Current SEC and PCAOB Developments, Leslie Overton, then associate chief accountant in the SEC’s Division of Corporation Finance, stated that the predecessor is “normally going to be the entity first controlled by the parent of the entities that are going to be combined.” However, at the 2015 AICPA Conference on Current SEC and PCAOB Developments, while not specifically talking about common-control transactions, the SEC staff further highlighted a number of factors for registrants to consider in determining the predecessor, including, but not limited to, (1) the order in which the entities are acquired, (2) the size of the entities, (3) the fair value of the entities, and (4) the ongoing management structure. The staff indicated that no one item is determinative on its own and that there could also be more than one predecessor. Thus, entities should use judgment when identifying the predecessor.

B.4.3 Financial Statement Presentation by the Transferring Entity

ASC 805-50 only addresses the receiving entity’s presentation. It contains no specific guidance on how the transferring entity should present a common-control transfer in its separate financial statements.

Although the transferring entity’s measurement generally matches the receiving entity’s, its presentation typically does not. Entities have analogized to SAB Topic 5.Z.7 for guidance on whether the transferring entity may present its separate financial statements as if a change in the reporting entity has occurred by derecognizing the transferred net assets and operations in the historical periods (sometimes referred to as a “depooling”). SAB Topic 5.Z.7, which addresses whether an entity may present a spin-off as a change in the reporting entity and restate its historical financial statements to exclude the subsidiary, states:

**Facts:** A Company disposes of a business through the distribution of a subsidiary's stock to the Company's shareholders on a pro rata basis in a transaction that is referred to as a spin-off.

**Question:** May the Company elect to characterize the spin-off transaction as resulting in a change in the reporting entity and restate its historical financial statements as if the Company never had an investment in the subsidiary, in the manner specified by FASB ASC Topic 250, Accounting Changes and Error Corrections?

**Interpretive Response:** Not ordinarily. If the Company was required to file periodic reports under the Exchange Act within one year prior to the spin-off, the staff believes the Company should reflect the disposition in conformity with FASB ASC Topic 360. This presentation most fairly and completely depicts for investors the effects of the previous and current organization of the Company. However, in limited circumstances involving the initial registration of a company under the Exchange Act or Securities Act, the staff has not objected to financial statements that retroactively reflect the reorganization of the business as a change in the reporting entity if the spin-off transaction occurs prior to effectiveness of the registration statement. This presentation may be acceptable in an initial registration if the Company and the subsidiary are in dissimilar businesses, have been managed and financed historically as if they were autonomous, have no more than incidental common facilities and costs, will be operated and financed autonomously after the spin-off, and will not have material financial commitments, guarantees, or contingent liabilities to each other after the spin-off. This exception to the prohibition against retroactive omission of the subsidiary is intended for companies that have not distributed widely financial statements that include the spun-off subsidiary. Also, dissimilarity contemplates substantially greater differences in the nature of the businesses than those that would ordinarily distinguish reportable segments as defined by FASB ASC paragraph 280-10-50-10 (Segment Reporting Topic).

While this guidance does not specifically address common-control transactions, entities have analogized to it in practice. Although this guidance specifically applies to SEC registrants, we believe the underlying concepts are relevant for private companies as well. All requirements in SAB Topic 5.Z.7 must be met for the transferring entity to depool the transferred net assets. Because the SEC staff will often challenge entities that assert that all of the requirements have been met, the transferring entity typically concludes that the requirements are not met and accounts for the transfer as a disposal in accordance with ASC 360. In that case, the transferring entity must also assess, from its perspective rather than from the perspective of the parent, whether the disposal qualifies for presentation as a discontinued operation in accordance with ASC 205-20. See Deloitte’s *A Roadmap to Impairments and Disposals of Long-Lived Assets and Discontinued Operations* for more information.
B.5 Disclosures

B.5.1 Disclosures by the Receiving Entity

<table>
<thead>
<tr>
<th>ASC 805-50</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>50-3</strong> The notes to 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:</td>
</tr>
<tr>
<td>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</td>
</tr>
<tr>
<td>b. The method of accounting for the transfer of net assets or exchange of equity interests.</td>
</tr>
<tr>
<td><strong>50-4</strong> 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.</td>
</tr>
</tbody>
</table>

In addition to the disclosures required by ASC 805-50-50-3 and ASC 850-10-50, if the net assets transferred result in a change in the reporting entity (see Section B.4.1), the receiving entity must provide the disclosures required by ASC 250-10-50-6, which states, in part:

When there has been a change in the reporting entity, the financial statements of the period of the change shall describe the nature of the change and the reason for it. In addition, the effect of the change on income from continuing operations, net income (or other appropriate captions of changes in the applicable net assets or performance indicator), other comprehensive income, and any related per-share amounts shall be disclosed for all periods presented. Financial statements of subsequent periods need not repeat the disclosures required by this paragraph. If a change in reporting entity does not have a material effect in the period of change but is reasonably certain to have a material effect in later periods, the nature of and reason for the change shall be disclosed whenever the financial statements of the period of change are presented.

B.5.1.1 Earnings per Share

<table>
<thead>
<tr>
<th>ASC 805-50</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>50-2</strong> The nature of and effects on earnings per share (EPS) of nonrecurring intra-entity transactions involving long-term assets and liabilities is not required to be eliminated under the guidance in paragraph 805-50-45-3 but shall be disclosed.</td>
</tr>
</tbody>
</table>

If the receiving entity is required to disclose EPS in its separate financial statements and presents the common-control transfer as a change in the reporting entity (see Section B.4.1), earnings-per-share amounts must be recast to include the earnings (or losses) of the transferred net assets.

B.5.2 Disclosures by the Transferring Entity

ASC 805-50-50 does not include any specific disclosure requirements for the transferring entity. If the transferring entity accounts for the transferred net assets as a disposal, it should provide the disclosures required by ASC 360-10-50 for long-lived assets that are disposed of. If the disposal qualifies for presentation as a discontinued operation from the perspective of the transferring entity, it should provide the disclosures required by ASC 205-20-50 in its separate financial statements. In addition, we believe that the transferring entity should provide disclosures sufficient for users of its separate financial statements to understand the nature of and accounting for the transfer (to the extent that such disclosures are not required by other GAAP). We believe that the transferring entity should analogize to the disclosure requirements for the receiving entity in ASC 805-50-50-3, ASC 850-10-50, and ASC 250-10-50-6.
B.6 Transactions Involving Master Limited Partnerships

ASC 805-50

Master Limited Partnership Transactions

05-7 Master limited partnerships are partnerships in which interests are publicly traded. Most master limited partnerships are formed from assets in existing businesses. Typically, the general partner of the master limited partnership is affiliated with the existing business (that is, the master limited partnership is usually operated as an extension of or complementary to the business of the general partner). The purposes for forming a master limited partnership vary. They can be formed to realize the value of undervalued assets, to pass income and tax-deductible losses directly through to owners, to raise capital, to combine several existing partnerships, or as a vehicle to enable entities to sell, spin off, or liquidate existing operations. A master limited partnership may be created in a variety of ways. Whether a particular transaction is a business combination that should be accounted for using the acquisition method or a transaction between entities under common control can be determined only after a careful analysis of all facts and circumstances. The Formation of a Master Limited Partnership Subsections identify specific transactions involving master limited partnerships and provide guidance on whether a new basis of accounting is appropriate.

Formation of a Master Limited Partnership

30-7 Because of such factors as the consideration of common ownership and changes in control, a new basis of accounting is not appropriate for any of the following transactions that create a master limited partnership:

a. A rollup in which the general partner of the new master limited partnership was also the general partner in some or all of the predecessor limited partnerships and no cash is involved in the transaction. Transaction costs in a rollup shall be charged to expense.

b. A dropdown in which the sponsor receives 1 percent of the units in the master limited partnership as the general partner and 24 percent of the units as a limited partner, the remaining 75 percent of the units are sold to the public, and a two-thirds vote of the limited partners is required to replace the general partner.

c. A rollout.

d. A reorganization.

30-8 In other situations, it is possible that a new basis of accounting would be appropriate.

30-9 The issuance of master limited partnership units to a general partner of a predecessor limited partnership who will not be the general partner of the new master limited partnership in settlement of management contracts or for other services that will not carry over to the new master limited partnership has characteristics of compensation rather than of equity and shall be accounted for accordingly by the new master limited partnership.

A master limited partnership (MLP) is a publicly traded partnership that combines the tax benefits of a limited partnership with the liquidity of publicly traded securities. For the MLP to qualify for the tax benefits, 90 percent of its income must come from activities related to natural resources, real estate, or commodities. MLPs commonly engage in petroleum and natural gas extraction and transportation. There are two classes of MLP owners: (1) the “sponsor” or the general partner and (2) the limited partners. The general partner manages the MLP’s day-to-day operations. The MLP technically has no employees, so all services are provided or managed by the general partner. All other investors are limited partners and have no involvement in the MLP’s operations. The limited partner units are publicly traded much like shares in a corporation, while the general partner units usually are not. The general partner stake is often 2 percent of the partnership, though the general partner can also own limited partner units to increase its overall ownership percentage.
An MLP may be formed in various ways. ASC 805-50-30-7 contains terms describing some of the ways in which MLPs may be formed. The ASC master glossary defines these terms as follows:

- **Dropdown** — “A transfer of certain net assets from a sponsor or general partner to [an MLP] in exchange for consideration.”
- **Reorganization** — “A way to create [an MLP] in which all of the assets of an entity are placed into [an MLP] and that entity ceases to exist.”
- **Rollout** — “A way to create [an MLP] in which certain assets of a sponsor are placed into a limited partnership and units are distributed to the shareholders.”
- **Rollup** — “A way to create [an MLP] in which two or more legally separate limited partnerships are combined into one [MLP].”

Before the adoption of ASU 2015-02, the transfer of assets or net assets to form an MLP and any subsequent transfers of assets or net assets to the MLP were often accounted for as common-control transactions because the general partner typically controlled the net assets before and after the transfer. After the adoption of ASU 2015-02, a general partner with a 2 percent interest in an MLP may not control the MLP. Entities should consider all facts and circumstances in determining whether the formation of an MLP and any subsequent transfers to the MLP should be accounted for as a common-control transaction in accordance with ASC 805-50 or as a business combination in accordance with ASC 805-10, ASC 805-20, and ASC 805-30. See Deloitte’s *A Roadmap to Consolidation — Identifying a Controlling Financial Interest* for more information. In addition, an entity should consider all facts and circumstances in determining whether the receiving entity should present the transfer as a change in the reporting entity (see Section B.4.1).
Appendix C — Accounting for Asset Acquisitions

C.1 Overview and Scope

The term “asset acquisition” is used to describe an acquisition of an asset, or a group of assets, that does not meet the U.S. GAAP definition of a business. An asset acquisition may also involve the assumption of liabilities. Entities should use the guidance in ASC 805-10 to determine whether the acquired assets meet the definition of a business. See Section 2.4 for more information.

An asset acquisition is accounted for in accordance with the “Acquisition of Assets Rather Than a Business” subsections of ASC 805-50 by using a cost accumulation model. In a cost accumulation model, the cost of the acquisition, including certain transaction costs, is allocated to the assets acquired on the basis of relative fair values. By contrast, a business combination is accounted for by using a fair value model under which the assets and liabilities are generally recognized at their fair values, and the difference between the consideration transferred, excluding acquisition-related costs, and the fair values of the assets and liabilities is recognized as goodwill. As a result, there are significant differences between the accounting for an asset acquisition and the accounting for a business combination.

Changing Lanes

The FASB has an active project on its agenda to improve the accounting for asset acquisitions and business combinations by narrowing the differences between the two acquisition models. At its September 2, 2020, meeting, the FASB affirmed that the project should address the accounting for contingent consideration, transaction costs, and certain other recognition and measurement exceptions. However, the Board that the scope of the project would no longer include (1) narrowing the differences between the accounting for IPR&D in an asset acquisition and a business combination and (2) the accounting for reassessments of lease contracts in an asset acquisition and the lease recognition and measurement exception. Practitioners should monitor the project for any developments that might change the current accounting for asset acquisitions.
### C.1.1 Summary of Significant Differences Between the Accounting for a Business Combination and the Accounting for an Asset Acquisition

The table below summarizes the significant differences between the accounting for a business combination and that for an asset acquisition. Each of these differences is described in further detail in later sections.

<table>
<thead>
<tr>
<th>Issue</th>
<th>Accounting in a Business Combination</th>
<th>Accounting in an Asset Acquisition</th>
</tr>
</thead>
<tbody>
<tr>
<td>General principle</td>
<td>Fair value model: assets and liabilities are recognized at fair value, with certain exceptions.</td>
<td>Cost accumulation model: the cost of the acquisition, including certain transaction costs, is allocated to the assets acquired on the basis of relative fair values, with some exceptions. This allocation results in the recognition of those assets at other than their fair values (see Sections C.1 and C.3).</td>
</tr>
<tr>
<td>Scope</td>
<td>Acquisition of a business as defined in ASC 805-10.</td>
<td>Acquisition of an asset or a group of assets (and liabilities) that does not meet the definition of a business in ASC 805-10 (see Section C.1.2).</td>
</tr>
<tr>
<td>Acquisition-related costs or transaction costs</td>
<td>Acquisition-related costs are expensed as incurred, except for costs of issuing debt and equity securities, which are accounted for under other GAAP.</td>
<td>Direct and incremental costs are included in the cost of the acquisition, except for costs of issuing debt and equity securities, which are accounted for under other GAAP. Indirect costs are expensed as incurred (see Section C.2.3).</td>
</tr>
<tr>
<td>Contingent consideration</td>
<td>Recognized at fair value and classified as a liability, equity, or an asset on the acquisition date on the basis of the terms of the arrangement. Subsequently, any changes in the fair value of contingent consideration classified as a liability or as an asset are recognized in earnings until settled.</td>
<td>Contingent consideration that is accounted for as a derivative is recognized at fair value under ASC 815. Otherwise, such consideration generally is recognized under ASC 450 when it becomes probable and reasonably estimable (see Section C.2.2).</td>
</tr>
<tr>
<td>Goodwill</td>
<td>If the sum of the consideration transferred, the fair value of any noncontrolling interests, and the fair value of any previously held interests exceeds the sum of the identifiable assets acquired and liabilities assumed, goodwill is recognized as the amount of the excess.</td>
<td>Goodwill is not recognized. Instead, any excess of the cost of the acquisition over the fair value of the net assets acquired is allocated to certain assets on the basis of relative fair values (see Section C.3).</td>
</tr>
<tr>
<td>Gain from bargain purchase</td>
<td>Recognized in earnings on the acquisition date.</td>
<td>Generally not recognized in earnings. Instead, any excess of the fair value of the net assets acquired over the cost of the acquisition is typically allocated to certain assets on the basis of relative fair values (see Section C.3).</td>
</tr>
</tbody>
</table>
(Table continued)

<table>
<thead>
<tr>
<th>Issue</th>
<th>Accounting in a Business Combination</th>
<th>Accounting in an Asset Acquisition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contingencies</td>
<td>Measured at fair value, if determinable; otherwise, measured at their estimated amounts if probable and reasonably estimable. If such assets or liabilities cannot be measured during the measurement period, they are accounted for separately from the business combination in accordance with ASC 450.</td>
<td>Accounted for in accordance with ASC 450 on the acquisition date and subsequently. Loss contingencies are recognized when they are probable and reasonably estimable. Gain contingencies are recognized on the earlier of when they are realized or are realizable and are thus not recognizable in an asset acquisition (see Section C.3.2).</td>
</tr>
<tr>
<td>Intangible assets</td>
<td>Recognized at fair value if they are identifiable (i.e., if they are separable or arise from contractual rights).</td>
<td>Generally, recognized on the basis of relative fair value under ASC 350-10 if they meet the asset recognition criteria in FASB Concepts Statement 5 (see Section C.3.4).</td>
</tr>
<tr>
<td>Assembled workforce</td>
<td>Not recognized because it is presumed not to be identifiable.</td>
<td>Recognized because it is presumed to meet the asset recognition criteria in FASB Concepts Statement 5 (see Section C.3.4.1).</td>
</tr>
<tr>
<td>IPR&amp;D</td>
<td>Measured at fair value and recognized as an indefinite-lived intangible asset until completion or abandonment of the related project, then reclassified as a finite-lived intangible asset and amortized.</td>
<td>Expensed under ASC 730 unless the IPR&amp;D has an alternative future use (see Section C.3.4.2).</td>
</tr>
<tr>
<td>Deferred taxes</td>
<td>Generally recognized for most temporary book/tax differences related to assets acquired and liabilities assumed under ASC 740.</td>
<td>Generally recognized for temporary book/tax differences in an asset acquisition by using the simultaneous equations method in accordance with ASC 740 (see Section C.3.5).</td>
</tr>
<tr>
<td>Lease classification</td>
<td>Under ASC 840-10-25-27, the acquirer retains the acquiree’s previous lease classification “unless the provisions of the lease are modified as indicated in paragraph 840-10-35-5.” Under ASC 842-10-55-11, the acquirer retains the acquiree’s previous lease classification “unless there is a lease modification and that modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8.”</td>
<td>ASC 805-50 does not provide guidance on an entity’s classification of a lease acquired in an asset acquisition (see Section C.3.6).</td>
</tr>
<tr>
<td>Measurement period</td>
<td>In accordance with ASC 805-10-25-13, the acquirer reports provisional amounts for the items for which the accounting “is incomplete by the end of the reporting period in which the combination occurs” and is allowed up to one year to adjust those provisional amounts. This time frame is referred to as the measurement period.</td>
<td>ASC 805-50 does not address a measurement period in the context of an asset acquisition (see Section C.3.8).</td>
</tr>
</tbody>
</table>
SEC Considerations

A registrant must also consider certain SEC reporting requirements when it acquires an asset or a group of assets. For instance, the registrant must separately evaluate whether the asset or group of assets meets the definition of a business for SEC reporting purposes under SEC Regulation S-X, Rule 11-01(d), since this definition differs from the U.S. GAAP definition of a business under ASC 805-10. The SEC reporting requirements for an asset acquisition are addressed in Section C.5.

C.1.2 Scope

<table>
<thead>
<tr>
<th>ASC 805-50</th>
</tr>
</thead>
<tbody>
<tr>
<td>Entities</td>
</tr>
<tr>
<td>15-2 The guidance in the Acquisition of Assets Rather than a Business Subsections applies to all entities.</td>
</tr>
<tr>
<td>Transactions</td>
</tr>
<tr>
<td>15-3 The guidance in the Acquisition of Assets Rather than a Business Subsections applies to a transaction or event in which assets acquired and liabilities assumed do not constitute a business.</td>
</tr>
<tr>
<td>15-4 The guidance in the Acquisition of Assets Rather than a Business Subsections does not apply to the initial measurement and recognition by a primary beneficiary of the assets and liabilities of a variable interest entity (VIE) when the VIE does not constitute a business. Guidance for such a VIE is provided in Section 810-10-30.</td>
</tr>
</tbody>
</table>

The guidance in the “Acquisition of Assets Rather Than A Business” subsections of ASC 805-50 applies to the acquisition of an asset or group of assets (and possibly the assumption of any liabilities) that do not meet the definition of a business in ASC 805-10. As a result, entities first need to assess whether the assets acquired and any liabilities assumed meet the definition of a business by applying the guidance in ASC 805-10. See Section 2.4 for more information about the U.S. GAAP definition of a business in ASC 805-10.

As discussed in Section 6.8, a reverse acquisition occurs when the entity that issues its shares or gives other consideration to effect the transaction is determined for accounting purposes to be the acquiree (also called the accounting acquiree or legal acquirer), while the entity whose shares are acquired is for accounting purposes the acquirer (also called the accounting acquirer or legal acquiree). If the accounting acquiree/legal acquirer does not meet the definition of a business in ASC 805-10 and the nature of the transaction is an acquisition of assets (rather than a recapitalization), the transaction is accounted for as a reverse asset acquisition. In that case, the accounting acquiree’s assets and liabilities are measured in accordance with the subsections in ASC 805-50 on the acquisition of assets rather than a business.

In addition, the SEC staff considers the acquisition of a private operating company by a nonoperating public shell company to be, in substance, a capital transaction rather than a business combination or an asset acquisition. Such a transaction is equivalent to the issuance of shares by the private company for the net monetary assets of the shell company, accompanied by a recapitalization, and is typically referred to as a reverse recapitalization (see Section 6.8.8 for more information).
SEC Considerations

SEC registrants are required to use the definition of a business in SEC Regulation S-X, Rule 11-01(d), when evaluating the requirements of SEC Regulation S-X, Rule 3-05, and SEC Regulation S-X, Article 11. The definition of a business in Rule 11-01(d) is different from the definition for U.S. GAAP accounting purposes. The SEC has not changed this definition as a result of the FASB's clarification of the definition of a business in ASU 2017-01. See Section C.5.2 for more information.

C.1.2.1 Scope Exception for Variable Interest Entities

ASC 805-50-15-4 states that “[t]he guidance in the Acquisition of Assets Rather than a Business Subsections does not apply to the initial measurement and recognition by a primary beneficiary of the assets and liabilities of a variable interest entity (VIE) when the VIE does not constitute a business. Guidance for such a VIE is provided in Section 810-10-30.” ASC 810-10-30-3 and 30-4 provide guidance on such acquisitions.

ASC 810-10

30-3 When a reporting entity becomes the primary beneficiary of a VIE that is not a business, no goodwill shall be recognized. The primary beneficiary initially shall measure and recognize the assets (except for goodwill) and liabilities of the VIE in accordance with Sections 805-20-25 and 805-20-30. However, the primary beneficiary initially shall measure assets and liabilities that it has transferred to that VIE at, after, or shortly before the date that the reporting entity became the primary beneficiary at the same amounts at which the assets and liabilities would have been measured if they had not been transferred. No gain or loss shall be recognized because of such transfers.

30-4 The primary beneficiary of a VIE that is not a business shall recognize a gain or loss for the difference between (a) and (b):

a. The sum of:
   1. The fair value of any consideration paid
   2. The fair value of any noncontrolling interests
   3. The reported amount of any previously held interests

b. The net amount of the VIE’s identifiable assets and liabilities recognized and measured in accordance with Topic 805.

The primary beneficiary of a VIE that does not meet the definition of a business should initially measure and recognize the assets and liabilities of the VIE in accordance with ASC 805-20-25 and ASC 805-20-30 but should not recognize goodwill. Because goodwill is not recognized, the primary beneficiary recognizes a gain or loss calculated on the basis of the requirements in ASC 810-10-30-4. The primary beneficiary recognizes the identifiable assets acquired (excluding goodwill), the liabilities assumed, and any noncontrolling interests as though the VIE was a business and subject to the guidance on recognition and measurement in a business combination. As a result, the assets acquired (excluding goodwill), liabilities assumed, and any noncontrolling interests are measured and recognized the same way as they would be in a business combination. IPR&D and contingent consideration therefore would be recognized at fair value upon acquisition, and the applicable recognition and fair value measurement exceptions would be the same as those for a business combination.
However, to prevent the improper recognition of gains or losses resulting from transfers of assets and liabilities to VIEs, the FASB developed the guidance in ASC 810-10-30-3. Under this guidance, assets and liabilities that a legal entity transfers to a VIE that is not a business “at, after, or shortly before the date that the . . . entity became the [VIE’s] primary beneficiary [should be measured] at the same amounts at which the assets and liabilities would have been measured if they had not been transferred.” In addition, under ASC 810-10-30-4, if the VIE is acquired in stages (i.e., step acquisition), the reported amount of the previously held interest must be used to calculate the gain or loss.

A legal entity’s failure to meet the business scope exception in ASC 810-10-15-17(d) does not mean that the legal entity does not qualify as a business under ASC 805-10. The determination of whether a legal entity is a business under ASC 810-10-30-2 is strictly related to whether the legal entity qualifies as a business under ASC 805-10. That is, even if the business scope exception is not applicable because one or more of the four additional conditions in that paragraph are met, as long as the definition of a business in ASC 805-10 is met, goodwill, if any, should be recorded. See Deloitte’s *A Roadmap to Consolidation — Identifying a Controlling Financial Interest* for more information about the business scope exception.

**Changing Lanes**

The FASB is reconsidering the accounting for contingent consideration and IPR&D by a primary beneficiary of a VIE that is not a business as part of its *project* to improve the accounting for asset acquisitions and business combinations. Practitioners should monitor the project for any developments that might change current accounting.

### C.2 Measuring the Cost of an Asset Acquisition

**ASC 805-50**

**Acquisition Date Recognition of Consideration Exchanged**

**25-1** Assets commonly are acquired in exchange transactions that trigger the initial recognition of the assets acquired and any liabilities assumed. If the consideration given in exchange for the assets (or net assets) acquired is in the form of assets surrendered (such as cash), the assets surrendered shall be derecognized at the date of acquisition. If the consideration given is in the form of liabilities incurred or equity interests issued, the liabilities incurred and equity interests issued shall be initially recognized at the date of acquisition.

**Pending Content (Transition Guidance: ASC 606-10-65-1)**

**25-1** Assets commonly are acquired in exchange transactions that trigger the initial recognition of the assets acquired and any liabilities assumed. If the consideration given in exchange for the assets (or net assets) acquired is in the form of assets surrendered (such as cash), the assets surrendered shall be derecognized at the date of acquisition. If the consideration given is in the form of liabilities incurred or equity interests issued, the liabilities incurred and equity interests issued shall be initially recognized at the date of acquisition. However, if the assets surrendered are nonfinancial assets or in substance nonfinancial assets within the scope of Subtopic 610-20 on gains and losses from the derecognition of nonfinancial assets, the assets surrendered shall be derecognized in accordance with the guidance in Subtopic 610-20 and the assets acquired shall be treated as noncash consideration in accordance with Subtopic 610-20.
Determining Cost

30-1 Paragraph 805-50-25-1 discusses exchange transactions that trigger the initial recognition of assets acquired and liabilities assumed. Assets are recognized based on their cost to the acquiring entity, which generally includes the transaction costs of the asset acquisition, and no gain or loss is recognized unless the fair value of noncash assets given as consideration differs from the assets’ carrying amounts on the acquiring entity’s books. For transactions involving nonmonetary consideration within the scope of Topic 845, an acquirer must first determine if any of the conditions in paragraph 845-10-30-3 apply.

Pending Content (Transition Guidance: ASC 606-10-65-1)

30-1 Paragraph 805-50-25-1 discusses exchange transactions that trigger the initial recognition of assets acquired and liabilities assumed. Assets are recognized based on their cost to the acquiring entity, which generally includes the transaction costs of the asset acquisition, and no gain or loss is recognized unless the fair value of noncash assets given as consideration differs from the assets’ carrying amounts on the acquiring entity’s books. For transactions involving nonmonetary consideration within the scope of Topic 845, an acquirer must first determine if any of the conditions in paragraph 845-10-30-3 apply. If the consideration given is nonfinancial assets or in substance nonfinancial assets within the scope of Subtopic 610-20 on gains and losses from the derecognition of nonfinancial assets, the assets acquired shall be treated as noncash consideration and any gain or loss shall be recognized in accordance with Subtopic 610-20.

30-2 Asset acquisitions in which the consideration given is cash are measured by the amount of cash paid, which generally includes the transaction costs of the asset acquisition. However, if the consideration given is not in the form of cash (that is, in the form of noncash assets, liabilities incurred, or equity interests issued), measurement is based on either the cost which shall be measured based on the fair value of the consideration given or the fair value of the assets (or net assets) acquired, whichever is more clearly evident and, thus, more reliably measurable. For transactions involving nonmonetary consideration within the scope of Topic 845, an acquirer must first determine if any of the conditions in paragraph 845-10-30-3 apply. If the consideration given is nonfinancial assets or in substance nonfinancial assets within the scope of Subtopic 610-20, the assets acquired shall be treated as noncash consideration and any gain or loss shall be recognized in accordance with Subtopic 610-20.

Pending Content (Transition Guidance: ASC 606-10-65-1)

30-2 Asset acquisitions in which the consideration given is cash are measured by the amount of cash paid, which generally includes the transaction costs of the asset acquisition. However, if the consideration given is not in the form of cash (that is, in the form of noncash assets, liabilities incurred, or equity interests issued) and no other generally accepted accounting principles (GAAP) apply (for example, Topic 845 on nonmonetary transactions or Subtopic 610-20), measurement is based on either the cost which shall be measured based on the fair value of the consideration given or the fair value of the assets (or net assets) acquired, whichever is more clearly evident and, thus, more reliably measurable. For transactions involving nonmonetary consideration within the scope of Topic 845, an acquirer must first determine if any of the conditions in paragraph 845-10-30-3 apply. If the consideration given is nonfinancial assets or in substance nonfinancial assets within the scope of Subtopic 610-20, the assets acquired shall be treated as noncash consideration and any gain or loss shall be recognized in accordance with Subtopic 610-20.

An asset acquisition is an exchange transaction that triggers the acquiring entity’s initial recognition of the assets acquired or liabilities assumed and the derecognition of any consideration given on the date of the acquisition. ASC 805-50-30-2 provides the general principle for measuring the cost of an asset acquisition and specifies, in part, that an asset acquisition should be recognized at cost, which is measured on the basis of either (1) “the fair value of the consideration given,” or (2) “the fair value of the assets (or net assets) acquired, whichever is more clearly evident and, thus, more reliably measurable.”
In many asset acquisitions, the consideration is cash and, therefore, determining the cost of the acquisition is relatively straightforward. If the consideration given is wholly in the form of cash, the cost of the asset acquisition is measured on the basis of the cash paid plus the direct transaction costs incurred to effect the acquisition (see Section C.2.3).

In some asset acquisitions, part or all of the consideration given may consist of noncash assets, equity interests, or liabilities incurred by the seller (e.g., contingent consideration). When consideration other than cash is used, entities should first determine whether the exchange is within the scope of other GAAP and, if so, apply the applicable standard’s guidance. If no other GAAP applies, an entity would refer to the general principle in ASC 805-50 (i.e., measure cost on the basis of the fair value of the consideration given or the assets acquired, whichever is more clearly evident, plus transaction costs).

The following table provides guidance on determining the GAAP to apply when the consideration given is not in the form of cash:

<table>
<thead>
<tr>
<th>Form of the Consideration Given</th>
<th>Measurement of the Cost of the Assets Acquired</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nonfinancial assets (or in-substance nonfinancial assets) given to a noncustomer, or goods or services given to a customer that do not meet the definition of a business in ASC 805-10 (after adoption of ASC 606-10 and ASC 610-20)</td>
<td>Fair value of the assets acquired in accordance with ASC 606-10-32-21 if their fair value can be reasonably estimated. Otherwise, based on the assets transferred or stand-alone selling price of the goods or services in accordance with ASC 606-10-32-22. See also ASC 610-20-32-3. See Section C.2.1.</td>
</tr>
</tbody>
</table>
| Nonmonetary assets (not within the scope of ASC 606-10 or 610-20) | Fair value of the assets given (i.e., after recognizing a gain or loss) in accordance with ASC 845-10-30-4 unless the exchange meets any of the following conditions in ASC 845-10-30-3:  
  1. “The fair value of neither the asset(s) received nor the asset(s) relinquished is determinable within reasonable limits.”  
  2. “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.”  
If any of those conditions are met, then the carrying amount of the assets given (i.e., no gain or loss recognized). See Section C.2.1. |
| Contingent consideration | See Section C.2.2. |
Appendix C — Accounting for Asset Acquisitions

(Table continued)

<table>
<thead>
<tr>
<th>Form of the Consideration Given</th>
<th>Measurement of the Cost of the Assets Acquired</th>
</tr>
</thead>
<tbody>
<tr>
<td>Acquiring entity's equity instruments</td>
<td>Based on the fair value of the equity interests issued. ASC 805-50-30-2 states, in part, that “if the consideration given is not in the form of cash . . . and no other generally accepted accounting principles (GAAP) apply . . . , measurement is based on either the cost which shall be measured based on the fair value of the consideration given or the fair value of the assets (or net assets) acquired, whichever is more clearly evident and, thus, more reliably measurable.” Thus, some believe that the issuance of shares as consideration in an asset acquisition represents a share-based payment to nonemployees in exchange for goods. If so, the acquiring entity would apply ASC 718 (after adoption of ASU 2018-07) or ASC 505-50-30-2 (before adoption of ASU 2018-07). Others believe that this was not the FASB's intent when it issued ASU 2018-07 and that the guidance in ASC 805-50 should apply. Application of ASC 718 may result in the measurement of the shares issued earlier (i.e., on the grant date) rather than on the closing date of the acquisition. Until the FASB provides further clarification, we believe that either view is acceptable.</td>
</tr>
<tr>
<td>Assets (or net assets) that meet the definition of a business in ASC 805-10</td>
<td>Fair value of the assets acquired in accordance with ASC 810-10-40-5.</td>
</tr>
<tr>
<td>Noncash assets (or liabilities) given as consideration that remain within the combined entity after the acquisition</td>
<td>Carrying amount of the assets (or liabilities) in the acquiring entity's financial statements immediately before the acquisition by analogy to ASC 805-30-30-8. See Section C.2.7 for more information.</td>
</tr>
</tbody>
</table>

The acquiring entity applies the guidance in ASC 820 to measure fair value; if such value differs from the carrying amount of the noncash assets given, the acquiring entity remeasures those noncash assets to fair value and recognizes a gain or loss on the date of acquisition for the difference (unless any of the conditions in ASC 845-10-30-3 are met).

A significant difference between the cost of an asset acquisition and the fair value of the net assets acquired may indicate that not all of the assets acquired or liabilities assumed have been recognized or that the cost of the asset acquisition includes a payment for something other than the acquired net assets that should be accounted for separately from the acquisition (see Section C.2.4).

### C.2.1 Consideration in the Form of Nonmonetary Assets or Nonfinancial Assets (After Adoption of ASC 606-10 and ASC 610-20)

While ASC 805-50 provides a general principle for measuring the cost of an asset acquisition, it refers to other GAAP if the noncash consideration is in the form of nonmonetary assets or nonfinancial assets (or in-substance nonfinancial assets). ASC 805-50-30-1 states, in part:

For transactions involving nonmonetary consideration within the scope of Topic 845, an acquirer must first determine if any of the conditions in paragraph 845-10-30-3 apply. If the consideration given is nonfinancial assets or in-substance nonfinancial assets within the scope of Subtopic 610-20 on gains and losses from the derecognition of nonfinancial assets, the assets acquired shall be treated as noncash consideration and any gain or loss shall be recognized in accordance with Subtopic 610-20.
Therefore, an entity begins its evaluation by determining whether the transaction meets any of the exceptions in ASC 845-10-30-3, which states:

A nonmonetary exchange shall be measured based on the recorded amount (after reduction, if appropriate, for an indicated impairment of value as discussed in paragraph 360-10-40-4) of the nonmonetary asset(s) relinquished, and not on the fair values of the exchanged assets, if any of the following conditions apply:

a. The fair value of neither the asset(s) received nor the asset(s) relinquished is determinable within reasonable limits.

b. 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.

c. The transaction lacks commercial substance (see the following paragraph [ASC 845-10-30-4]).

We believe that it is unlikely that the condition in ASC 845-10-30-3(a) above would be met because the fair value of either or both of the assets that were surrendered or the assets (or net assets) that were received should be determinable “within reasonable limits.” Entities therefore should consider whether the transaction (1) represents “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” or (2) lacks commercial substance. Entities should consider the guidance in ASC 845-10 in making that determination. If any of these exceptions applies, the acquiring entity accounts for the transaction on the basis of the carrying amount of the nonmonetary asset given and recognizes no gain or loss (other than for impairment, if necessary).

If the transaction does not meet any of the three conditions in ASC 845-10-30-3, we believe that entities should then consider whether the consideration given is in the form of nonfinancial assets (or in-substance nonfinancial assets). If so, then the transaction is within the scope of ASC 610-20 if the transaction is with a noncustomer (or ASC 606-10 if the transaction is with a customer).

ASC 805-50-30-1 states, in part, that “[i]f the consideration given is nonfinancial assets or in substance nonfinancial assets within the scope of Subtopic 610-20 on gains and losses from the derecognition of nonfinancial assets, the assets acquired shall be treated as noncash consideration and any gain or loss shall be recognized in accordance with Subtopic 610-20.” Therefore, regardless of whether the assets are being received from a customer or a noncustomer, an entity applies the guidance in ASC 606-10-32-21 and 32-22 for measuring noncash consideration. However, the guidance an entity applies for recognizing the gain or loss depends on whether the assets are being received from a noncustomer or a customer. If the assets are received from a noncustomer, the entity applies the guidance in ASC 610-20 for recognizing the gain or loss, whereas if the assets are received from a customer in exchange for goods or services and the transaction is within the scope of ASC 606-10, the entity applies the guidance in ASC 606-10 on recognizing the gain or loss.

ASC 610-20-15-2 indicates that “[n]onfinancial assets . . . include intangible assets, land, buildings, or materials and supplies and may have a zero carrying value.” In addition, ASC 610-20-15-5 describes an in-substance nonfinancial asset as follows:

[A] financial asset (for example, a receivable) promised to a counterparty in a contract if substantially all of the fair value of the assets (recognized and unrecognized) that are promised to the counterparty in the contract is concentrated in nonfinancial assets. If substantially all of the fair value of the assets that are promised to a counterparty in a contract is concentrated in nonfinancial assets, then all of the financial assets promised to the counterparty in the contract are in substance nonfinancial assets. For purposes of this evaluation, when a contract includes the transfer of ownership interests in one or more consolidated subsidiaries that is not a business, an entity shall evaluate the underlying assets in those subsidiaries.
According to ASC 610-20-15-4(g), ASC 610-20 does not apply to a “nonmonetary transaction within the scope of Topic 845 on nonmonetary transactions.” Therefore, if the assets are not nonfinancial assets (or in-substance nonfinancial assets), entities should consider whether the assets are nonmonetary assets. The ASC master glossary defines nonmonetary assets and liabilities as “assets and liabilities other than monetary ones” and notes that examples of such assets and liabilities include “inventories; investments in common stocks; property, plant, and equipment; and liabilities for rent collected in advance.” We believe that it may be challenging for entities to determine whether an exchange of noncash assets is an exchange of nonfinancial assets within the scope of ASC 610-20 or a nonmonetary exchange within the scope of ASC 845, and there is no additional guidance in U.S. GAAP on how to make this determination. However, we believe that the definition of nonmonetary assets and liabilities is broader than the definitions of nonfinancial assets and in-substance nonfinancial assets.

Entities are required to adopt ASC 610-20 at the same time that they adopt ASC 606. See Deloitte’s A Roadmap to Applying the New Revenue Recognition Standard for more information.

C.2.2 Contingent Consideration

The ASC master glossary defines “contingent consideration” as follows:

> Usually an obligation of the acquirer to transfer additional assets or equity interests to the former owners of an acquiree as part of the exchange for control of the acquiree if specified future events occur or conditions are met. However, contingent consideration also may give the acquirer the right to the return of previously transferred consideration if specified conditions are met.

While that definition applies to contingent consideration issued in a business combination, contingent consideration may also be issued in an asset acquisition. The acquiring entity should assess the terms of the transaction to determine whether consideration payable at a future date is contingent consideration or seller financing. If the payment depends on the occurrence of a specified future event or the meeting of a condition and the event or condition is substantive, the additional consideration should be accounted for as contingent consideration. If the additional payment depends only on the passage of time or is based on a future event or the meeting of a condition that is not substantive, the arrangement should be accounted for as seller financing.

ASC 805-50 states that any liabilities incurred by the acquiring entity are part of the cost of the asset acquisition, but it does not provide any specific guidance on accounting for contingent consideration in an asset acquisition. However, in EITF Issue 09-2, the Task Force addressed contingent consideration in an asset acquisition. While a final consensus was not reached, the minutes from the September 9–10, 2009, EITF meeting state that “the Task Force reached a consensus-for-exposure that contingent consideration in an asset acquisition shall be accounted for in accordance with existing U.S. GAAP.” For example:

- “[I]f the contingent consideration meets the definition of a derivative, Topic 815 (formerly Statement 133) would require that it be recognized at fair value.”
- “Topic 450 (formerly Statement 5) may require recognition of the contingent consideration if it is probable that a liability has been incurred and the amount of that liability can be reasonably estimated.”
- “Subtopic 323-10 (formerly Issue 08-6) may require the recognition of the contingent consideration if it relates to the acquisition of an investment that is accounted for under the equity method.”
The minutes also state that when contingent consideration related to an asset acquisition is recognized at inception, “such [an] amount would be included in the initial measurement of the cost of the acquired assets. . . . However, if the contingent consideration arrangement is a derivative, changes in the carrying value of a derivative instrument subsequent to inception [would be recognized in accordance with ASC 815] and would not be recognized as part of the cost of the asset.”

**Connecting the Dots**

We understand that in the absence of a final consensus on EITF Issue 09-2, some practitioners continue to analogize to the guidance in FASB Statement 141 when accounting for contingent consideration that is outside the scope of ASC 815 and ASC 323-10 (i.e., contingent consideration that is neither a derivative nor related to the acquisition of an equity method investment). Under paragraph 27 of Statement 141, “contingent consideration usually should be recorded when the contingency is resolved and consideration is issued or becomes issuable.”

Contingent consideration that is recognized at a later date (i.e., not recognized as of the acquisition date) should be capitalized as part of the cost of the assets acquired and allocated to increase the eligible assets on a relative fair value basis. (However, if the contingent consideration is related to IPR&D assets with no alternative future use, the amount of the contingent payment should be expensed. See Deloitte’s Life Sciences Industry Accounting Guide.) Similarly, we believe that if the acquiring entity receives a payment from the seller for the return of previously transferred consideration (i.e., a contingent consideration asset), the entity should allocate that amount to reduce the eligible assets on a relative fair value basis.

Diversity in practice has been observed regarding how entities that recognize contingent consideration at a later date make the resulting adjustments to amortizable or depreciable identifiable assets (e.g., PP&E or a finite-lived intangible asset). Some entities have recognized a cumulative catch-up in the amortization or depreciation of the asset as if the amount had been capitalized as of the date of acquisition, and other entities have accounted for the adjustment prospectively in a manner similar to a change in estimate. In the absence of guidance, we believe that either approach is acceptable.

**C.2.2.1 Contingent Consideration When the Fair Value of the Assets Acquired Exceeds the Initial Consideration Paid**

We believe that if the fair value of the assets acquired exceeds the initial consideration paid as of the date of acquisition but includes a contingent consideration arrangement, an entity may analogize to the guidance in ASC 323-10-25-2A and ASC 323-10-30-2B on recognizing contingent consideration in the acquisition of an equity method investment (unless the contingent consideration arrangement meets the definition of a derivative, in which case it would be accounted for in accordance with ASC 815). That guidance states that if an entity acquires an equity method investment in which the fair value of its share of the investee’s net assets exceeds its initial cost and the agreement includes contingent consideration, the entity recognizes a liability equal to the lesser of:

- The maximum amount of contingent consideration.
- The excess of its share of the investee’s net assets over the initial cost measurement.

Like acquisitions of equity method investments, asset acquisitions are accounted for by using a cost accumulation model. Therefore, we believe that the guidance above could be applied to asset acquisitions by analogy. (However, if the contingent payment is related to IPR&D assets with no alternative future use, the amount of the contingent payment would be expensed. See Deloitte’s Life Sciences Industry Accounting Guide.) Accordingly, if an entity acquires a group of assets in which the fair
value of the net assets exceeds its initial cost and the agreement includes contingent consideration that does not meet the definition of a derivative, the entity could recognize a liability equal to the lesser of:
- The maximum amount of contingent consideration.
- The excess of the fair value of the net assets acquired over the initial consideration paid.

Once recognized, the contingent consideration liability is not derecognized until the contingency is resolved or the consideration is issued. In accordance with the requirements of ASC 323-10-35-14A for equity method investments, the entity recognizes “any excess of the fair value of the contingent consideration issued or issuable over the amount that was [initially] recognized as a liability . . . as an additional cost” of the asset acquisition (i.e., the amount is allocated to increase the eligible assets on a relative fair value basis). Further, “[i]f the amount initially recognized as a liability exceeds the fair value of the [contingent] consideration issued or issuable,” the entity recognizes that amount as a reduction of the cost of the asset acquisition (i.e., the amount is allocated to reduce the eligible assets on a relative fair value basis).

C.2.3 Transaction Costs, Including Costs of Issuing Debt or Equity Securities

ASC 805-50-30-1 states that in an asset acquisition, “[a]ssets are recognized based on their cost to the acquiring entity, which generally includes the transaction costs." ASC 805-50 does not, however, define transaction costs. We believe that transaction costs should be limited to the direct and incremental costs incurred to complete the asset acquisition, such as third-party costs for finders’ fees and advisory, legal, accounting, valuation, and other professional or consulting fees. Costs such as general and administrative expenses, and salaries and benefits of the acquiring entity’s employees who work on the acquisition, should not be considered transaction costs.

We also believe that the acquiring entity should recognize the costs of issuing debt or equity securities in an asset acquisition in accordance with applicable GAAP, which is how those costs are recognized in a business combination. SAB Topic 5.A provides guidance on accounting for the costs of issuing equity securities and states, in part, that “[s]pecific incremental costs directly attributable to a proposed or actual offering of securities may properly be deferred and charged against the gross proceeds of the offering." Therefore, the costs of issuing equity securities are generally reflected as a reduction of the amount that would have otherwise been recognized in APIC.

If the acquiring entity incurs debt to fund the asset acquisition, it should present the debt issuance costs on the balance sheet as a direct deduction from the face amount of the debt and amortize them as interest expense in accordance with ASC 835-30-45 (unless the debt financing is from a revolving arrangement, in which case the acquiring entity can elect to either deduct the costs from the drawn balance or recognize them as an asset).

See Section 5.4 for more information about accounting for acquisition-related costs in a business combination.

C.2.4 Transactions That Are Separate From an Asset Acquisition

An acquiring entity and the seller of the assets may have a preexisting relationship or other arrangement before negotiations for the acquisition begin, or they may enter into an arrangement during the negotiations that is separate from the acquisition of the assets. ASC 805-50 includes only general principles related to accounting for an asset acquisition. We believe that those principles presume that the cost of the acquisition includes only amounts related to the acquisition of the asset or group of assets and not amounts related to separate transactions, even though the guidance does not explicitly say so. Further, we believe that in the absence of specific guidance, an entity should analogize to ASC
805-10-25-20 through 25-22, which provide guidance on identifying and accounting for transactions that are separate from a business combination. Under this guidance, the acquirer must, when applying the acquisition method, recognize “only the consideration transferred for the acquiree and the assets acquired and liabilities assumed in the exchange for the acquiree.” Any separate transactions must be accounted for separately from the business combination in accordance with the relevant GAAP. See Section 6.2 for more information about transactions that should be accounted for separately from a business combination.

**Example C-1**

**Asset Acquisition and Related Supply Agreement**

Company A enters into an agreement with Company B to acquire machinery and equipment that will be used to manufacture Product X. The machinery and equipment do not meet the definition of a business in ASC 805-10. In addition to stipulating a cash amount to be paid by A upon transfer of the machinery and equipment, the agreement specifies that A will provide B with a specified number of units of Product X for two years after the acquisition at a fixed per-unit price that is determined to be below market.

In determining the cost of the asset acquisition, A should take into account both the amount it paid upon transfer of the machinery and equipment and the value transferred to B under the below-market fixed-price supply agreement. Company A would recognize a balance sheet credit on the date of acquisition for the unfavorable supply contract; the credit would be recognized in income as units of Product X are delivered.

**Example C-2**

**Asset Acquisition That Settles a Dispute**

Company A has an agreement with Company B that gives B the exclusive right to distribute A's goods in a specific region. Company B asserts that A has inappropriately given the distribution right to B's competitor. Company A and B decide to settle the dispute so that A reacquires the distribution right from B. The distribution right does not meet the definition of a business in ASC 805-10. Company A believes that if it does not reacquire the distribution right, it is liable to B for breach of contract.

In determining the cost of the asset acquisition, A should exclude from this cost any amount related to the dispute's settlement to avoid the capitalization of what would otherwise be an operating expense if paid separately from the asset acquisition.

In prepared remarks at the 2007 AICPA Conference on Current SEC and PCAOB Developments, Eric West, then associate chief accountant in the SEC's OCA, discussed a fact pattern in which a company pays cash and conveys licenses to a plaintiff to settle a claim related to patent infringement and misappropriation of trade secrets. In exchange, the company receives a promise to drop the patent infringement lawsuit, a covenant not to sue with respect to the misappropriation of trade secrets claim, and a license to use the patents subject to the litigation. Mr. West notes that “[t]o properly account for this arrangement, a company must identify each item given and received and determine whether those items should be recognized.” In addition, Mr. West states the following regarding the valuation of the elements of the transaction:

> [W]e believe that it would be acceptable to value each element of the arrangement and allocate the consideration paid to each element using relative fair values. To the extent that one of the elements of the arrangement just can't be valued, we believe that a residual approach may be a reasonable solution. In fact, we have found that many companies are not able to reliably estimate the fair value of the litigation component of any settlement and have not objected to judgments made when registrants have measured this component as a residual. In a few circumstances companies have directly measured the value of the litigation settlement component. In the fact pattern that I just described, the company may be able to calculate the value of the settlement by applying a royalty rate to the revenues derived from the products sold using the patented technology during the infringement period. Admittedly, this approach requires judgment and we are willing to consider reasonable judgments.
Accordingly, we believe that the elements of the transaction should be valued on the basis of relative fair values unless the fair value of one of the elements cannot be estimated. In that case, a residual approach may be acceptable.

### C.2.5 Asset Acquisitions in Which a Noncontrolling Interest Remains

In some asset acquisitions, the acquiring entity may obtain control, but less than 100 percent of the equity interests, in a legal entity holding only an asset or group of assets such that a noncontrolling interest in the legal entity remains after the acquisition. We believe that if the legal entity is not a VIE, the acquiring entity in an asset acquisition should include the fair value of any noncontrolling interests remaining as of the date of acquisition in determining the cost to allocate to the assets or group of assets acquired by analogy to the guidance for business combinations in ASC 805-30-30-1. Under that guidance, an acquirer in a business combination must add the fair value of any noncontrolling interests remaining as of the date of acquisition to the consideration transferred to determine the amount recognized for the assets acquired and liabilities assumed. If the acquiring entity in an asset acquisition does not include the fair value of any noncontrolling interests remaining as of the date of acquisition, the asset or group of assets acquired may be recognized at an amount lower than their current fair value.

If the acquired legal entity is a VIE, entities should apply the guidance in ASC 810-10-30-4. See Section C.1.2.1.

#### Example C-3

**Acquisition in Which a Noncontrolling Interest Remains**

Company A acquires an 80 percent controlling interest in a legal entity whose only asset is a finite-lived license for intellectual property. As part of the acquisition, A pays $800,000 in cash and incurs $50,000 in transaction costs for third-party advisory fees. Company A determines that the license does not meet the definition of a business in ASC 805-10 and that the entity is not a VIE. The seller of the license retains a 20 percent noncontrolling interest in the entity. The fair value of the noncontrolling interest is determined to be $195,000.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consideration paid</td>
<td>$800,000</td>
</tr>
<tr>
<td>Transaction costs</td>
<td>50,000</td>
</tr>
<tr>
<td>Fair value of noncontrolling interest</td>
<td>195,000</td>
</tr>
<tr>
<td>Cost allocated to the license</td>
<td>$1,045,000</td>
</tr>
</tbody>
</table>

Although the fair value of the noncontrolling interest is used to measure the cost of the acquisition, A would recognize the noncontrolling interest at its proportionate share of the relative fair value of the assets (and liabilities) acquired ($1,045,000 × 20 percent, or $209,000).

### C.2.6 Asset Acquisitions in Which the Acquiring Entity Previously Held an Interest

In some asset acquisitions, the acquiring entity may obtain control of an asset or group of assets that are held in a legal entity in which it held a noncontrolling interest immediately before the date of acquisition. ASC 805-50 provides no guidance on how an entity should account for a previously held interest in an asset acquisition when measuring the asset or group of assets acquired. In the absence of guidance, we believe that there are two alternatives if the legal entity is not a VIE. Under the first alternative, the acquiring entity in an asset acquisition would include the carrying amount of any previously held interest along with the consideration paid and transaction costs incurred in determining the cost to allocate to the assets acquired. This view is consistent with the cost accumulation model because each step is measured on the basis of the respective cost incurred.
Under the second alternative, the acquiring entity in an asset acquisition would include the fair value of any previously held interest (after recognizing a gain or loss for the difference between the interest’s fair value and its carrying value) along with the consideration paid and transaction costs incurred in determining the cost to allocate to the assets acquired by analogy to the guidance for business combinations in ASC 805-30-30-1. Under that guidance, an acquirer in a business combination must add the fair value of any previously held interest to the consideration transferred to determine the amount recognized for the assets acquired and liabilities assumed.

If the acquired legal entity is a VIE, entities should apply the guidance in ASC 810-10-30-4. See Section C.1.2.1.

### Example C-4

**Acquisition in Which the Acquiring Entity Previously Held an Interest**

Company A has a 20 percent noncontrolling interest in a legal entity whose only asset is a finite-lived license for intellectual property. The carrying value of A’s investment is $100,000, and its fair value is $200,000. Company A acquires the remaining 80 percent interest for $800,000 in cash and incurs $50,000 in transaction costs for third-party advisory fees. Company A determines that the license does not meet the definition of a business in ASC 805-10 and that the entity is not a VIE.

Under alternative 1, $950,000 would be allocated to the license as follows:

<table>
<thead>
<tr>
<th>Alternative 1</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Consideration paid</td>
<td>$ 800,000</td>
</tr>
<tr>
<td>Transaction costs</td>
<td>50,000</td>
</tr>
<tr>
<td>Carrying value of previously held interest</td>
<td>100,000</td>
</tr>
<tr>
<td>Cost allocated to the license</td>
<td>$ 950,000</td>
</tr>
</tbody>
</table>

Under alternative 2, $1,050,000 would be allocated to the license as follows:

<table>
<thead>
<tr>
<th>Alternative 2</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Carrying value of previously held interest</td>
<td>$ 100,000</td>
</tr>
<tr>
<td>Fair value of previously held interest</td>
<td>$ 200,000</td>
</tr>
<tr>
<td>Gain recognized on remeasurement of previously held interest</td>
<td>$ 100,000</td>
</tr>
<tr>
<td>Consideration paid</td>
<td>$ 800,000</td>
</tr>
<tr>
<td>Transaction costs</td>
<td>50,000</td>
</tr>
<tr>
<td>Fair value of previously held interest</td>
<td>$ 200,000</td>
</tr>
<tr>
<td>Cost allocated to the license</td>
<td>$ 1,050,000</td>
</tr>
</tbody>
</table>
C.2.7 Noncash Assets Given as Consideration That Remain Within the Combined Entity After the Acquisition

In some asset acquisitions, the consideration given may include assets or liabilities that remain within the combined entity after the acquisition. Therefore, the acquiring entity controls them before and after the asset acquisition. Under ASC 805-30-30-8, in a business combination, the acquirer must recognize those assets and liabilities at their carrying amounts immediately before the acquisition date; the acquirer is precluded from recognizing a gain or loss on assets or liabilities it controls both before and after the business combination. While ASC 805-50 does not address this issue, we believe that it is appropriate to apply the guidance in ASC 805-30-30-8 to asset acquisitions by analogy.

In addition, ASC 805-50 does not address the measurement of any noncontrolling interests, and thus alternatives may exist in practice, such as those shown in Example C-5 below. In alternative 1 in that example, the fair value of the noncontrolling interest is used to measure the cost of the asset acquisition by analogy to the business combinations guidance (although the noncontrolling interest is recognized at its proportionate share of the relative fair value of the assets and liabilities acquired). In alternative 2, the noncontrolling interest is measured at a part fair value and a part carryover basis.

Example C-5

Assets Transferred as Consideration That Remain Under the Control of the Acquiring Entity

Company A enters into an agreement to acquire an 80 percent interest in Entity B for $875,000 in cash and equipment; A incurs $50,000 in transaction costs for third-party advisory fees. Entity B's only assets include three buildings, which do not meet the definition of a business in ASC 805-10. The equipment A gives as consideration will be transferred not to the seller but to B and will therefore remain in the combined entity. This equipment has a carrying value of $500,000 and a fair value of $625,000. The three buildings A acquires have fair values of $300,000, $500,000, and $450,000, a total of $1,250,000.

<table>
<thead>
<tr>
<th>Alternative 1:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash paid</td>
<td>$ 875,000</td>
</tr>
<tr>
<td>Transaction costs</td>
<td>50,000</td>
</tr>
<tr>
<td>Carrying value of the equipment transferred to B</td>
<td>500,000</td>
</tr>
<tr>
<td>Fair value of noncontrolling interest</td>
<td>375,000*</td>
</tr>
<tr>
<td>Total</td>
<td>1,800,000</td>
</tr>
<tr>
<td>Less: carrying value of the equipment transferred to B</td>
<td>(500,000)</td>
</tr>
<tr>
<td>Amount allocable to acquired buildings</td>
<td>$1,300,000</td>
</tr>
</tbody>
</table>

* Calculated as 20 percent of the sum of $1,250,000 and the fair value of the equipment of $625,000 (i.e., 20% × [$1,250,000 + $625,000], or $375,000).
### Example C-5 (continued)

<table>
<thead>
<tr>
<th></th>
<th>Initial Measurement</th>
<th>Percentage of Fair Value**</th>
<th>Amount Allocable to Acquired Buildings</th>
<th>Allocated Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value of Building 1</td>
<td>$ 300,000</td>
<td>24%</td>
<td>$ 1,300,000</td>
<td>$ 312,000</td>
</tr>
<tr>
<td>Fair value of Building 2</td>
<td>500,000</td>
<td>40%</td>
<td>1,300,000</td>
<td>520,000</td>
</tr>
<tr>
<td>Fair value of Building 3</td>
<td>450,000</td>
<td>36%</td>
<td>1,300,000</td>
<td>468,000</td>
</tr>
<tr>
<td>Total of the buildings acquired</td>
<td>1,250,000</td>
<td></td>
<td>1,300,000</td>
<td></td>
</tr>
<tr>
<td>Add: Equipment transferred to B</td>
<td>500,000</td>
<td></td>
<td>500,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>$ 1,750,000</td>
<td>$ 1,800,000</td>
</tr>
<tr>
<td>Noncontrolling interest***</td>
<td></td>
<td></td>
<td></td>
<td>$ 360,000</td>
</tr>
</tbody>
</table>

** Because the equipment transferred by A must be recognized at its carrying amount, the percentages are calculated on the basis of only the fair value of the acquired assets ($300,000 ÷ $1,250,000; $500,000 ÷ $1,250,000; and $450,000 ÷ $1,250,000).

*** Although the fair value of the noncontrolling interest is used to measure the cost of the acquisition, A would recognize the noncontrolling interest at its proportionate share of the recognized assets (and liabilities) acquired ($1,800,000 × 20 percent, or $360,000).

### Alternative 2:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash paid</td>
<td>$ 875,000</td>
</tr>
<tr>
<td>Transaction costs</td>
<td>50,000</td>
</tr>
<tr>
<td>Carrying value of the equipment transferred to B</td>
<td>500,000</td>
</tr>
<tr>
<td>Noncontrolling interest</td>
<td>350,000*</td>
</tr>
<tr>
<td>Total</td>
<td>1,775,000</td>
</tr>
<tr>
<td>Less: carrying value of the equipment transferred to B</td>
<td>(500,000)</td>
</tr>
<tr>
<td>Amount allocable to acquired buildings</td>
<td>$1,275,000</td>
</tr>
</tbody>
</table>

* Calculated as the sum of 20 percent of the $500,000 carrying amount of the equipment and 20 percent of the $1,250,000 fair value of the buildings (i.e., 20% × ($1,250,000 + $500,000), or $350,000).
**Example C-5 (continued)**

<table>
<thead>
<tr>
<th></th>
<th>Initial Measurement</th>
<th>Percentage of Fair Value**</th>
<th>Amount Allocable to Acquired Buildings</th>
<th>Allocated Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value of Building 1</td>
<td>$ 300,000</td>
<td>24%</td>
<td>$ 1,275,000</td>
<td>$ 306,000</td>
</tr>
<tr>
<td>Fair value of Building 2</td>
<td>500,000</td>
<td>40%</td>
<td>1,275,000</td>
<td>510,000</td>
</tr>
<tr>
<td>Fair value of Building 3</td>
<td>450,000</td>
<td>36%</td>
<td>1,275,000</td>
<td>459,000</td>
</tr>
<tr>
<td>Total of the buildings acquired</td>
<td>1,250,000</td>
<td></td>
<td>1,275,000</td>
<td></td>
</tr>
<tr>
<td>Equipment transferred to B</td>
<td>500,000</td>
<td></td>
<td>500,000</td>
<td></td>
</tr>
<tr>
<td>Noncontrolling interest***</td>
<td></td>
<td></td>
<td>$ 1,750,000</td>
<td>$ 355,000</td>
</tr>
</tbody>
</table>

**Because the equipment transferred by A must be recognized at its carrying amount, the percentages are calculated on the basis of only the fair value of the acquired assets ($300,000 ÷ $1,250,000; $500,000 ÷ $1,250,000; and $450,000 ÷ $1,250,000).**

***Company A would recognize the noncontrolling interest at its proportionate share of the recognized assets (and liabilities) acquired ($1,775,000 × 20 percent, or $355,000).**

**C.3 Allocating the Cost in an Asset Acquisition**

**ASC 805-50**

**Allocating Cost**

**30-3** Acquiring assets in groups requires not only ascertaining the cost of the asset (or net asset) group but also allocating that cost to the individual assets (or individual assets and liabilities) that make up the group. The cost of such a group is determined using the concepts described in the preceding two paragraphs. The cost of a group of assets acquired in an asset acquisition shall be allocated to the individual assets acquired or liabilities assumed based on their relative fair values and shall not give rise to goodwill. The allocated cost of an asset that the entity does not intend to use or intends to use in a way that is not its highest and best use, such as a brand name, shall be determined based on its relative fair value. See paragraph 805-50-55-1 for an illustration of the relative fair value method to assets acquired outside a business combination.

**30-4** See paragraphs 740-10-25-49 through 25-55 for guidance on the accounting for acquired temporary differences in certain purchase transactions that are not accounted for as business combinations.

An acquiring entity allocates the cost of an asset acquisition to the assets acquired (and liabilities assumed) on the basis of their relative fair values and is not permitted to recognize goodwill. However, if the fair values of the assets acquired and liabilities assumed are more reliably determinable (e.g., because the consideration is in the form of noncash assets), the entity measures the cost of the transaction by using these fair values. Fair value is measured in accordance with ASC 820.

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Goodwill is recognized only if a business is acquired. Thus, no goodwill is recognized in an asset acquisition. If initial indications are that the cost of the acquisition is in excess of the fair value of acquired assets, an entity should carefully consider whether the acquired assets represent a business or an asset acquisition, whether the entity has appropriately identified all assets acquired, and whether the entity has appropriately measured the cost of the acquisition and the fair values of assets acquired. If, after this exercise, it is determined that the cost of the acquisition exceeds the fair value of the assets acquired, the acquiring entity allocates the difference pro rata on the basis of relative fair values to increase certain of the assets acquired (see Section C.3.1).

Bargain purchase gains are generally not recognized in an asset acquisition. If the fair value of the net assets acquired exceeds the acquiring entity’s cost, the acquiring entity allocates the difference pro rata on the basis of relative fair values to reduce certain of the assets acquired (see Section C.3.1 below). However, such pro rata allocation cannot reduce monetary assets below their fair values. In unusual cases, pro rata allocation either reduces the eligible assets to zero or there are no eligible assets to reduce; we do not believe that an entity should reduce monetary assets below their fair values in such circumstances. However, before recognizing a gain, the entity should consider whether (1) it has appropriately recognized all of the liabilities assumed, any contingent consideration, and any separate transactions or (2) whether the assets received are more reliably measurable than the assets given. If only monetary assets are acquired, the entity should also consider whether the transaction is, in substance, an asset acquisition. For example, if the assets being acquired are primarily cash, the substance of the transaction may be a recapitalization.

C.3.1 Exceptions to Pro Rata Allocation

Pro rata allocation of the acquiring entity's cost to the assets acquired on a relative fair value basis results in the recognition of assets at amounts that are more (or less if a bargain purchase) than their fair values. In deliberating ASC 805-10, ASC 805-20, and ASC 805-30, the FASB discussed a number of exceptions to the recognition and fair value measurement principles in a business combination for assets or liabilities for which the subsequent accounting is prescribed by other GAAP and application of such GAAP would result in the acquirer's recognition of an immediate gain or loss. Examples of such exceptions include assets held for sale, employee benefits, and income taxes. ASC 805-50 provides only general guidance on allocating cost in an asset acquisition. However, we believe that the same principles should apply to an asset acquisition. That is, an acquiring entity should not recognize an asset at an amount that would result in the entity's recognition of an immediate gain or loss as a result of the subsequent application of GAAP if no economic gain or loss has occurred (with the exception of IPR&D assets with no alternative future use, which are discussed in Section C.3.4.2).

Therefore, we believe that certain assets should be recognized at the amounts required by applicable U.S. GAAP or should not be recognized at amounts that exceed their fair values. Such assets (and liabilities) include:

- Cash and other financial assets (other than investments accounted for under the equity method).
- Other current assets.
- Contract assets.
- Assets subject to fair value impairment testing, such as indefinite-lived intangible assets.
- Assets held for sale.
- Income taxes.
• Employee benefits.
• Indemnification assets (see Section C.3.3).

Example C-6

**Excess of Cost Over the Fair Values of the Assets Acquired**

Company A acquires three assets from Company B: machinery and equipment with a fair value of $20,000, a building with a fair value of $50,000, and an indefinite-lived intangible asset with a fair value of $30,000. The total cost of the acquisition, including transaction costs, is $120,000. Company A has determined that the assets do not constitute a business and allocates the cost as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Fair Value (ASC 820)</th>
<th>Percentage of Fair Value*</th>
<th>Cost of Acquisition Less Intangible Asset</th>
<th>Allocated Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Machinery and equipment</td>
<td>$20,000</td>
<td>29%</td>
<td>$90,000</td>
<td>$25,714</td>
</tr>
<tr>
<td>Building</td>
<td>50,000</td>
<td>71%</td>
<td>$90,000</td>
<td>64,286</td>
</tr>
<tr>
<td>Indefinite-lived intangible asset</td>
<td>30,000</td>
<td></td>
<td></td>
<td>30,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$100,000</strong></td>
<td></td>
<td><strong>$120,000</strong></td>
<td></td>
</tr>
</tbody>
</table>

* Because the indefinite-lived intangible asset is not recognized at an amount that exceeds its fair value, the percentages are calculated on the basis of only the eligible assets ($20,000 ÷ $70,000 and $50,000 ÷ $70,000).

Sometimes the fair value of the net assets acquired exceeds the acquiring entity's cost (i.e., a bargain purchase), though this is unusual. Allocation of a bargain purchase will reduce assets below their fair values. We believe there are two acceptable views on how to allocate the acquiring entity's cost in such cases. Under the first alternative, the same assets that are ineligible for pro rata allocation when cost exceeds the fair value of the assets should also be ineligible for pro rata allocation in a bargain purchase.

Example C-7

**Excess of Fair Values of the Assets Acquired Over Cost (Alternative 1)**

Assume the same facts as in Example C-6 above, except that the total cost of the acquisition, including transaction costs, is $90,000. Company A's cost is allocated as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Fair Value (ASC 820)</th>
<th>Percentage of Fair Value*</th>
<th>Cost of Acquisition Less Ineligible Asset</th>
<th>Allocated Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Machinery and equipment</td>
<td>$20,000</td>
<td>29%</td>
<td>$60,000</td>
<td>17,143</td>
</tr>
<tr>
<td>Building</td>
<td>50,000</td>
<td>71%</td>
<td>$60,000</td>
<td>42,857</td>
</tr>
<tr>
<td>Indefinite-lived intangible asset</td>
<td>30,000</td>
<td></td>
<td></td>
<td>30,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$100,000</strong></td>
<td></td>
<td><strong>$90,000</strong></td>
<td></td>
</tr>
</tbody>
</table>

* Because the indefinite-lived intangible asset is recognized at its fair value, the percentages are calculated on the basis of only the eligible assets ($20,000 ÷ $70,000 and $50,000 ÷ $70,000).
Under the second alternative, it is appropriate to allocate a bargain purchase to any asset for which the subsequent application of U.S. GAAP would not result in an immediate gain, such as indefinite-lived intangible assets or assets held for sale.

### Example C-8

**Excess of Fair Values of the Assets Acquired Over Cost (Alternative 2)**

Assume the same facts as in Example C-6, except that the total cost of the acquisition, including transaction costs, is $90,000. Company A’s cost is allocated as follows:

<table>
<thead>
<tr>
<th></th>
<th>Fair Value (ASC 820)</th>
<th>Percentage of Fair Value*</th>
<th>Cost of the Acquisition</th>
<th>Allocated Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Machinery and equipment</td>
<td>$ 20,000</td>
<td>20%</td>
<td>$ 90,000</td>
<td>$ 18,000</td>
</tr>
<tr>
<td>Building</td>
<td>50,000</td>
<td>50%</td>
<td>$ 90,000</td>
<td>45,000</td>
</tr>
<tr>
<td>Indefinite-lived intangible asset</td>
<td>30,000</td>
<td>30%</td>
<td>$ 90,000</td>
<td>27,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$ 100,000</strong></td>
<td></td>
<td><strong>$ 90,000</strong></td>
<td><strong>$ 90,000</strong></td>
</tr>
</tbody>
</table>

* This example assumes that an indefinite-lived intangible asset can be recognized at less than its fair value (but not at greater than its fair value), so the total cost must be allocated to all of the acquired assets.

### C.3.2 Contingencies

An entity accounts for gain or loss contingencies acquired or assumed in an asset acquisition in accordance with ASC 450. A loss contingency is recognized when it is probable that a loss has been incurred and the loss can be reasonably estimated. A gain contingency is not recognized until the earlier of when the gain is realized or is realizable and therefore is not recognizable in an asset acquisition. If an acquiring entity acquires a gain or loss contingency in an asset acquisition but the contingency does not qualify for recognition on the date of acquisition, the entity would allocate the cost of the acquisition only to the recognizable assets acquired and may initially recognize certain assets at more or less than their fair values because of the nonrecognition of the contingency.

### C.3.3 Indemnification Assets

The seller in an asset acquisition may contractually indemnify the acquiring entity for the outcome of a contingency or uncertainty related to all or part of a specific asset or liability. For example, the seller may indemnify the acquiring entity against losses above a specified amount on a liability that arises from a particular contingency; in other words, the seller will guarantee that the acquiring entity’s liability will not exceed a specified amount. As a result, the acquiring entity obtains an indemnification asset.

Under ASC 805-20-25-27, an acquirer in a business combination must “recognize an indemnification asset at the same time that it recognizes the indemnified item, measured on the same basis as the indemnified item, subject to the need for a valuation allowance for uncollectible amounts.” We believe that an entity should also apply this guidance by analogy in an asset acquisition. See Section 4.3.4 for more information about the accounting for indemnification assets in a business combination.
Appendix C — Accounting for Asset Acquisitions

C.3.4 Intangible Assets
An entity recognizes intangible assets that are acquired in an asset acquisition if they meet the asset recognition criteria in FASB Concepts Statement 5, even if they are not separable or do not arise from contractual rights. There is a lower threshold for recognizing intangible assets in an asset acquisition than in a business combination (with the exception of IPR&D, which is discussed in Section C.3.4.2 below). In a business combination, if the consideration transferred includes amounts for intangible assets that do not qualify for recognition (e.g., assembled workforce), those unrecognized intangible assets are subsumed into goodwill but the assets acquired are still generally recognized at their fair values. However, in an asset acquisition, no goodwill is recognized. If the consideration paid includes amounts for intangible assets that were not separately recognized, the cost of the acquisition would be allocated to the recognizable assets and those assets may be recognized at amounts that exceed their fair values. Since there is no residual into which unrecognized intangible assets could be subsumed, the FASB decided that the threshold for recognizing intangible assets in an asset acquisition should be lower than in a business combination.

C.3.4.1 Assembled Workforce
ASC 805-20-55-6 defines an assembled workforce as “an existing collection of employees that permits the acquirer to continue to operate an acquired business from the acquisition date.” Under ASC 805-20-55-6, an assembled workforce is not recognized in a business combination because it neither is separable nor arises from contractual rights (i.e., identifiable). However, in an asset acquisition, an assembled workforce would generally meet the asset recognition criteria in FASB Concepts Statement 5 and would be separately recognized. But because an assembled workforce is often associated with substantive processes, the presence of an assembled workforce may indicate that the acquisition involves a business rather than an asset or a group of assets. An entity must evaluate all facts and circumstances in determining whether a group of acquired assets constitutes a business under ASC 805.

C.3.4.2 IPR&D Assets
An acquiring entity must allocate, on the basis of relative fair values, the cost of the acquisition to both the tangible and intangible R&D assets acquired. On the date of acquisition, the acquiring entity expenses IPR&D assets with no alternative future use and capitalizes those with an alternative future use in accordance with ASC 730.

One of the most significant differences between the accounting for an asset acquisition and that for a business combination lies in the accounting for IPR&D assets. In a business combination, the acquirer must recognize all IPR&D assets at fair value and initially characterize them as indefinite-lived intangible assets, regardless of whether the IPR&D assets have an alternative future use. In EITF Issue 09-2, the Task Force considered amending ASC 730 with respect to IPR&D assets acquired in an asset acquisition; however, the Task Force was unable to reach a consensus and removed the project from its agenda. Therefore, entities continue to apply the guidance in ASC 730 in accounting for IPR&D assets acquired in an asset acquisition.

C.3.4.3 Defensive Intangible Assets
ASC 805-20-30-6 states that “[t]o protect its competitive position, or for other reasons, the acquirer may intend not to use an acquired nonfinancial asset actively, or it may not intend to use the asset according to its highest and best use.” While such assets are not being actively used, they are most likely contributing to an increase in the value of other assets owned by the acquiring entity. Common examples of such assets, which are known as “defensive assets,” include brand names and patents.
While ASC 805-50 does not address the accounting for defensive intangible assets, we believe that because such assets must be recognized under ASC 805-20, they meet the asset recognition criteria in FASB Concepts Statement 5 and therefore should be recognized in an asset acquisition on the basis of their relative fair values. Fair value would be measured in accordance with ASC 820-10, and the asset’s highest and best use by market participants would be assumed, both initially and for subsequent impairment testing. See Section 4.10.4.8 for more information about the accounting for defensive intangible assets in a business combination.

C.3.5 Deferred Taxes

ASC 740-10-25-49 through 25-55 provide guidance on accounting for acquired temporary differences in certain purchase transactions that are not accounted for as business combinations (i.e., asset acquisitions). Because goodwill is not recognized in an asset acquisition, an entity generally recognizes deferred taxes for temporary book/tax differences in an asset acquisition by using the simultaneous equations method. For more information about accounting for income taxes in an asset acquisition, see Deloitte’s A Roadmap to Accounting for Income Taxes.

C.3.6 Lease Classification

ASC 805-50 does not provide guidance on how an acquiring entity should classify a lease acquired in an asset acquisition. In the absence of such guidance, one approach is to analogize to the guidance applied by an acquirer in a business combination. Specifically, ASC 840-10-25-27 states that for leases under ASC 840, the acquirer retains the acquiree’s previous classification “unless the provisions of the lease are modified as indicated in paragraph 840-10-35-5,” whereas ASC 842-10-35-3 specifies that for leases under ASC 842, the acquirer retains the acquiree’s previous lease classification “unless the lease is modified and that modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8.” Under this approach, an entity would not reassess the lease classification when a lease is acquired in a business combination, provided that only the identity of the lessee or lessor, but not any other lease provision, is changed. This is because ASC 842-20-20 defines a lease modification as a “change to the terms and conditions of a contract that results in a change in the scope of or the consideration for a lease.” We do not believe that a change only in the parties to a lease is contemplated in this definition since such a change does not alter scope or consideration. Thus, in these circumstances, an entity would view the asset acquisition as a continuation of the historical lease agreement. See Section 4.3.11 for further discussion of the accounting for leases in a business combination.

Another approach to determining the classification of a lease acquired in an asset acquisition is to apply ASC 840 or ASC 842 (as applicable) and consider each lease acquired as a new lease on the acquisition dates since the FASB provided specific guidance related to business combinations but did not extend that guidance to asset acquisitions. In addition, unlike an acquirer in a business combination, an acquiring entity in an asset acquisition may not have the information necessary to determine the original classification of the lease. Under this alternative, an acquiring entity in an asset acquisition would reassess lease classification as of the acquisition date since that date marks the entity’s first involvement with the lease (i.e., it is a new lease from the acquiring entity’s perspective). Thus, if this alternative is used, an acquiring entity’s lease classification may be different from that of the seller even in the absence of a lease modification as defined in ASC 840 or ASC 842.

While either approach to classifying a lease acquired in an asset acquisition is considered acceptable, application of more than one approach within the same asset acquisition transaction would not be expected.
If the acquiring entity becomes the lessor in an acquired lease arrangement, the guidance in ASC 350-30 applies. The cost of the acquisition is allocated to tangible assets (e.g., land and buildings) and any in-place lease intangible asset on the basis of their relative fair values. The fair value of assets does not incorporate any value from the leases. For example, the fair value of the land and building is measured as if the building was vacant.

For more information, see Deloitte's *A Roadmap to Applying the New Leasing Standard*.

[Section C.3.7 has been deleted.]

C.3.8 Measurement Period

In a business combination, an acquirer is allowed a period during which it may adjust provisional amounts recognized as of the acquisition date. This time frame is referred to as the measurement period. ASC 805-50 does not address the concept of a measurement period and, in practice, entities have not been provided a measurement period in an asset acquisition. We believe that because asset acquisitions are generally less complex than business combinations, the acquiring entity should be able to obtain any valuations and information necessary to complete its accounting for an asset acquisition before its next reporting date.

C.3.9 Subsequent Accounting for Assets Acquired or Liabilities Assumed in an Asset Acquisition

<table>
<thead>
<tr>
<th><strong>ASC 805-50</strong></th>
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</thead>
<tbody>
<tr>
<td><strong>Accounting After Acquisition</strong></td>
</tr>
<tr>
<td>35-1 After the acquisition, the acquiring entity accounts for the asset or liability in accordance with the appropriate generally accepted accounting principles (GAAP). The basis for measuring the asset acquired or liability assumed has no effect on the subsequent accounting for the asset or liability.</td>
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The initial measurement of an asset acquired or liability assumed in an asset acquisition does not affect its subsequent accounting. The subsequent accounting for contingent consideration is described in Section C.2.2. Otherwise, the acquirer subsequently accounts for the assets or any liabilities assumed or incurred in accordance with the appropriate GAAP, as applicable.

C.4 Disclosures

ASC 805-50 does not prescribe any disclosure requirements for asset acquisitions. However, the acquiring entity will need to provide disclosures in accordance with other GAAP depending on the assets acquired or the liabilities assumed or incurred. For example:

- ASC 360-10-50-1 requires disclosure of the balances of major classes of depreciable assets, by nature or function, and accumulated depreciation on the balance sheet date; depreciation expense for the period; and a general description of the method or methods used to compute depreciation with respect to major classes of depreciable assets.
- ASC 350-30-50-1 includes disclosure requirements for intangible assets acquired either individually or as part of a group of assets.
- ASC 450-20-50 requires disclosures regarding loss contingencies.
- ASC 845-10-50-1 includes specific disclosure requirements for nonmonetary transactions.
In addition, depending on the size of the asset acquisition, acquiring entities may decide to provide some of the disclosures prescribed in ASC 805-10-50, ASC 805-20-50, or ASC 805-30-50 for a business combination. For example, disclosures about the reason for the acquisition, the amounts recognized as of the date of acquisition for each major class of assets acquired and liabilities assumed, and information about any separate transactions may enhance users' understanding of the transaction.

C.5 SEC Reporting Considerations Related to Asset Acquisitions

When an SEC registrant acquires an asset or a group of assets, the registrant may be required to report the acquisition on Form 8-K, Item 2.01. The nature of the registrant's disclosures depends on whether the asset or group of assets (1) represents a business for SEC reporting purposes or (2) is significant.

The definition of a business in SEC Regulation S-X, Rule 11-01(d), for SEC reporting purposes differs from the definition of a business in ASC 805-10 for U.S. GAAP accounting purposes. Accordingly, the registrant must perform a separate evaluation under Rule 11-01(d) to determine its SEC reporting requirements. In addition, the significance tests for an asset or a group of assets that represents a business for SEC reporting differ from the significance tests for an asset or a group of assets that does not represent a business. In certain circumstances, a registrant may be required to file separate preacquisition historical financial statements for the acquired asset or group of assets under SEC Regulation S-X, Rule 3-05, as well as pro forma financial information that gives effect to the acquisition under SEC Regulation S-X, Article 11.

Connecting the Dots

The sections below provide general guidance on, and are based on the assumption that, registrants have a general understanding of, the reporting requirements in Rule 3-05 (under which separate pre-acquisition historical financial statements of the acquired business must be filed when the acquisition of a significant business has occurred or is probable) and Article 11 (which establishes the requirements for pro forma financial information).

As discussed in more detail in Appendix D, the SEC issued a final rule in May 2020 that amends the financial statement requirements for acquisitions and dispositions of businesses, including real estate operations, and related pro forma financial information. The final rule is effective for fiscal years beginning after December 31, 2020; however, early application is permitted.

The sections below outline general considerations related to the new SEC requirements for asset acquisitions. Registrants should also consider the guidance on the final rule's requirements in Deloitte's June 2, 2020, Heads Up. For guidance on the requirements before adoption of the final rule, see the June 2020 edition of Deloitte's A Roadmap to SEC Reporting Considerations for Business Combinations.

Registrants may also consult with their legal advisers and independent accountants regarding these requirements.

C.5.1 Form 8-K Reporting Obligations

A registrant is required to periodically file current reports on Form 8-K to inform investors of certain events. Under Form 8-K, Item 2.01, the registrant must file a Form 8-K within four business days after consummation of an acquisition of (1) a significant amount of assets or (2) a business that is significant. A registrant’s filing requirements vary on the basis of whether the acquired asset or group of assets (1) represents a business for SEC reporting purposes and (2) is significant. See Section C.5.2 for a discussion of the definition of a business for SEC reporting purposes.
Instruction 4 of Item 2.01 discusses significance and states, in part:

An acquisition or disposition shall be deemed to involve a significant amount of assets:

(i) if the registrant's and its other subsidiaries' equity in the net book value of such assets or the amount paid or received for the assets upon such acquisition or disposition exceeded 10% of the total assets of the registrant and its consolidated subsidiaries; or

(ii) if it involved a business (see 17 CFR 210.11-01(d)) that is significant (see 17 CFR 210.11-01(b)).

See Section C.5.3 and Section C.5.4, respectively, for a discussion of the Form 8-K reporting requirements under Item 2.01 for the acquisition of an asset or a group of assets that (1) does not meet the definition of a business for SEC reporting purposes and (2) meets the definition of a business for SEC reporting purposes.

Connecting the Dots

A registrant may also be required by Form 8-K, Item 1.01, to file a Form 8-K when it has entered into a material definitive agreement for an acquisition (e.g., when it executes a contract for an acquisition). Item 1.01 is generally filed earlier than Item 2.01, which the registrant is not required to file until the acquisition is consummated.

C.5.2 Definition of a Business for SEC Reporting Purposes

The definition of a business for SEC reporting purposes in Rule 11-01(d) differs from the definition in ASC 805-10 for U.S. GAAP accounting purposes. A registrant must carefully evaluate the requirements in Rule 11-01(d) to determine whether the asset or group of assets acquired represents a business for SEC reporting purposes. As noted in paragraph 2010.1 of the FRM, it is possible for the determination under Rule 11-01(d) to differ from that under ASC 805-10. Therefore, it is possible for an acquired asset or a group of assets to meet the definition of a business in ASC 805-10 and be accounted for as a business combination but not to meet the definition of a business in Rule 11-01(d) and be reported for as an asset acquisition, or vice versa.

The definition of a business in Rule 11-01(d) states, in part:

[T]he term business should be evaluated in light of the facts and circumstances involved and whether there is sufficient continuity of the acquired entity's operations prior to and after the transactions so that disclosure of prior financial information is material to an understanding of future operations. A presumption exists that a separate entity, a subsidiary, or a division is a business.

However, a lesser component (e.g., a product line) may also constitute a business. Rule 11-01(d) lists several factors an entity should consider in determining whether such a component constitutes a business. These factors include:

- Whether the nature of the revenue-producing activity will generally remain the same after the acquisition.
- Whether any of the following will remain after the acquisition: the physical facilities, employee base, market distribution system, sales force, customer base, operating rights, production techniques, or trade names.
The SEC staff’s analysis of whether an acquisition meets the definition of a business focuses primarily on whether the nature of the revenue-producing activity generally remains the same after the acquisition. In addition, the note to paragraph 2010.2 of the FRM states, in part:

New carrying values of assets, or changes in financing, management, operating procedures, or other aspects of the business are not unusual following a business acquisition. Such changes typically do not eliminate the relevance of historical financial statements.

If the revenue-producing activity continues after the acquisition, it is presumed that a business was acquired and that prior financial information would be relevant to the understanding of future operations.

The form in which the transaction takes place typically will not affect the determination of whether the acquisition is a business. For example, the transaction may involve the acquisition of the stock of an entity or the acquisition of selected assets and the assumption of selected liabilities of that entity. Either form can constitute the acquisition of a business. For more information, see Section 1.3 of the June 2020 edition of Deloitte’s A Roadmap to SEC Reporting Considerations for Business Combinations.

Example C-9

**Acquisition Does Not Meet the Definition of a Business for SEC Reporting Purposes**

This example summarizes an issue addressed at the March 2001 CAQ SEC Regulations Committee joint meeting with the SEC staff (the “joint meeting”).

Registrant A acquired a power plant from Company X. Before the acquisition, the output from the power plant was historically transferred to X’s transmission and distribution operations. During some periods, X sold a small amount of the power plant output to third parties. Registrant A expected to sell the output from the power plant to third parties, including X. At issue is whether A’s acquisition of the power plant meets the definition of a business under Rule 11-01(d).

According to the SEC staff, the acquisition of the power plant does not meet the definition of a business for SEC reporting purposes. At the joint meeting, the SEC staff noted:

Generally, the absence of third party sales is a persuasive indicator that historical information would not be meaningful. However, determinable market prices directly attributable to a commodity (such as posted oil prices for a producing property) may permit the preparation of meaningful historical financial information.

The SEC staff also stated that “pre-clearance may continue to be wise in many circumstances.”

Example C-10

**Acquisition Does Meet the Definition of a Business for SEC Reporting Purposes**

This example summarizes an issue discussed with the SEC staff.

Registrant B acquired 100 contracts, intellectual property, leases, and certain other assets from Registrant C. Registrant B also acquired the right and obligation to hire approximately 1,200 employees from C. Upon completion of the acquisition, B performed the activities obligated by the contracts; however, there were some changes in the cost structure and management. At issue is whether the acquisition meets the definition of a business under Rule 11-01(d).

The SEC staff concluded that B’s acquisition of 100 contracts, intellectual property, leases, and certain other assets meets the definition of a business under Rule 11-01(d). The SEC staff noted that the contractual nature of the revenue streams acquired suggests that the revenue-producing activity will generally remain the same. Changes in cost structure and management are not unusual after an acquisition. The SEC staff believes that the historical financial statements would be relevant to the understanding of future operations.
Paragraphs 2010.3 through 2010.6 of the FRM note that the following types of acquisitions may also meet the definition of a business:

- **An investment accounted for under the equity method** — According to Rule 3-05(a)(2)(ii), the definition of a business acquisition includes the purchase of an interest in a business accounted for under the equity method or, in lieu of the equity method, the fair value option. This definition also includes the acquisition of a joint venture investment that is accounted for under the equity method.

- **A working interest in an oil and gas property** — As discussed in paragraph 2010.4 of the FRM, the OCA of the Division of Corporation Finance “considers the acquisition of a working interest in an oil and gas property to be a business for reporting purposes.” Registrants should refer to Rule 3-05(f) for guidance on preparing financial statements for a business that includes oil and gas producing activities, including on when abbreviated financial statements will be accepted.

- **Customer deposits at bank branches** — Paragraph 2010.5 of the FRM states that the “assumption of customer deposits at bank branches may constitute the acquisition of a business if historical revenue producing activity is reasonably traceable to the management or customer and deposit base of the acquired branches, and that activity will remain generally the same following the acquisition.”

- **Blocks of insurance policies acquired by an insurance company and liabilities assumed in reinsurance transactions** — Paragraph 2010.6 of the FRM states that “[a]quisitions of blocks of insurance policies by an insurance company or the assumption of policy liabilities in reinsurance transactions may also be deemed the acquisition of a business because the right to receive future premiums generally indicates continuity of historical revenues. The degree of continuity between historical investment income streams and the assets acquired to fund the acquired policy liabilities should also be considered.”

In addition, a cost center (i.e., part of a company that incurs internal expenses but does not generate revenues) or an entity that has not commenced planned principal operations, or has commenced planned principal operations but has not generated significant revenue, may also meet the definition of a business. In such circumstances, the criteria in Rule 11-01(d) should be evaluated.

### C.5.3 Form 8-K Reporting — Acquisition of Assets That Does Not Meet the Definition of a Business for SEC Reporting Purposes

If the acquired asset or group of assets does not meet the definition of a business for SEC reporting purposes, the acquisition should be regarded as an asset acquisition and reported under Form 8-K, Item 2.01, if it exceeds the 10 percent threshold specified in the two significance tests in Instruction 4 (i.e., net book value of such assets or the amount paid or received for the assets compared with the registrant’s total assets).

The required disclosures for acquisitions of significant assets differ from the disclosures required for a significant business acquisition. Since Rule 3-05 does not apply, no historical financial statements need to be filed. However, the disclosures in Item 2.01 of Form 8-K should clearly (1) describe the assets acquired, (2) describe the anticipated effects on the registrant’s financial condition, and (3) indicate that the acquisition did not constitute the acquisition of a business. When such information would be material to investors, the registrant may consider including limited pro forma balance sheet information reflecting the effects of the asset acquisition (or include a narrative discussion, for example, when adjustments are easily understood).
The initial Form 8-K must be filed within four business days after consummation of the acquisition. If material, the pro forma balance sheet information must be included in the initial Form 8-K. The 71-calendar-day extension in Form 8-K, Item 9.01, that is available for a business acquisition is not available for an asset acquisition.

### C.5.4 Form 8-K Reporting — Acquisition of Assets That Meets the Definition of a Business for SEC Reporting Purposes

If the acquired asset or group of assets meets the definition of a business for SEC reporting purposes, the registrant should use Item 2.01 of Form 8-K to report the acquisition if it is significant. As noted in Instruction 4 and Regulation S-X, Rule 11-01(b), a business is significant if any of the results of the three significance tests in Regulation S-X, Rule 1-02(w) (i.e., the asset, income, and investment tests), exceed 20 percent.

To comply with Form 8-K, Item 2.01, the registrant must apply Rule 3-05, which generally requires the filing of separate preacquisition historical audited financial statements for the acquired business. The financial statement periods that a registrant is required to file (i.e., one or two years of audited financial statements) will be based on the highest significance level determined after the performance of the three tests in Rule 1-02(w). Unaudited preacquisition historical financial statements as of and for the appropriate interim periods preceding the acquisition may also be required. In addition, the registrant must provide pro forma financial information in accordance with Article 11 to give effect to the acquisition (see Section C.5.6).

The initial Form 8-K must be filed within four business days after consummation of the acquisition. If available, the historical and pro forma financial statements may be filed along with the initial Form 8-K. Otherwise, the registrant has an additional 71 calendar days to file an amended Form 8-K that includes these historical and pro forma financial statements.

### Connecting the Dots

A Form 8-K is not the only type of SEC filing in which financial statements of a significant consummated business acquisition may be required. For example, such information may also be required in a registration statement, prospectus supplement, or proxy statement. Note that the financial statement requirements in Rule 3-05 do not extend to target companies included in a proxy statement or registration statement on Form S-4. For example, a third year of financial statements for these companies may be required. See Section D.3.2 for more information on financial statement requirements under Rule 3-05.

A registrant is not required to file a Form 8-K that includes financial statements for a significant probable business acquisition. However, such information may be required in connection with a registration statement, prospectus supplement, or proxy statement.

See Section D.3.3 regarding when a registrant may want to seek relief from complying with Rule 3-05’s reporting requirements.
C.5.5 Form and Content of Financial Statements for an Asset or a Group of Assets That Meets the Definition of a Business for SEC Reporting Purposes

The form and content of the historical financial statements of an asset or a group of assets that meets the definition of a business for SEC reporting purposes may be as follows:

**Full Financial Statements**

If the acquired asset or group of assets represents substantially all of an entity, the entire entity's full audited financial statements (and unaudited interim financial statements, if appropriate) are generally required. Paragraph 2065.1 of the FRM states that in these circumstances, “full audited financial statements of the entity are presumed to be necessary in order to provide investors with the complete and comprehensive financial history of the acquired business.”

**Carve-Out Financial Statements**

Paragraph 2065.2 of the FRM notes that if the acquired asset or group of assets does not represent substantially all of the selling entity, “financial statements of the larger entity of which the acquired business was a part may not be informative.” Therefore, the audited financial statements (and unaudited interim financial statements, if appropriate) should only represent the selected parts of the entity acquired, excluding the operations retained by the seller. These financial statements are often referred to as **carve-out financial statements**. Carve-out financial statements include a balance sheet, a statement of operations (through net income), a statement of cash flows, a stockholders’ equity statement, and the respective notes to the financial statements. The SEC staff believes that carve-out financial statements should reflect (1) all assets and liabilities of the acquired business even if they are not acquired or assumed as part of the acquisition and (2) all costs of doing business. For further discussion, see Deloitte's *A Roadmap to Accounting and Financial Reporting for Carve-Out Transactions*. Also see SAB Topic 1.B as well as Sections 7200 and 7400 of the FRM.

**Abbreviated Financial Statements**

In certain circumstances, carve-out financial statements may not be practicable to prepare, such as when the acquired asset or group of assets is a small portion of, or a product line associated with, a much larger business and information necessary to prepare full financial statements is not available. In such instances, the SEC staff may allow registrants to provide abbreviated financial information — that is, audited statements of assets acquired and liabilities assumed (in lieu of a full balance sheet) and audited statements of revenues and direct expenses (in lieu of a full statement of operations) as well as unaudited interim statements, if appropriate — to meet the financial statement requirements in Rule 3-05. In accordance with the SEC's May 2020 final rule, if the following conditions are met, registrants may present such abbreviated financial statements for an acquiree without seeking permission from the SEC staff:

- The assets and revenue of the acquiree represent 20 percent or less of the assets and revenue of the seller as of and for the most recently completed fiscal year.
- The acquiree's financial statements have not been previously prepared.
- The acquiree was not a separate entity, subsidiary, operating segment, or division during the periods for which its financial statements would be required.
- The seller did not maintain the “distinct and separate accounts” that would be necessary for presentation of financial statements that include the omitted expenses, and the preparation of such financial statements is impracticable.
If these conditions are not met, registrants may submit a waiver request for permission to nonetheless present abbreviated financial statements. The abbreviated financial statements must include expenses incurred by or on behalf of the acquiree, including “costs of sales or services, selling, distribution, marketing, general and administrative, depreciation and amortization, and research and development.” Such statements may omit corporate overhead expense, interest expense for debt that will not be assumed, and income tax expense. The notes to the abbreviated financial statements should include:

- A description of the expenses excluded and why they were excluded.
- A statement that preparing financial statements that include the omitted expenses would be impracticable.
- An explanation that the abbreviated financial statements may not be indicative of the financial condition or results of operations of the acquiree going forward as a result of the omission of certain expenses.
- If available, disclosure of the acquiree’s operating, investing, and financing cash flows.

**Connecting the Dots**

When a registrant acquires (or it is probable that it will acquire) real estate operations, the registrant may be required to provide abbreviated income statements in accordance with SEC Regulation S-X, Rule 3-14, which differ in certain respects from those provided under Rule 3-05. For additional information about real estate operations, see Section D.10 of this Roadmap.

**C.5.6 Pro Forma Financial Information**

Article 11 lists several circumstances in which a registrant may be required to provide pro forma financial information, including when an acquisition of a significant business has occurred or is probable. Such circumstances include those in which the acquired asset or group of assets meets the definition of a business for SEC reporting purposes. Pro forma financial information for the appropriate periods may be required in a registration statement, proxy statement, or Form 8-K. For additional SEC interpretive guidance on Article 11, see Appendix D of this Roadmap.

When a registrant acquires an asset or a group of assets that does not meet the definition of a business for SEC reporting purposes, it may consider including limited pro forma balance sheet information (or a narrative discussion, for example, in cases in which adjustments are easily understood) reflecting the effects of the asset acquisition when such information would be material to investors.
Appendix D — SEC Reporting Considerations for Business Acquisitions

On May 20, 2020, the SEC issued a final rule that amends the financial statement requirements for acquisitions and dispositions of businesses, including real estate operations, and related pro forma financial information. The final rule is effective for fiscal years beginning after December 31, 2020; however, early application is permitted. The sections below outline general considerations related to the new requirements. For information regarding the requirements before adoption of the final rule, see the June 2020 edition of Deloitte’s A Roadmap to SEC Reporting Considerations for Business Combinations.

The discussion in this appendix addresses SEC reporting requirements for a domestic SEC registrant (an acquirer) that consummates or for which it is probable that it will consummate a business acquisition. Such a registrant may be required to file certain financial statements for the acquired or to be acquired business (the acquiree) under SEC Regulation S-X, Rule 3-05. For example, if an acquirer files a registration statement or a proxy statement, it may also be required to file separate financial statements for the acquiree in addition to its own financial statements. Including the acquiree’s separate preacquisition financial statements in a filing allows current and prospective investors to evaluate the future impact of the acquiree on the registrant’s consolidated results.

The following factors govern whether and, if so, for what period financial statements for the acquiree are required:

- Whether the acquired or to be acquired assets and liabilities meet the definition of a business in SEC Regulation S-X, Rule 11-01(d), which differs from the definition of a business in ASC 805.1
- Whether the business acquisition is probable or has occurred.
- The significance of the acquired or to be acquired business.

Pro forma information may also be required under SEC Regulation S-X, Article 11, for the acquisition or probable acquisition of a business (see Section D.8).

In addition, a registrant may acquire, or it may be probable that it will acquire, a significant amount of real estate operations under SEC Regulation S-X, Rule 3-14. See Section D.10 for a discussion of the financial statement and pro forma requirements for real estate operations.

For more information and interpretive guidance on these rules and other SEC requirements related to business acquisitions, see Deloitte’s June 2, 2020, Heads Up. Entities are also advised to consult with their independent auditors and legal counsel when applying such rules and requirements. For a discussion of the special considerations related to the filing of financial statements under Rule 3-05 in an IPO, see Section 2.4 of Deloitte’s A Roadmap to Initial Public Offerings.

1 See Section 2.4 for the definition of a business under U.S. GAAP.
D.1 Definition of a Business for SEC Reporting Purposes

A registrant is required to file the separate financial statements of an acquired or to be acquired business only if the acquiree meets the definition of a business for SEC reporting purposes in Rule 11-01(d). Because the definition of a business in Rule 11-01(d) is different from that under U.S. GAAP, a registrant must carefully evaluate Rule 11-01(d) to determine whether it has acquired a business for SEC reporting purposes. As noted in paragraph 2010.1 of the FRM, it is possible for the determination of a business to be different under Rule 11-01(d) and ASC 805.

The definition of a business in Rule 11-01(d) states, in part:

[T]he term business should be evaluated in light of the facts and circumstances involved and whether there is sufficient continuity of the acquired entity's operations prior to and after the transactions so that disclosure of prior financial information is material to an understanding of future operations. A presumption exists that a separate entity, a subsidiary, or a division is a business.

However, a lesser component, such as a product line or, for example, an entity that has not generated significant revenue to date, may also constitute a business. Rule 11-01(d) provides several attributes that should be considered in this determination, including:

- Whether the nature of the revenue-producing activity will generally remain the same after the acquisition.
- Whether any of the following attributes will remain after the acquisition: the physical facilities, employee base, market distribution system, sales force, customer base, operating rights, production techniques, or trade names.

The SEC staff's analysis of whether an acquisition meets the definition of a business focuses primarily on whether the nature of the revenue-producing activity generally remains the same after the acquisition. If the revenue-producing activity continues after the acquisition, it is presumed under SEC rules that a business was acquired and that prior financial information would be relevant to the understanding of future operations.²

Paragraphs 2010.3 through 2010.6 of the FRM provide additional examples of acquisitions that may also meet the definition of a business. For example, if the purchase of an interest in a business, including the acquisition of a joint venture investment, is accounted for as an equity method investment, the acquired interest generally meets the definition of a business.

The form in which the transaction takes place (e.g., the acquisition of assets and liabilities vs. the acquisition of a legal entity's stock) typically will not affect the determination of whether the acquiree is a business.

If a registrant acquires assets and liabilities that do not meet the definition of a business, Rule 3-05 does not apply. In that case, no financial statements are required to be filed, although other disclosures may be required under SEC rules (such as those required under Form 8-K, Items 1.01 and 2.01).

For additional considerations related to business versus asset acquisitions, see Section 1.3 of the June 2020 edition of Deloitte's A Roadmap to SEC Reporting Considerations for Business Combinations.

² See paragraph 2010.2 of the FRM for additional information.
D.2 Determining Whether a Business Acquisition Is Probable

The term “probable” is not defined in Rule 3-05; thus, determining whether an acquisition is probable requires a careful analysis of the specific facts and circumstances. Paragraph 2005.4 of the FRM states, in part, that an “acquisition is probable where registrant’s financial statements alone would not provide adequate financial information to make an investment decision.”

Registrants may consider the following list of factors (not all-inclusive) in determining whether an acquisition is probable for SEC reporting purposes:

- A signed definitive agreement or letter of intent.
- Approval from the board of directors or shareholders of the companies.
- Submission of the terms of the proposed transaction to appropriate regulatory agencies for approval.
- Public announcement of a business acquisition.

For more information, see Section 1.2 of the June 2020 edition of Deloitte’s A Roadmap to SEC Reporting Considerations for Business Combinations.

D.3 Determining Financial Statement Requirements

A registrant must calculate the significance of an acquiree to determine the number of periods, if any, for which the acquiree’s financial statements should be presented.

D.3.1 Measuring Significance

The paragraphs below outline the general requirements related to the three significance tests in SEC Regulation S-X, Rule 1-02(w), which can be quite complex. Entities are advised to consult with their independent auditors and legal counsel for assistance in applying them.

To determine whether separate acquiree financial statements are required and, if so, for what periods, a registrant must evaluate the significance of the business acquisition on the basis of the following tests:

- **Investment test** — The U.S. GAAP purchase price is compared with the aggregate worldwide market value of the registrant’s common equity (i.e., market capitalization). If there is no aggregate worldwide market value of the registrant’s common equity, the registrant’s total assets are used.
- **Asset test** — The registrant’s share of the acquiree’s total assets is compared with the registrant’s total assets.
- **Income test** — The income test consists of an income component and a revenue component:
  - **Income component** — The registrant’s share of the absolute value of the acquiree’s pretax income or loss from continuing operations\(^4\) is compared with the absolute value of the registrant’s pretax income or loss from continuing operations.
  - **Revenue component** — If both the registrant and the acquiree have material revenue in each of the two most recently completed fiscal years, the revenue component is calculated by comparing the registrant’s share of the acquiree’s revenue with the registrant’s revenue.

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\(^3\) See also SEC Codified Financial Reporting Release Section 506.02(c)(ii).

\(^4\) Rule 1-02(w) indicates that pretax income from continuing operations is “income from continuing operations before income taxes. . . attributable to the controlling interests.”
If either the registrant or the acquiree does not have material revenue for each of the two most recently completed fiscal years, only the income component should be used.

For income test purposes, an acquiree will only be considered significant if both the income component and the revenue component (if applicable) exceed the significance threshold (i.e., 20 percent). When both components exceed the significance threshold, the lower of the two components is used to determine the number of periods for which the acquiree’s financial statements are required.

Registrants must perform all three tests to determine the significance of an acquiree. The test that results in the highest significance level will determine whether an acquisition is significant and the financial statement periods that must be presented. Generally, the most recent preacquisition annual financial statements of both the acquirer and acquiree should be used for the tests (regardless of whether they have different fiscal year-ends).

While significance is generally calculated separately for each acquisition or probable acquisition, a registrant may need to aggregate multiple acquisitions in certain circumstances, such as when the acquired businesses are “related businesses,” or it may need to consider other factors, such as whether it owns an equity interest in a business and subsequently acquires an additional equity interest. A registrant may also need to aggregate multiple individually insignificant acquisitions when filing a registration or proxy statement. See Section 2.4.1.2 of Deloitte’s A Roadmap to Initial Public Offerings.

D.3.2 Financial Statement Requirements

The following table summarizes the general requirements for an acquiree’s financial statements at the various significance thresholds:

<table>
<thead>
<tr>
<th>Highest Level of Significance</th>
<th>Financial Statements Required</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consummated Business Acquisition</td>
<td></td>
</tr>
<tr>
<td>Less than 20 percent</td>
<td>• Acquisition is not individually significant; no financial statements are required</td>
</tr>
<tr>
<td>Exceeds 20 percent but not 40 percent</td>
<td>• Audited balance sheet as of the end of the most recent fiscal year</td>
</tr>
<tr>
<td></td>
<td>• Audited statements of operations, comprehensive income, cash flows, and changes in stockholders’ equity for the most recent fiscal year</td>
</tr>
<tr>
<td></td>
<td>• Unaudited financial statements as of and for the latest interim period required (the comparative prior-year interim period is not required)</td>
</tr>
<tr>
<td>Exceeds 40 percent</td>
<td>• Audited balance sheets as of the end of the two most recent fiscal years</td>
</tr>
<tr>
<td></td>
<td>• Audited statements of operations, comprehensive income, cash flows, and changes in stockholders’ equity for the two most recent fiscal years</td>
</tr>
<tr>
<td></td>
<td>• Unaudited financial statements as of and for the latest interim period required and the corresponding interim period of the prior year</td>
</tr>
</tbody>
</table>

5 There may be circumstances in which different financial statements are used to measure significance (e.g., certain pro forma financial statements and financial statements for the most recent fiscal year reported in the Form 10-K filed after the initial Form 8-K but before the due date of the amended Form 8-K. See Rule 11-01(b)(3)).

6 See Section 1.12.3 of Deloitte’s A Roadmap to SEC Reporting Considerations for Business Combinations for financial statements periods to be presented for an acquired or to be acquired foreign business.

7 See footnote 6.
(Table continued)

<table>
<thead>
<tr>
<th>Highest Level of Significance</th>
<th>Financial Statements Required</th>
</tr>
</thead>
<tbody>
<tr>
<td>Probable Business Acquisition</td>
<td></td>
</tr>
<tr>
<td>Less than 50 percent</td>
<td>• No financial statements are required</td>
</tr>
</tbody>
</table>
| Exceeds 50 percent            | • Audited balance sheets as of the end of the two most recent fiscal years  
                                | • Audited statements of operations, comprehensive income, cash flows, and changes  
                                |     in stockholders' equity for the two most recent fiscal years  
                                | • Unaudited financial statements as of and for the latest interim period required and  
                                |     the corresponding interim period of the prior year |

While the table above outlines the general financial statement requirements for an acquiree, there are exceptions to these rules. For example:

- SEC Regulation S-X, Rule 3-06, permits a registrant to provide audited financial statements of an acquiree for a period of nine to twelve months to satisfy the one-year requirement under Rule 3-05.

- In certain circumstances, a registrant may be able to omit an acquiree's annual and interim financial statements and the related pro forma information in a “draft registration statement” if the registrant reasonably believes that those financial statements will not be required at the time of the public filing (or, for EGCs, at the time of the offering). See Section 2.3.4 of Deloitte's A Roadmap to Initial Public Offerings for more information.

Note that the financial statement requirements under Rule 3-05 do not extend to (1) target companies included in a proxy statement or registration statement on Form S-4 or (2) a company that is considered the predecessor of a registrant. For these companies, a third year of acquiree financial statements may be required.

D.3.3 Rule 3-13 Waivers

Registrants may want to seek relief from complying with the reporting requirements under Rule 3-05, such as by omitting one or more years of an acquiree's financial statements. The SEC staff has acknowledged that relief may be warranted in some cases and has encouraged registrants to request relief or modifications to their reporting requirements under SEC Regulation S-X, Rule 3-13, when such requirements may not be material to the total mix of information available to investors. Therefore, if a registrant believes that the literal application of the significance test leads to a requirement for historical financial statements of the acquiree that are not material to investors, the registrant may submit a written request to the chief accountant of the Division of Corporation Finance to modify or waive the financial statement requirements specified by Rule 3-05.

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8 See footnote 6.
9 This guidance on the omission of financial information of an acquiree is consistent with certain accommodations that are available for the historical financial statements of the registrant. We believe that a registrant may similarly omit from its draft registration statement the related pro forma financial information required by Article 11.
10 See the C&DIs on Securities Act forms (Questions 101.04 and 101.05) and the FAST Act (Questions 1 and 2). See also Deloitte's August 24, 2017, Heads Up.
11 See paragraph 1170.1 of the FRM.
12 Rule 3-13 has historically given the staff authority to permit the omission or substitution of certain financial statements otherwise required by Regulation S-X “where consistent with the protection of investors.”
13 See Appendix B of Deloitte’s A Roadmap to SEC Comment Letter Considerations, Including Industry Insights for more information about such requests.
D.4 Filing Requirements

The types of SEC filings in which a registrant may be required to present historical financial statements of a significant business acquisition or significant probable business acquisition include the following:

- Form 8-K.
- Registration statements.
- Prospectus supplements.
- Proxy materials for business combinations.

Separate financial statements of a significant business acquisition or probable business acquisition are not required in annual or quarterly reports filed on Form 10-K or Form 10-Q.

D.5 Age of Acquiree’s Financial Statements

If a registrant is required to include the financial statements of an acquiree in a Form 8-K, registration statement, or merger proxy statement, the registrant must determine the specific annual and interim periods (i.e., the “age of financial statements”) for which the acquiree’s financial statements are required.

A registrant, as well as its acquirees, must comply with the requirements related to the age of financial statements in its filings. To determine the requirements for an acquiree, registrants may find it helpful to understand the general rules for determining the age of financial statements since Rule 3-05(b), which applies to acquirees, refers to that same guidance. The general rule for determining the age of the registrant’s financial statements to include in a filing is that the latest balance sheet must be as of a date no more than 134 days (129 days if the company is an accelerated filer or a large accelerated filer) before the filing date, the effective date of the registration statement, or the mailing date of a proxy statement. Under an exception to the general rule, additional time may be allowed before audited financial statements for the most recently completed fiscal year are required.

Note that a registrant may need to update the historical financial statements of an acquiree that were previously filed in a Form 8-K, registration statement, or proxy statement when the registrant subsequently files (or amends) a registration or proxy statement.

See Section 2045 of the FRM for a detailed discussion of the updated requirements and Section 1.11 of the June 2020 edition of Deloitte’s A Roadmap to SEC Reporting Considerations for Business Combinations for further interpretive guidance.

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14 See SEC Regulation S-X, Rule 3-12.
15 See Section 1.12.3 of the June 2020 edition of Deloitte’s A Roadmap to SEC Reporting Considerations for Business Combinations for information about financial statements periods to be presented for an acquired or to be acquired foreign business.
16 See Section D.7 on SEC filings that require pro forma financial information for a discussion of when such information may need to be updated.
Appendix D — SEC Reporting Considerations for Business Acquisitions

D.6 Pro Forma Financial Information

There are several situations in which pro forma financial information may be required (see Rule 11-01(a)). The following are some of the most common circumstances related to a business acquisition:

- A significant business acquisition has occurred or is probable.
- A significant acquisition of one or more real estate properties has occurred or is probable (see Section D.10 for more information).
- A significant business acquisition or a combination of entities under common control is probable or was consummated after the latest balance sheet date but is not yet reflected in the historical financial statements.

The objective of pro forma financial information is to enable investors to understand and evaluate how a specific transaction (or group of transactions) might have affected the registrant's historical financial position and results of operations had the transaction occurred at an earlier date. In certain circumstances, pro forma financial information may need to reflect multiple outcomes or transactions, such as pro forma information presented in a registration statement to reflect the impact of multiple significant acquisitions. Registrants must consider their specific facts and circumstances to determine whether pro forma information is meaningful to an investor and, if so, the appropriate manner of presenting it.

Factors that may affect whether a registrant is required to include pro forma financial information in a filing to reflect a business acquisition include the following:

- Whether the business acquisition is significant.
- Whether the separate financial statements of the acquired or to be acquired business are included in the filing.
- Whether the transaction is reflected in the historical financial statements.\(^{17}\)

D.7 SEC Filings That Require Pro Forma Financial Information

The types of SEC filings in which a registrant may be required to present pro forma financial information for a significant consummated or probable business acquisition include the following:

- Form 8-K.
- Registration statements.
- Proxy statements.
- Prospectus supplements.

Pro forma information is not required in annual or quarterly reports on Form 10-K or 10-Q, respectively. Note, however, that pro forma data that is required by U.S. GAAP under ASC 805 must be included in the notes to the financial statements in a Form 10-K or Form 10-Q, as appropriate (see Section 7.9).

Section 3.3.3 of the June 2020 edition of Deloitte’s A Roadmap to SEC Reporting Considerations for Business Combinations addresses whether a registrant needs to update pro forma financial information that was previously filed in a Form 8-K, registration statement, or proxy statement when it subsequently files (or amends) a registration or proxy statement. The registrant may be required to update the pro forma financial information even if Rule 3-05 does not require the acquiree’s historical financial statements to be updated (see Section D.5 for more information).

\(^{17}\) See Section D.3 regarding when pro forma financial information may be omitted from a draft registration statement.
D.8 Form and Content

SEC Regulation S-X, Rule 11-02, outlines the basic presentation requirements for pro forma financial information and the periods to be presented. Pro forma information generally includes a pro forma balance sheet and income statements, along with accompanying explanatory notes. Such statements may be presented in a condensed format similar to that required under SEC Regulation S-X, Article 10.

Rule 11-02(c)(1) indicates that a pro forma balance sheet should be presented “as of the end of the most recent period for which a consolidated balance sheet of the registrant is required by [SEC Regulation S-X, Rule 3-01] unless the transaction is already reflected in such balance sheet.” Only one pro forma balance sheet is required — either as of the end of the fiscal year or the subsequent interim period, whichever is later. Adjustments to the pro forma balance sheet should assume that the transaction occurred as of the balance sheet date presented.

Rule 11-02(c)(2) indicates that pro forma income statements should be presented for the most recent (1) fiscal year and (2) interim period (i.e., the period from the fiscal year-end to the most recent interim date for which a balance sheet is required by Rule 3-01). An exception exists for a transaction that requires the historical financial statements to be retrospectively revised (e.g., a combination of entities under common control and discontinued operations); in this case, pro forma income statements should be presented for all periods for which the registrant’s financial statements are required. A pro forma income statement does not, however, need to be presented when the “historical statement of comprehensive income reflects the transaction for the entire period.” For adjustments to the pro forma income statement, it should be assumed that the transaction occurred at the beginning of the most recent full fiscal year presented and was carried forward to the interim period, if applicable.

Pro forma financial information is generally presented in columnar form, with separate columns for the historical financial information, pro forma adjustments, and pro forma results. There are two categories of required pro forma adjustments and one optional disclosure:

- Transaction accounting adjustments (required).
- Autonomous entity adjustments (required).
- Management’s adjustments (optional disclosure).

Registrants should provide separate columns in their pro forma financial information for (1) historical financial information, (2) transaction accounting adjustments, and (3) autonomous entity adjustments as well as a pro forma total, which would include pro forma EPS. In the notes to the pro forma financial information, they must (1) clearly explain each adjustment and (2) detail any revenues, expenses, gains and losses, and related tax effects that will not recur in their statement of comprehensive income beyond a year from the transaction date.

In addition to the required adjustments noted above, registrants have the flexibility to present, in the explanatory notes to the pro forma financial information, management’s adjustments, which reflect synergies and dis-synergies identified by management when evaluating whether to consummate an acquisition. Management’s adjustments also may provide insight into the potential effects of the acquisition and the plans that management expects to take after the acquisition (which may include forward-looking information). When certain criteria are met, such adjustments that do not qualify as transaction accounting or autonomous entity adjustments may be made for, among other things, facilities closures, product line discontinuances, and employee terminations. When synergies are presented, any related dis-synergies must also be presented.

For additional information about the required pro forma adjustments and the optional disclosure of management’s adjustments, see Deloitte’s June 2, 2020, Heads Up.
D.9 Other Considerations

Registrants should be mindful of other considerations regarding the preparation of financial statements for an acquired or to be acquired business (the acquiree) under Rule 3-05 and pro forma financial information, including, but not limited to, those related to:

- **Form 8-K filing and timing requirements:**
  - Significant business acquisitions:
    - A registrant must file an initial Form 8-K within four business days of the consummation of a business acquisition that exceeds the 20 percent significance level. If they are available, the financial statements required by Rule 3-05 may be filed by the registrant along with the initial Form 8-K.\(^{18}\) Otherwise, the registrant has an additional 71 calendar days to file an amended Form 8-K that includes these financial statements.\(^{19}\)
    - A registrant may elect to report a business acquisition that does not exceed the 20 percent significance level in accordance with Form 8-K, Item 8.01.
  - Significant probable business acquisitions — A registrant is not required to file a Form 8-K that includes financial statements for a significant probable business acquisition. However, upon the consummation of such an acquisition, the registrant must comply with the applicable Form 8-K filing requirements.

- **Abbreviated financial statements** — Audited financial statements of assets acquired and liabilities assumed and statements of revenues and expenses (excluding corporate overhead, interest, and taxes) are referred to as abbreviated financial statements. When the following qualifying conditions are met, registrants are permitted to present such financial statements for an acquiree without seeking permission from the SEC staff:
  - The assets and revenue of the acquiree represent 20 percent or less of the assets and revenue of the seller as of and for the most recently completed fiscal year.
  - The acquiree financial statements have not been previously prepared.
  - The acquiree was not a separate entity, subsidiary, operating segment,\(^{20}\) or division during the periods for which acquiree financial statements would be required.
  - The seller did not maintain the “distinct and separate accounts” that would be necessary to present financial statements that include the omitted expenses, and the preparation of such financial statements is impracticable.

When the qualifying conditions are not met, registrants may consider requesting permission through a waiver request under Rule 3-13 (see Section D.3.3).

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\(^{18}\) In certain circumstances, the financial statements required by Rule 3-05 may not be required in a Form 8-K if they were previously filed by the registrant. See paragraph 2045.16 of the FRM and Section 1.11.1 of the June 2020 edition of Deloitte’s A Roadmap to SEC Reporting Considerations for Business Combinations for additional information.

\(^{19}\) If the registrant is a shell company, the financial statements and related pro forma financial information and all the content required by Form 10 must be filed in the initial Form 8-K. That is, the registrant does not have an additional 71 calendar days to include these financial statements. See Items 2.01(f) and 9.01(c) of Form 8-K and paragraphs 2040.1 and 12220.1(b) of the FRM.

\(^{20}\) ASC 280 defines operating segments. FPIs that report in accordance with IFRS Standards should refer to IFRS 8.
• **Foreign acquiree** — SEC rules and regulations for financial statements of a foreign acquiree differ depending on whether the foreign acquiree\(^{21}\) meets the definition of a foreign business,\(^{22}\) meets the definition of an FPI,\(^{23}\) or meets neither definition.
  
  o **Foreign acquiree that meets the definition of “foreign business” or “foreign private issuer”** — The financial statements of an acquiree that meets the definition of a foreign business, or of an FPI if the acquiree were a registrant, may be presented in accordance with (1) U.S. GAAP; (2) IFRS Standards as issued by the IASB without reconciliation to U.S. GAAP; or (3) home-country GAAP reconciled to either U.S. GAAP or to IFRS Standards as issued by the IASB if the registrant is an FPI that prepares its financial statements in accordance with IFRS Standards as issued by the IASB.
  
  o **Foreign acquiree** — The financial statements of a foreign acquiree that does not meet the definition of a foreign business or an FPI may be prepared in accordance with (1) U.S GAAP; (2) IFRS Standards, with reconciliation to U.S. GAAP; or (3) home-country GAAP reconciled to U.S. GAAP.

### D.10 Real Estate Operations

When a registrant consummates, or it is probable that it will consummate, a significant acquisition of real estate operations, the registrant may be required to file abbreviated income statements for the acquired or to be acquired real estate operations (acquiree) in accordance with Rule 3-14, as well as pro forma financial information. Note that the financial statement requirements under Rule 3-14 differ in certain respects from those under Rule 3-05, which are discussed above. Under Rule 3-14, registrants are required to file only abbreviated income statements for a significant acquiree for the most recent fiscal year and interim period.

Under Rule 3-14, the following factors govern whether a registrant is required to file the acquiree's abbreviated financial statements for a consummated or probable acquisition:

• **Whether a real estate operation has been or will be acquired** — Rule 3-14 applies to an acquisition of a real estate operation. The definition of a real estate operation is different from the determination of a business versus an asset acquisition for U.S. GAAP or SEC reporting purposes. Rule 3-14(a)(2)(i) defines a real estate operation as “a business . . . that generates substantially all of its revenues through the leasing of real property.” As indicated in paragraph 2305.2 of the FRM, such operations may include “office, apartment and industrial buildings as well as shopping centers and malls.” Conversely, operations that “are more susceptible to variations in costs and revenues over shorter periods” as a result of “market and managerial factors” (e.g., parking garages, assisted living facilities, “nursing homes, hotels, motels, golf courses, auto dealerships, and equipment rental operations”) are subject to the requirements of Rule 3-05. The abbreviated income statement(s) required by Rule 3-14 are “premised on the continuity and predictability of cash flows ordinarily associated with leasing real property.”

• **Whether the acquisition is significant** — The only significance test in Rule 3-14 is the investment test, under which the registrant's investment in the real estate operation (excluding any debt secured by the real properties that is assumed by the registrant) is compared to the registrant’s aggregate worldwide market value unless such value is not available. In that case, the registrant’s investment in the real estate operation (including any debt secured by the real properties that is assumed by the registrant) is compared with the registrant’s total assets as of the most recently

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\(^{21}\) A foreign acquiree, as used in the context of this publication, is an acquired or to be acquired business that is not incorporated in the United States.

\(^{22}\) See paragraph 6110.4 of the FRM.

\(^{23}\) See paragraph 6110.2 of the FRM.
completed fiscal year. Because many real estate companies rely on mortgages and other debt to finance their investments, total assets may exceed their aggregate worldwide market value. See the discussion below for further information.

A registrant's ability to file only abbreviated income statements for acquired or to be acquired real estate operations in accordance with Rule 3-14 is not affected by whether the real estate operation is a business for accounting purposes. For example, an apartment building may meet the definition of a business under ASC 805 but still be subject to Rule 3-14 rather than Rule 3-05. Similarly, an apartment building may not meet the definition of a business under ASC 805 (and thus be considered an asset) but still be subject to Rule 3-14 rather than the rules for an asset acquisition.

A registrant may be required to include the abbreviated income statements of acquired real estate operations in a Form 8-K, a registration statement, or proxy materials if the real estate operations are significant (see below). In addition, if the acquisition of real estate operations is deemed probable, the abbreviated income statements may need to be included in a registration statement or proxy materials. Abbreviated income statements of significant acquired or to be acquired real estate operations are not required in annual or quarterly reports on Form 10-K or 10-Q, respectively.

A registrant needs to perform only the investment test described in Rule 1-02(w) to determine the significance of real estate operations. The asset and income tests discussed in Section D.3.1 do not apply.

When acquired or to be acquired real estate operations are related to one another, a registrant must use the aggregate investment in these operations when performing the significance test.

A real estate operation is significant if the result of the investment test is greater than or equal to 10 percent of the registrant's total assets. For significant acquisitions of real estate operations, an entity must include preacquisition abbreviated income statements for one year and the subsequent year-to-date interim period. Further, for consummated acquisitions or probable acquisitions of significant real estate operations, registrants must provide pro forma financial information in accordance with Article 11.

24 Real estate operations acquired or to be acquired are related to one another if they are under common control or management, the acquisition of one real estate operation is conditioned on the acquisition of the other operations, or each acquisition is conditioned on a single common event.

25 See the exception in paragraph 2330.10 of the FRM for properties that either do not have any leasing history or have a nominal history (i.e., less than three months), in which case financial statements are not required. Note also that paragraph 2330.8 of the FRM allows a registrant to provide financial statements on an unaudited basis if the operating property has a limited rental history (i.e., more than three, but less than nine, months of operations).
Appendix E — Differences Between U.S. GAAP and IFRS Standards

Although ASC 805 and IFRS 3 were the result of a joint project between the FASB and the IASB, differences exist between the two standards. Certain differences have been present from the time the joint project was completed, some of which are because of differences in other U.S. GAAP or IFRS Standards. Other differences have resulted from subsequent standard setting. The table below summarizes the significant differences between ASC 805 and IFRS 3.

<table>
<thead>
<tr>
<th>Subject</th>
<th>ASC 805</th>
<th>IFRS 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Definition of control</td>
<td>The ASC master glossary defines a business combination as “[a] transaction or other event in which an acquirer obtains control of one or more businesses,” and acquirer as “[t]he entity that obtains control of the acquiree.” ASC 805 refers to the guidance in ASC 810-10 on determining the existence of a controlling financial interest in the assessment of control.</td>
<td>While IFRS 3 provides the same definitions of business combination and acquirer as ASC 805, IFRS 3 refers to the consolidation guidance in IFRS 10 on determining control. Differences between IFRS 10 and ASC 810-10 could lead to differences in the determination of whether a transaction is a business combination and in the identification of the acquirer.</td>
</tr>
<tr>
<td>Identifying the acquirer if the acquiree is a VIE</td>
<td>Under ASC 805-10-25-5, “in a business combination in which a variable interest entity (VIE) is acquired, the primary beneficiary of that entity always is the acquirer.”</td>
<td>IFRS 3 does not include similar guidance because there is no VIE model under IFRS Standards.</td>
</tr>
<tr>
<td>Definition of a business — screen (i.e., concentration test under IFRS 3)</td>
<td>ASC 805 requires an entity to evaluate whether substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets (the “screen”). If the screen is met, the set would not be considered a business. The use of the screen is mandatory.</td>
<td>IFRS 3 includes a concentration test that is similar to the screen in ASC 805; however, its use is optional.</td>
</tr>
<tr>
<td>Definition of a business — substantive processes</td>
<td>Under ASC 805, an acquired contract (e.g., outsourcing arrangement) cannot provide a substantive process if the set does not have outputs.</td>
<td>IFRS 3 allows an acquired contract to be considered a substantive process even if the set does not have outputs if it provides access to an assembled workforce that performs a critical process that the entity controls.</td>
</tr>
</tbody>
</table>
### Appendix E — Differences Between U.S. GAAP and IFRS Standards

<table>
<thead>
<tr>
<th>Subject</th>
<th>ASC 805</th>
<th>IFRS 3</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Noncontrolling interests and goodwill — initial measurement</strong></td>
<td>ASC 805 requires entities to recognize and measure noncontrolling interests at fair value.</td>
<td>Under IFRS 3, an entity must make an accounting policy election, on an acquisition-by-acquisition basis, to measure certain components of a noncontrolling interest either at (1) the noncontrolling interest's proportionate share of the net fair value of the acquiree's identifiable net assets (referred to as the &quot;proportionate share method&quot;) or (2) fair value (i.e., the &quot;full goodwill&quot; approach). The latter approach is consistent with that in ASC 805.</td>
</tr>
<tr>
<td><strong>Liabilities arising from contingencies (i.e., contingent liabilities under IFRS Standards) — recognition and initial measurement</strong></td>
<td>Under ASC 805, a liability arising from a contingency is recognized at fair value, if determinable, as of the measurement (acquisition) date. If the fair value cannot be determined, the entity will recognize a liability if both (1) &quot;[i]nformation available before the end of the measurement period indicates that it is probable that . . . a liability had been incurred at the acquisition date&quot; and (2) the &quot;amount of the . . . liability can be reasonably estimated.&quot;</td>
<td>An entity recognizes a liability arising from a contingency at fair value if it (1) is a present obligation that results from a past event and (2) can be measured reliably.</td>
</tr>
<tr>
<td><strong>Assets arising from contingencies (i.e., contingent assets under IFRS Standards) — recognition and initial measurement</strong></td>
<td>Under ASC 805, an asset arising from a contingency is recognized at fair value, if determinable, as of the measurement (acquisition) date. If fair value cannot be determined, the entity will recognize an asset if both (1) &quot;[i]nformation available before the end of the measurement period indicates that it is probable that an asset existed . . . at the acquisition date&quot; and (2) the &quot;amount of the asset . . . can be reasonably estimated.&quot;</td>
<td>An entity is not permitted to recognize a contingent asset in a business combination.</td>
</tr>
</tbody>
</table>
| **Liabilities arising from contingencies (i.e., contingent liabilities under IFRS Standards) — subsequent measurement** | There is no specific guidance in U.S. GAAP on subsequent measurement. ASC 805-20-35-3 requires entities to subsequently account for liabilities arising from contingencies on a "systematic and rational basis . . . depending on their nature." | An entity recognizes a contingent liability at the higher of:
- The amount calculated as the best estimate of the expenditure needed to settle the present obligation at the end of the reporting period.
- The acquisition-date fair value less the cumulative amortization recognized in accordance with IFRS 15 (if appropriate). |
(Table continued)

<table>
<thead>
<tr>
<th>Subject</th>
<th>ASC 805</th>
<th>IFRS 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets arising from contingencies (i.e., contingent assets under IFRS Standards) — subsequent measurement</td>
<td>There is no specific guidance in U.S. GAAP on subsequent measurement. ASC 805-20-35-3 requires entities to subsequently account for assets arising from contingencies on a “systematic and rational basis . . . depending on their nature.”</td>
<td>Under IFRS Standards, recognition is appropriate only when realization of the income is virtually certain and therefore the related asset is no longer contingent.</td>
</tr>
<tr>
<td>Operating leases (after the adoption of ASC 842)</td>
<td>If the acquiree is the lessor in an operating lease, the acquirer separately recognizes an intangible asset or liability if the terms of the lease are favorable or unfavorable, respectively, relative to current market terms.</td>
<td>As indicated in paragraph B42 of IFRS 3, if the acquiree is the lessor in an operating lease, any favorable or unfavorable terms of the operating lease are recognized as part of the fair value of the leased asset (i.e., no separate asset or liability is recognized), which is consistent with the guidance in IAS 40.</td>
</tr>
<tr>
<td>Operating leases (before the adoption of ASC 842)</td>
<td>Regardless of whether the acquiree is the lessee or the lessor in an operating lease, ASC 805 requires entities to separately recognize an intangible asset or liability if the terms of the lease are favorable or unfavorable, respectively, relative to current market terms.</td>
<td>As indicated in paragraph B42 of IFRS 3, if the acquiree is the lessor in an operating lease, any favorable or unfavorable terms of the operating lease are recognized as part of the fair value of the leased asset (i.e., no separate asset or liability is recognized), which is consistent with the guidance in IAS 40.</td>
</tr>
<tr>
<td>Deferred taxes and uncertain tax positions</td>
<td>ASC 805 requires entities to recognize and measure deferred taxes and uncertain tax positions in accordance with ASC 740, which is not converged with IAS 12.</td>
<td>As indicated in paragraphs 24 and 25 of IFRS 3, entities must recognize and measure deferred taxes and uncertain tax positions in accordance with IAS 12, which is not converged with ASC 740. For example, IAS 12 does not provide explicit guidance on the recognition and measurement of uncertain tax positions.</td>
</tr>
<tr>
<td>Employee benefits</td>
<td>Under ASC 805, entities must recognize and measure employee benefits in accordance with existing standards (e.g., ASC 715), which are not converged with IFRS Standards.</td>
<td>Paragraph 26 of IFRS 3 requires entities to recognize and measure employee benefits in accordance with IAS 19, which is not converged with U.S. GAAP.</td>
</tr>
<tr>
<td>Contingent consideration — initial classification</td>
<td>Entities must classify contingent consideration as a liability, equity, or an asset in accordance with U.S. GAAP (e.g., ASC 480-10, ASC 815-10, ASC 815-40), which is not converged with IFRS Standards.</td>
<td>Paragraph 40 of IFRS 3 requires entities to classify contingent consideration as a liability, equity, or an asset in accordance with existing IFRS Standards, such as IAS 32. Because U.S. GAAP and IFRS Standards are not converged, differences in the initial classification could lead to differences in the subsequent accounting.</td>
</tr>
<tr>
<td>Subject</td>
<td>ASC 805</td>
<td>IFRS 3</td>
</tr>
<tr>
<td>------------------------------------------------------------------------</td>
<td>------------------------------------------------------------------------</td>
<td>------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Share-based payment awards — initial measurement</td>
<td>Entities must initially recognize and measure share-based payment awards in accordance with ASC 718, which is not converged with IFRS 2. The two standards’ implementation guidance also differs.</td>
<td>Paragraphs 30 and B56–B62B of IFRS 3 require entities to initially recognize and measure share-based payment awards in accordance with IFRS 2, which is not converged with ASC 718. Differences between ASC 718 and IFRS 2 may lead to differences in the accounting for share-based payment awards. The two standards’ implementation guidance also differs.</td>
</tr>
<tr>
<td>Measurement-period adjustments</td>
<td>As a result of the amendments to ASC 805 made by ASU 2015-16, an acquirer must recognize adjustments to provisional amounts identified during the measurement period in the reporting period in which the adjustments are determined rather than retrospectively.</td>
<td>Paragraph 49 of IFRS 3 requires adjustments to provisional amounts identified during the measurement period to be recognized on a retrospective basis as if the accounting for the business combination had been completed on the acquisition date.</td>
</tr>
<tr>
<td>Disclosure of pro forma financial information</td>
<td>Required for public entities only:</td>
<td>Required for all entities:</td>
</tr>
<tr>
<td></td>
<td>In accordance with ASC 805-10-50-2(h), if comparative financial statements are presented, the acquirer must disclose “the revenue and earnings of the combined entity . . . as though the business combination(s) that occurred during the current year had occurred as of the beginning of the comparable prior annual reporting period.”</td>
<td>As indicated in paragraph B64(q) of IFRS 3, disclosure of revenue and profit or loss of the combined entity for the comparable prior period is not required even if comparative financial statements are presented.</td>
</tr>
<tr>
<td>Disclosure of a gain or loss recognized after the acquisition date related to the identifiable assets acquired</td>
<td>Under ASC 805, there is no disclosure requirement for gains or losses recognized in connection with identifiable assets acquired in a business combination.</td>
<td>In accordance with paragraph B67(e) of IFRS 3, an acquirer must disclose “the amount and an explanation of any gain or loss recognised in the current reporting period that both: i. relates to the identifiable assets acquired or liabilities assumed in a business combination that was effected in the current or previous reporting period; and ii. is of such a size, nature or incidence that disclosure is relevant to understanding the combined entity’s financial statements.”</td>
</tr>
<tr>
<td>Pushdown accounting</td>
<td>An acquired entity has the option to apply pushdown accounting in its separate financial statements.</td>
<td>IFRS Standards provide no authoritative guidance on the application of pushdown accounting. In practice, IFRS preparers do not apply pushdown accounting to the separate financial statements of an acquiree.</td>
</tr>
<tr>
<td>Common control</td>
<td>Assets and liabilities transferred between entities under common control are generally recognized at their historical carrying amounts, as reflected in the parent’s financial statements.</td>
<td>IFRS Standards provide no authoritative guidance on the accounting for transfers of businesses between entities under common control. In practice, entities can elect to apply either the acquisition method or the predecessor’s historical cost.</td>
</tr>
</tbody>
</table>
Appendix F — Titles of Standards and Other Literature

AICPA Literature

Accounting and Valuation Guide
Assets Acquired to Be Used in Research and Development Activities

Issues Paper
Identification and Discussion of Certain Financial Accounting and Reporting Issues Concerning LIFO Inventories

EITF Literature
Issue No. 18-A, “Recognition Under Topic 805 for an Assumed Liability in a Revenue Contract”

FASB Literature

ASC Topics
ASC 205, Presentation of Financial Statements
ASC 250, Accounting Changes and Error Corrections
ASC 260, Earnings per Share
ASC 270, Interim Reporting
ASC 280, Segment Reporting
ASC 310, Receivables
ASC 320, Investments — Debt and Equity Securities
ASC 323, Investments — Equity Method and Joint Ventures
ASC 325, Investments — Other
ASC 326, Financial Instruments — Credit Losses
ASC 330, Inventory
ASC 340, Other Assets and Deferred Costs
ASC 350, Intangibles — Goodwill and Other
ASC 360, Property, Plant, and Equipment
ASC 405, Liabilities
ASC 410, Asset Retirement and Environmental Obligations
ASC 420, Exit or Disposal Cost Obligations
ASC 450, Contingencies
ASC 460, Guarantees
ASC 470, Debt
ASC 480, Distinguishing Liabilities From Equity
ASC 505, Equity
ASC 605, Revenue Recognition
ASC 606, Revenue From Contracts With Customers
ASC 610, Other Income
ASC 710, Compensation — General
ASC 712, Compensation — Nonretirement Postemployment Benefits
ASC 715, Compensation — Retirement Benefits
ASC 718, Compensation — Stock Compensation
ASC 730, Research and Development
ASC 740, Income Taxes
ASC 805, Business Combinations
ASC 810, Consolidation
ASC 815, Derivatives and Hedging
ASC 820, Fair Value Measurement
ASC 825, Financial Instruments
ASC 830, Foreign Currency Matters
ASC 835, Interest
ASC 840, Leases
ASC 842, Leases
ASC 845, Nonmonetary Transactions
ASC 850, Related Party Disclosures
ASC 852, Reorganizations
ASC 855, Subsequent Events
ASC 860, Transfers and Servicing
ASC 930, Extractive Activities — Mining
ASC 944, Financial Services — Insurance
ASC 946, Financial Services — Investment Companies
ASC 958, Not-for-Profit Entities
ASC 960, Plan Accounting — Defined Benefit Pension Plans
ASC 965, Plan Accounting — Health and Welfare Benefit Plans
ASC 980, Regulated Operations

**ASUs**

ASU 2013-12, Definition of a Public Business Entity — An Addition to the Master Glossary

ASU 2014-02, Intangibles — Goodwill and Other (Topic 350): Accounting for Goodwill — a consensus of the Private Company Council


ASU 2014-17, Business Combinations (Topic 805): Pushdown Accounting — a consensus of the FASB Emerging Issues Task Force

ASU 2014-18, Business Combinations (Topic 805): Accounting for Identifiable Intangible Assets in a Business Combination — a consensus of the Private Company Council

ASU 2015-02, Consolidation (Topic 810): Amendments to the Consolidation Analysis

ASU 2015-03, Interest — Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs

ASU 2015-08, Business Combinations (Topic 805): Pushdown Accounting — Amendments to SEC Paragraphs Pursuant to Staff Accounting Bulletin No. 115 (SEC Update)

ASU 2015-16, Business Combinations (Topic 805): Simplifying the Accounting for Measurement-Period Adjustments

ASU 2016-02, Leases (Topic 842)

ASU 2016-13, Financial Instruments — Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments

ASU 2017-01, Business Combinations (Topic 805): Clarifying the Definition of a Business

ASU 2018-07, Compensation — Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting

ASU 2018-17, Consolidation (Topic 810): Targeted Improvements to Related Party Guidance for Variable Interest Entities

ASU 2019-06, Intangibles — Goodwill and Other (Topic 350), Business Combinations (Topic 805), and Not-for-Profit Entities (Topic 958): Extending the Private Company Accounting Alternatives on Goodwill and Certain Identifiable Intangible Assets to Not-for-Profit Entities

ASU 2020-05, Revenue From Contracts With Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities

ASU 2020-06, Debt — Debt With Conversion and Other Options (Subtopic 470-20) and Derivatives and Hedging — Contracts in Entity’s Own Equity (Subtopic 815-40): Accounting for Convertible Instruments and Contracts in an Entity’s Own Equity
Proposed ASU
No. 2019-600, Disclosure Improvements: Codification Amendments in Response to SEC’s Disclosure Update and Simplification Initiative

Concepts Statements
No. 5, Recognition and Measurement in Financial Statements of Business Enterprises
No. 6, Elements of Financial Statements — a replacement of FASB Concepts Statement No. 3 (incorporating an amendment of FASB Concepts Statement No. 2)

Invitation to Comment
No. 2019-720, Identifiable Intangible Assets and Subsequent Accounting for Goodwill

IFRS Literature
IFRS 2, Share-Based Payment
IFRS 3, Business Combinations
IFRS 8, Operating Segments
IFRS 10, Consolidated Financial Statements
IFRS 15, Revenue From Contracts With Customers
IAS 12, Income Taxes
IAS 19, Employee Benefits
IAS 32, Financial Instruments: Presentation
IAS 40, Investment Property

PCAOB Literature
Auditing Standard
AU Section 558, Required Supplementary Information

SEC Literature
Codified Financial Reporting Release
Section 506.02(c)(ii), “Business to Be Acquired and Other Transactions Not Yet Consummated”

FRM Topics
Topic 1, “Registrant’s Financial Statements”
Topic 2, “Other Financial Statements Required”
Topic 6, “Foreign Private Issuers”
Topic 7, “Related Party Matters”
Topic 12, “Reverse Acquisitions and Reverse Recapitalizations”
**Regulation M-A**

Item 1015, “Reports, Opinions, Appraisals and Negotiations”

**Regulation S-K**

Item 601, “Exhibits”
- Item 601(b), “Description of Exhibits”

**Regulation S-X**

Rule 1-02, “Definitions of Terms Used in Regulation S-X (17 CFR part 210)”
- Rule 1-02(w), “Significant Subsidiary”

Rule 3-01, “Consolidated Balance Sheets”

Rule 3-05, “Financial Statements of Businesses Acquired or to Be Acquired”

Rule 3-06, “Financial Statements Covering a Period of Nine to Twelve Months”

Rule 3-09, “Separate Financial Statements of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons”

Rule 3-12, “Age of Financial Statements at Effective Date of Registration Statement or at Mailing Date of Proxy Statement”

Rule 3-13, “Filing of Other Financial Statements in Certain Cases”

Rule 3-14, “Special Instructions for Real Estate Operations to Be Acquired”

Rule 4-08, “General Notes to the Financial Statements”
- Rule 4-08(g), “Summarized Financial Information of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons”

Article 10, “Interim Financial Statements”

Article 11, “Pro Forma Financial Information”
- Rule 11-01, “Presentation Requirements”
- Rule 11-02, “Preparation Requirements”

**SAB Topics**


No. 2.A, “Acquisition Method”

No. 5.A, “Expenses of Offering”

No. 5.J, “New Basis of Accounting Required in Certain Circumstances” (rescinded by SAB 115)

No. 5.L, “LIFO Inventory Practices”

No. 5.T, “Accounting for Expenses or Liabilities Paid by Principal Stockholder(s)”

No. 5.Y, “Accounting and Disclosures Relating to Loss Contingencies”

No. 5.Z, “Accounting and Disclosure Regarding Discontinued Operations”

No. 115, [Untitled]
Securities Act of 1933 Rules
Rule 408, “Additional Information”
Rule 436, “Consents Required in Special Cases”

Superseded Literature

AICPA Accounting Principles Board (APB)
Opinion 16, Business Combinations
Opinion 18, The Equity Method of Accounting for Investments in Common Stock

EITF Issues and Topics
Issue 85-21, “Changes of Ownership Resulting in a New Basis of Accounting”
Issue 01-10, “Accounting for the Impact of the Terrorist Attacks of September 11, 2001”
Issue 02-5, “Definition of ‘Common Control’ in Relation to FASB Statement No. 141”
Issue 02-17, “Recognition of Customer Relationship Intangible Assets Acquired in a Business Combination”
Issue 08-6, “Equity Method Investment Accounting Considerations”
Issue 08-7, “Accounting for Defensive Intangible Assets”
Issue 09-2, “Research and Development Assets Acquired in an Asset Acquisition”
Topic D-97, “Push-Down Accounting”
Topic D-108, “Use of the Residual Method to Value Acquired Assets Other Than Goodwill”

FASB Statements
No. 5, Accounting for Contingencies
No. 87, Employers’ Accounting for Pensions
No. 106, Employers’ Accounting for Postretirement Benefits Other Than Pensions
No. 109, Accounting for Income Taxes
No. 112, Employers’ Accounting for Postemployment Benefits — an amendment of FASB Statements No. 5 and 43
No. 133, Accounting for Derivative Instruments and Hedging Activities
No. 141, Business Combinations
No. 141(R), Business Combinations
No. 142, Goodwill and Other Intangible Assets
No. 160, Noncontrolling Interests in Consolidated Financial Statements — an amendment of ARB No. 51
FASB Interpretation
FIN 45, Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others — an interpretation of FASB Statements No. 5, 57, and 107 and rescission of FASB Interpretation No. 34

FASB Staff Position (FSP)
FSP FAS 141(R)-1, Accounting for Assets Acquired and Liabilities Assumed in a Business Combination That Arise From Contingencies

FASB Technical Bulletin
No. 85-5, Issues Relating to Accounting for Business Combinations
## Appendix G — Abbreviations

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>AICPA</td>
<td>American Institute of Certified Public Accountants</td>
</tr>
<tr>
<td>APB</td>
<td>FASB Accounting Principles Board</td>
</tr>
<tr>
<td>APIC</td>
<td>additional paid-in capital</td>
</tr>
<tr>
<td>ARO</td>
<td>asset retirement obligation</td>
</tr>
<tr>
<td>ASC</td>
<td>FASB Accounting StandardsCodification</td>
</tr>
<tr>
<td>ASU</td>
<td>FASB Accounting Standards Update</td>
</tr>
<tr>
<td>C&amp;DI</td>
<td>SEC Compliance and Disclosure Interpretation</td>
</tr>
<tr>
<td>CAQ</td>
<td>Center for Audit Quality</td>
</tr>
<tr>
<td>CEO</td>
<td>chief executive officer</td>
</tr>
<tr>
<td>CFR</td>
<td>Code of Federal Regulations</td>
</tr>
<tr>
<td>EBIT</td>
<td>earnings before interest and taxes</td>
</tr>
<tr>
<td>EBITDA</td>
<td>earnings before interest, taxes, depreciation, and amortization</td>
</tr>
<tr>
<td>EITF</td>
<td>Emerging Issues Task Force</td>
</tr>
<tr>
<td>EPS</td>
<td>earnings per share</td>
</tr>
<tr>
<td>FASB</td>
<td>Financial Accounting Standards Board</td>
</tr>
<tr>
<td>FAST Act</td>
<td>Fixing America’s Surface Transportation Act</td>
</tr>
<tr>
<td>FCC</td>
<td>Federal Communications Commission</td>
</tr>
<tr>
<td>FDA</td>
<td>U.S. Food and Drug Administration</td>
</tr>
<tr>
<td>FIFO</td>
<td>first in, first out</td>
</tr>
<tr>
<td>FRM</td>
<td>SEC Division of Corporation Finance’s Financial Reporting Manual</td>
</tr>
<tr>
<td>FSP</td>
<td>FASB Statement of Position</td>
</tr>
<tr>
<td>FTB</td>
<td>FASB Technical Bulletin</td>
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</table>

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>GAAP</td>
<td>generally accepted accounting principles</td>
</tr>
<tr>
<td>IAS</td>
<td>International Accounting Standard</td>
</tr>
<tr>
<td>IASB</td>
<td>International Accounting Standards Board</td>
</tr>
<tr>
<td>IFRS</td>
<td>International Financial Reporting Standard</td>
</tr>
<tr>
<td>IPO</td>
<td>initial public offering</td>
</tr>
<tr>
<td>IPR&amp;D</td>
<td>in-process research and development</td>
</tr>
<tr>
<td>LIFO</td>
<td>last in, first out</td>
</tr>
<tr>
<td>MD&amp;A</td>
<td>Management’s Discussion and Analysis</td>
</tr>
<tr>
<td>MLP</td>
<td>master limited partnership</td>
</tr>
<tr>
<td>NFP</td>
<td>not-for-profit</td>
</tr>
<tr>
<td>OPEB</td>
<td>other postemployment benefits</td>
</tr>
<tr>
<td>OCA</td>
<td>SEC Office of the Chief Accountant</td>
</tr>
<tr>
<td>PBE</td>
<td>public business entity</td>
</tr>
<tr>
<td>PCAOB</td>
<td>Public Company Accounting Oversight Board</td>
</tr>
<tr>
<td>PCC</td>
<td>Private Company Council</td>
</tr>
<tr>
<td>PP&amp;E</td>
<td>property, plant, and equipment</td>
</tr>
<tr>
<td>R&amp;D</td>
<td>research and development</td>
</tr>
<tr>
<td>ROU</td>
<td>right of use</td>
</tr>
<tr>
<td>SAB</td>
<td>SEC Staff Accounting Bulletin</td>
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<tr>
<td>SEC</td>
<td>Securities and Exchange Commission</td>
</tr>
<tr>
<td>SFAS</td>
<td>Statement of Financial Accounting Standards</td>
</tr>
<tr>
<td>SPAC</td>
<td>special-purpose acquisition company</td>
</tr>
<tr>
<td>Abbreviation</td>
<td>Description</td>
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<tr>
<td>--------------</td>
<td>------------------------------------------------</td>
</tr>
<tr>
<td>TSA</td>
<td>transition services agreement</td>
</tr>
<tr>
<td>VBPP</td>
<td>value beyond proven and probable reserves</td>
</tr>
<tr>
<td>VIE</td>
<td>variable interest entity</td>
</tr>
<tr>
<td>VRG</td>
<td>FASB's Valuation Resource Group</td>
</tr>
</tbody>
</table>
# Appendix H — Changes Made in the 2020 Edition of This Publication

The table below summarizes the substantive changes made in the 2020 edition of this Roadmap.

<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.5</td>
<td>SEC Reporting for Business Combinations</td>
<td>Section updated to reflect the SEC’s May 20, 2020, issuance of a final rule that amends the financial statement requirements for acquisitions and disposions of businesses, including real estate operations, and related pro forma financial information.</td>
</tr>
<tr>
<td>2.2.4</td>
<td>Multiple Arrangements With a Seller That Result in a Business Combination</td>
<td>Section added to describe factors entities should consider in determining whether multiple acquisition transactions should be viewed as a single business combination.</td>
</tr>
<tr>
<td>2.4.1.4</td>
<td>Transactions That Are Separate From the Business Combination</td>
<td>Section added to clarify that transactions that are determined to be separate from the business combination should be excluded from the acquired set in the determination of whether it represents a business.</td>
</tr>
<tr>
<td>2.4.2.3</td>
<td>Step 3 — Measure the Fair Value of the Gross Assets Acquired</td>
<td>Discussion added to clarify the treatment of AROs in the performance of the screen test.</td>
</tr>
<tr>
<td>2.4.3.2</td>
<td>Sets Without Outputs</td>
<td>Discussions added to (1) help entities determine whether an acquired organized workforce has the necessary skills, knowledge, or experience to perform a critical process and (2) clarify that a set must also have at least one input to be a business.</td>
</tr>
<tr>
<td>2.4.3.3</td>
<td>Sets With Outputs</td>
<td>Discussion added to clarify that an acquired contract may represent an input and that a transition services arrangement generally would not represent a substantive process.</td>
</tr>
<tr>
<td>4.3.11.1.3</td>
<td>Acquiree Is the Lessee in an Operating or Finance Lease</td>
<td>Discussions added to clarify how (1) the acquirer determined the incremental borrowing rate and (2) off-market terms are considered in an acquired related-party lease.</td>
</tr>
<tr>
<td>4.3.11.1.7</td>
<td>Favorable or Unfavorable Terms in Leases</td>
<td>Discussion added to clarify that the recognition of favorable or unfavorable terms in a lease arrangement in sublease transactions where the lessee/intermediate lessor is not relieved of its primary obligation under the head lease arrangement.</td>
</tr>
</tbody>
</table>
(Table continued)

<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>6.2.2.3</td>
<td>Settlement of a Preexisting Relationship if the Acquirer Had Previously Recognized an Asset or Liability</td>
<td>Discussion and example added to clarify the accounting when an acquirer has recognized an asset or liability related to the preexisting relationship before the acquisition. Also renumbered and reorganized the guidance in Sections 6.2.2.3 through 6.2.2.7.</td>
</tr>
<tr>
<td>6.2.2.3.1</td>
<td>Effective Settlement of Debt Between the Parties to a Business Combination</td>
<td>Discussion and example added to clarify the accounting for the effective settlement of debt between an acquirer and an acquiree.</td>
</tr>
<tr>
<td>6.8.8</td>
<td>Public Shell Corporations and SPACs</td>
<td>Discussion added to clarify the process for identifying the accounting acquirer in the acquisition of a private operating company by a SPAC.</td>
</tr>
<tr>
<td>A.10</td>
<td>Goodwill and Bargain Purchase Gains</td>
<td>Deleted Example A-3 and moved guidance to Section 3.4.1 of Deloitte's <em>A Roadmap to Impairments and Disposals of Long-Lived Assets and Discontinued Operations</em>.</td>
</tr>
<tr>
<td>C.2</td>
<td>Measuring the Cost of an Asset Acquisition</td>
<td>Discussion added describing diversity in practice related to measuring the cost when the acquirer's equity securities are used as consideration.</td>
</tr>
<tr>
<td>C.5</td>
<td>SEC Reporting Considerations Related to Asset Acquisitions</td>
<td>Section updated to reflect the SEC's May 20, 2020, issuance of a final rule that amends the financial statement requirements for acquisitions and dispositions of businesses, including real estate operations, and related pro forma financial information.</td>
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<tr>
<td>Appendix D</td>
<td>SEC Reporting Considerations for Business Combinations</td>
<td>Appendix updated to reflect the SEC's May 20, 2020, issuance of a final rule that amends the financial statement requirements for acquisitions and dispositions of businesses, including real estate operations, and related pro forma financial information.</td>
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