BLUEPRINT: A BDO SERIES

Business Combinations Under ASC 805

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Introduction

Mergers and acquisitions are common ways for entities to grow; however, because of the uniqueness of each transaction and the infinite ways deals can be structured, the accounting can be complex. To make things more challenging, the accounting for mergers and acquisitions is different for a business combination (the acquisition of a business), an asset acquisition (the acquisition of an asset or group of assets), or an in-substance capital transaction or recapitalization (the acquisition of assets that primarily consist of cash and investments).

Accounting Standards Codification (ASC) 805, *Business Combinations,* provides guidance for accounting and reporting for both business combinations and asset acquisitions. More specifically, ASC 805-10 through ASC 805-40 provides guidance for accounting for business combinations, and ASC 805-50 provides guidance for accounting for asset acquisitions.

ACCOUNTING FOR BUSINESS COMBINATIONS – IN A NUTSHELL

For acquisitions that qualify as business combinations, ASC 805 requires the use of the acquisition method, which includes the following steps:

- Identifying the acquirer
- Determining the acquisition date
- Recognizing and measuring the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest (NCI) in the acquiree
- Recognizing and measuring goodwill or a gain from a bargain purchase

With limited exceptions, under the acquisition method the acquirer recognizes the acquired assets and assumed liabilities of the acquiree at fair value at the acquisition date. Further, goodwill or a bargain purchase gain is recognized for the difference between the net assets acquired and the aggregate fair values of the consideration transferred, the NCI, and the acquirer's previously held ownership interests.

SCOPE

The guidance in ASC 805 applies to public and privately held entities for all transactions or other events that meet the definition of a business combination or an acquisition by an NFP entity.

Business Combination	*"A transaction or event in which an acquirer obtains controls of one or more businesses. Transactions sometimes referred to as true mergers or mergers of equals are also business combinations."*
Acquisition by Not-for-Profit Entity	*"A transaction or other event in which a not-for-profit acquirer obtains control of one or more nonprofit activities or businesses and initially recognizes their assets and liabilities in the acquirer's financial statements."*

The business combination guidance does not apply to any of the following:

- The formation of a joint venture
- The acquisition of an asset or a group of assets that does not constitute a business or a nonprofit activity
- A combination between entities, businesses, or nonprofit activities under common control
- Mergers and acquisitions between NFP entities
- Financial assets and financial liabilities of a consolidated variable interest entity (VIE) that is a collateralized financing entity

IDENTIFYING THE ACQUIRER

The starting point for determining whether a merger or acquisition is a business combination, an asset acquisition, or a recapitalization is to identify the acquirer, or the entity that gains control of a business or group of assets. Sometimes this determination is straightforward, but in some cases it may be less clear. For example, in many instances the legal acquirer is also the accounting acquirer; however, in some transactions, the legal acquiree gains control of the legal acquirer. In such cases, the legal acquirer would be deemed the acquiree for accounting purposes (the accounting acquiree) and the legal acquiree would be deemed the acquirer for accounting purposes (the accounting acquirer). Such transactions are referred to as “reverse acquisitions” or “reverse mergers”.

The principles for determining which entity obtains control are defined in ASC 810, *Consolidation*, defines the principles for determining which entity obtains control and provides two primary models for evaluating control – one for variable interest entities and one for voting interest entities. Thus, the legal acquirer must assess whether the legal acquiree is a VIE or a voting interest entity to determine which model to apply.

DETERMINING THE ACQUISITION DATE

The next step in the acquisition method is determining the acquisition date, or the date on which:

- The consideration transferred in the acquisition is measured, including contingent consideration and equity issued to the sellers.
- The acquired assets, assumed liabilities, and noncontrolling interests are measured.
- Previously held equity interests are remeasured.
- The acquirer begins consolidating the acquiree.

The acquisition date is the date the acquirer gains control of the acquiree. It is generally the date on which the acquirer legally transfers the consideration, acquires the assets, and assumes the liabilities of the acquiree (the closing date). An acquirer must consider the facts and circumstances in identifying the acquisition date.

DEFINITION OF A BUSINESS

Once the acquirer has been identified and the acquisition date has been determined, the acquirer must evaluate whether the acquired group of assets and liabilities (the acquired set) meets the definition of a business. If so, the transaction is accounted for as a business combination; if not, it must be accounted for as an asset acquisition or recapitalization. This distinction is important because there are several differences in accounting for a business combination and for an asset acquisition or recapitalization.

RECOGNIZING ASSETS ACQUIRED, LIABILITIES ASSUMED, AND NONCONTROLLING INTERESTS

If the acquired set meets the definition of a business the acquirer must recognize and measure the identifiable assets acquired, liabilities assumed, and any NCI in the acquiree at fair value (with limited exceptions). The acquirer must also determine the appropriate classification of the assets acquired and liabilities assumed and the accounting policies to apply.

RECOGNIZING GOODWILL OR BARGAIN PURCHASE GAIN

The final step in the acquisition method is to recognize and measure goodwill or a gain from a bargain purchase.

The acquirer recognizes goodwill if the consideration transferred (plus the fair value of any noncontrolling interest in the acquiree and the fair value of previously held equity interests, if applicable) exceeds the acquired net assets (assets acquired less liabilities assumed). In most business combinations the acquirer pays a premium over the acquired net assets, resulting in the recognition of goodwill. However, occasionally, the aggregate of the consideration transferred, the NCI, and the acquirer’s previously held equity interest in the acquiree is less than the values assigned to the identifiable assets acquired and liabilities assumed. In such cases, the acquisition represents a bargain purchase, and the acquirer recognizes a gain at the acquisition date.

MEASUREMENT PERIOD

In some cases, the accounting for a business combination may be incomplete at the end of the interim or annual financial reporting period in which the combination occurs. ASC 805 allows an acquirer to recognize provisional amounts for which the accounting is incomplete for up to one year after the acquisition date (the measurement period). The measurement period allows the acquirer a reasonable amount of time to obtain information necessary to identify and measure the various elements needed to account for the business combination (including the identifiable assets acquired, liabilities assumed, noncontrolling interests, equity interests previously held by the acquirer, and the consideration transferred).

During the measurement period, the acquirer adjusts the provisional amounts, with corresponding adjustments to increase or decrease goodwill or bargain purchase gain, to reflect new information about facts and circumstances that existed at the acquisition date. The measurement period ends when the acquirer receives the information it was seeking about facts and circumstances that existed at the acquisition date or learns that the information is not obtainable. However, the measurement period cannot exceed one year from the acquisition date.

The measurement period guidance applies only to business combinations. While we believe it can be applied by analogy to pushdown accounting, it does not apply to other transactions, including asset acquisitions or recapitalizations.

DETERMINING WHICH ELEMENTS ARE PART OF A BUSINESS COMBINATION

An acquirer may enter transactions with the sellers or the acquiree that must be accounted for separate from the business combination. Such transactions may arise as a result of a relationship or other arrangement between the acquirer and acquiree that existed before the business combination, or they may be negotiated in connection with the business combination. Examples of such transactions include the settlement of preexisting relationships, compensation for future services, and payments for the acquirer's transaction costs.

ASC 805 provides principles and a framework for evaluating whether transactions should be accounted for apart from the business combination. Any elements that are not part of a business combination are not accounted for using the acquisition method, but instead must be accounted for under other applicable generally accepted accounting principles (U.S. GAAP).

PRESENTATION AND DISCLOSURES

ASC 805 provides two disclosure objectives for business combinations. These disclosure objectives are meant to provide financial statement users with sufficient information to:

- Evaluate the nature and financial effect of a business combination that occurs either during the current reporting period or after the reporting date but before the financial statements are issued.
- Evaluate the financial effects of adjustments recognized in the current reporting period that relate to previous business combinations.

To satisfy those objectives, ASC 805 provides detailed disclosure requirements. However, if the specific disclosures required by ASC 805 and other GAAP are not sufficient to meet the disclosure objectives, the acquirer must disclose whatever additional information is necessary to meet those objectives. Disclosures are required for material business combinations, as well as for immaterial business combinations that in the aggregate are material to the financial statements.

ADDITIONAL TOPICS

Pushdown Accounting

As discussed above, the accounting acquirer must apply the acquisition method to account for a business combination. As a result, the accounting acquirer establishes a new basis of accounting for the acquired assets and liabilities of the acquiree. The question arises about whether this new basis of accounting must also be reflected in the acquiree's standalone financial statements. ASC 805-50 gives the acquiree an option to elect to recognize its assets and liabilities at the acquirer's basis (referred to as "pushdown accounting") or to continue to recognize its assets and liabilities at carryover basis. However, this election is available only if the acquiree meets the definition of a business. In other words, the election is not available unless the acquisition is a business combination.

Common Control Transactions

Common control transactions involve the transfer of net assets (including businesses) or the exchange of equity interests among entities under the control of the same ultimate parent, which could be an entity; individual; or a common control group, such as a married couple. Although common control transfers of businesses have similar characteristics as business combinations, there is one key difference: Common control transactions do not involve a change in control (that is, at the ultimate parent or controlling shareholder level), which is required to apply business combination accounting. As such, the guidance on business combinations does not apply to combinations among entities or businesses under common control.

ASC 805-50 provides guidance for transactions between entities under common control. Unlike accounting for business combinations, accounting for common control transactions does not typically result in a step-up in basis; rather, common control transactions are accounted for at the ultimate parent's carrying amount of the net assets or equity interests transferred. Further, the common control transfer of a business may result in a change in reporting entity, which may require retrospective adjustments to the receiving entity's financial statements.

Common control transactions have no effect (other than potential income tax effects) on the ultimate 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 separate financial statements of the transferring and receiving entities but is eliminated in consolidation. No gain or loss is recognized by the ultimate parent.

Asset Acquisitions and Recapitalizations

The term "asset acquisition" is used to describe the acquisition of an asset or group of assets that does not meet the definition of a business under U.S. GAAP. Some asset acquisitions also include the assumption of liabilities. Although asset acquisitions may be similar to business combinations, it is critical to determine whether the acquired set meets the definition of a business because the accounting for an asset acquisition is fundamentally different than the accounting for a business combination.

Sometimes, an operating company may combine with another company that holds only financial assets and does not have substantive operations. In such case, the substance may be a capital transaction in which the operating company issues its equity in exchange for the financial assets of the nonoperating company.

Initial Accounting by a Joint Venture

In August 2023, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2023-05, *Business Combinations – Joint Venture Formations (Subtopic 805-60): Recognition and Initial Measurement*, which provides guidance for the initial accounting by a joint venture at its formation date. ASC 805-60 requires a joint venture (as defined in U.S. GAAP) to apply a new basis of accounting at the formation date, in which it recognizes and initially measures its assets and liabilities at fair value (with exceptions consistent with the business combinations guidance).

ASC 805-60 applies only to the initial accounting by a joint venture. It does not change the accounting by a venturer for its investment in a joint venture. That is, the venturer applies other applicable U.S. GAAP to account for its contribution to the joint venture. Before the issuance of ASC 805-60, there was no specific authoritative guidance for the accounting by a joint venture upon formation, so there was diversity in practice, with some joint ventures initially measuring their net assets at carryover basis and others measuring them at fair value.

ABOUT THIS BLUEPRINT

This Blueprint includes detailed guidance on accounting for business combinations, asset acquisitions, and recapitalizations. While this Blueprint does not include all requirements of ASC 805, it summarizes key aspects that are commonly considered when accounting for an acquisition, including options available only to private companies. It also includes practical examples and interpretive guidance to assist entities and practitioners in their accounting for business combinations and similar transactions. The accounting for each transaction may vary based on the specific facts and circumstances and, therefore, may differ from the examples and insights in this Blueprint.

The Blueprint has been divided into chapters that address key aspects of accounting for business combinations. These chapters are generally organized in the order in which an entity would apply the acquisition method spelled out in ASC 805.

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Chapter 1 — Scope of ASC 805

1.1 WHAT IS IN THE SCOPE OF BUSINESS COMBINATION GUIDANCE

FASB REFERENCES

ASC 805-10-15-3 and ASC 805-10-55-3

ASC 805-10-20: Business Combination; Acquisition by a Not-For Profit Entity

The guidance in ASC 805 applies to public and privately held entities for all transactions or other events that meet the definition of a business combination or an acquisition by an NFP entity.

Business Combination	*"A transaction or event in which an acquirer obtains control of one or more businesses. Transactions sometimes referred to as true mergers or mergers of equals are also business combinations."*
Acquisition by Not-for-Profit Entity	*"A transaction or other event in which a not-for-profit acquirer obtains control of one or more nonprofit activities or businesses and initially recognizes their assets and liabilities in the acquirer's financial statements."*

ASC 805 provides the following examples of transactions that may qualify as business combinations:

FASB REFERENCES

ASC 805-10-55-3

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.

ASC 805 also clarifies that the following transactions must be accounted for as business combinations:

- True mergers or mergers of equals (see Section 1.1.1)
- Combinations between mutual entities (see Section 1.1.2)
- Roll-up or put-together transactions (see Section 1.1.3)
- Business combinations with no consideration transferred (see Section 1.1.4)

1.1.1 True Mergers or Mergers of Equals

True mergers or mergers of equals occur when two entities of similar size combine to form a single new entity. Such transactions are included within the scope of business combination guidance because they are economically like acquisitions of businesses; therefore, a separate accounting treatment is not warranted.[1]

1.1.2 Combinations Between Mutual Entities

FASB REFERENCES

ASC Master Glossary

Mutual Entity

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

Although mutual entities have characteristics that distinguish them from other business entities, they also share many characteristics. Therefore, the FASB determined that combinations of mutual entities are in the scope of business combination guidance.[2] Section 5.4.4.1.1 includes guidance for measuring the consideration transferred in a combination between mutual entities.

[1] *Statement of Financial Accounting Standards No. 141 (revised 2007)* (FAS 141(R)), paragraph B35

[2] FAS 141(R), paragraph B68

1.1.3 Roll-Up or Put-Together Transactions

FASB REFERENCES

ASC 805-10-55-3(c)

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 (NewCo) in a roll-up (put-together) transaction. Such transactions are within the scope of business combination guidance.

Example 1-1 illustrates the accounting for a roll-up transaction.

EXAMPLE 1-1: ACCOUNTING FOR ROLL-UP TRANSACTION INVOLVING TWO BUSINESSES

FACTS

Two unrelated parties contribute businesses into NewCo in exchange for equity interests in NewCo. The NewCo had no precombination activities before the transaction and, therefore, lacked substance. Investor A contributed Business A and Investor B contributed Business B. After the transaction, Investor A owns 60% of NewCo and Investor B owns 40%. Voting rights are proportionate with each investor's ownership interest. NewCo, Business A, and Business B are not VIEs. There are no other factors that indicate which of the combining entities is the acquirer.

CONCLUSION

This roll-up transaction is within the scope of business combination guidance.

ANALYSIS

Because NewCo was not substantive, it is not the accounting acquirer (see Section 2.2.2.4). As such, one of the businesses that existed before the business combination must be identified as the accounting acquirer (see Section 2.2.2) and must apply the acquisition method to account for the acquisition of the other business.

In this case, Business A is the acquirer because Investor A has the majority of the voting rights and there are no other factors that indicate which of the combining entities is the acquirer. Thus, NewCo would recognize the assets and liabilities of Business A at their carryover bases but would recognize and measure the acquired assets and assumed liabilities of Business B using the acquisition method in ASC 805.

In its deliberations for FAS 141(R), the FASB considered whether the definition of a business combination should include roll-up transactions in which multiple businesses are combined but none of the former shareholder groups of the combining entities obtained control over the combined entity.[3] Ultimately, the FASB concluded that unless they meet the definition of a joint venture, such transactions are in the scope of business combination guidance — even though no former shareholder (or shareholder group) gains control of the combined business. As such, an accounting acquirer must be identified and must apply the acquisition method to account for the business combination.

Example 1-2 illustrates this concept.

[3] FAS 141(R), paragraph B5

EXAMPLE 1-2: ACCOUNTING FOR ROLL-UP TRANSACTION IN WHICH NO SHAREHOLDER GAINS CONTROL

FACTS

Four unrelated parties contribute businesses into NewCo in exchange for equity interests in the new entity. NewCo had no precombination activities before the transaction and therefore lacked substance. The ownership percentages of the businesses before and after the transaction are as follows:

	OWNERSHIP BEFORE				OWNERSHIP AFTER
	BUSINESS A	BUSINESS B	BUSINESS C	BUSINESS D	COMBINED BUSINESS
Investor A	100%				20%
Investor B		100%			25%
Investor C			100%		15%
Investor D				100%	40%

Voting rights are proportionate with each investor’s ownership interest, so, after the transaction, no single investor has a controlling interest in the combined business.

CONCLUSION

Although no party gained control of the combined business, this roll-up transaction is within the scope of business combination guidance.

ANALYSIS

Because NewCo was not substantive, it is not the accounting acquirer (see Section 2.2.2.4). As such, one of the businesses that existed before the business combination must be identified as the accounting acquirer and must apply the acquisition method to account for the acquisitions of the other businesses. Section 2.2.2.3 discusses identifying the acquirer in a business combination involving more than two entities.

In this case, if there are no other factors that indicate which of the combining entities is the acquirer, Business D would be the acquirer because Investor D has the most voting rights. Therefore, NewCo would recognize the assets and liabilities of Business D at their carryover bases but would recognize and measure the acquired assets and assumed liabilities of Businesses A, B, and C using the acquisition method in ASC 805.

1.1.4 Business Combinations With No Consideration Transferred

FASB REFERENCES

ASC 805-10-25-11

Most often, business combinations involve the transfer of consideration in exchange for the target’s equity interests or net assets. However, business combination accounting is not limited to such transactions. Nearly all transactions that result in an entity gaining control of a business will result in business combination accounting. Even transactions that do not directly involve an investor or do not involve the transfer of consideration could result in business combination accounting. ASC 805 includes three examples:

- **Share repurchases by an investee** — An investee repurchases its own shares from other parties; as a result, an investor’s proportionate ownership interest increases and results in the investor gaining control of the business.
- **Lapse of participating rights held by other investors** — An investor with majority voting rights that is precluded from controlling an entity because other parties hold substantive participating (veto) rights would gain control of the business when such participating rights expire.

- **Combinations achieved by contract alone** — 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 by forming a dual-listed corporation.

Section 5.4.7 includes guidance on accounting for business combinations with no consideration transferred.

BDO INSIGHTS — STAPLING ARRANGEMENTS AND DUAL-LISTED CORPORATIONS

Stapling arrangements and dual-listed corporations are rare, but they are accounted for as business combinations in accordance with ASC 805.

In a stapling arrangement, a legal entity issues equity securities that are combined with the securities issued by another legal entity through a contractual arrangement. Such "stapled" securities are quoted at a single price and cannot be traded or transferred independently.

Dual-listed corporations are sometimes used to achieve the substance of a business combination while retaining some tax benefits to the shareholders. A dual-listed corporation is a contractual arrangement in which two separate legal entities are managed as a single entity by executing contracts that equalize voting and dividend rights of the two companies and establishing common governance and executive management.

In stapling arrangements and dual-listed corporations, the legal entities involved function as a single business; therefore, one of the entities must be identified as the acquirer and account for the business combination.

1.1.5 Business Combinations When Control Is Temporary

FASB REFERENCES

ASC 805-20-30-22

ASC 805 does not provide an exception for accounting for a business combination if control is expected to be temporary. As such, an acquirer that obtains control of a business must apply the acquisition method, even if control is maintained only for a short time. If the acquirer intends to sell or dispose of a business or group of assets at the time of the business combination, it must assess whether such business or group of assets meets the assets-held-for-sale criteria; if so, they would be recognized at fair value less costs to sell.

Example 1-3 illustrates this concept.

EXAMPLE 1-3: TEMPORARY CONTROL OF A BUSINESS

FACTS

Company A acquires Company B in a business combination transaction. Company B consists of three separate divisions (Divisions X, Y, and Z), all of which meet the definition of a business on a stand-alone basis. Because of regulatory requirements, Company A must divest its ownership of Division Z and has committed to a plan to sell it. Company A determines that it meets the requirements in ASC 205-20-45-1E to classify the assets of Division Z as held for sale. One month after the acquisition date, Company A sells Division Z.

CONCLUSION

The acquisition of Division Z is part of the business combination.

ANALYSIS

Although Company A controlled Division Z for only a short period of time, it still must account for the acquired assets and assumed liabilities of Division Z as part of the business combination. As discussed in ASC 805, Company A measures the disposal group on the acquisition date at fair value less costs to sell.

1.1.6 Multiple Transactions That Result in a Business Combination

FASB REFERENCES

ASC 810-10-40-6

BDO INSIGHTS — EVALUATING WHETHER MULTIPLE TRANSACTIONS MUST BE ACCOUNTED FOR AS A SINGLE BUSINESS COMBINATION

In many cases, a business combination is structured as a single transaction; however, sometimes (for example, for tax, regulatory, or other reasons) an entity may enter multiple transactions that result in obtaining control of a business. If the transactions were accounted for separately, the individual elements may not meet the definition of a business, but combining the transactions would result in a business combination. In such instances, it may be appropriate to treat the transactions as a single arrangement and account for them as a business combination.

The following factors in ASC 810 may help determine whether multiple transactions must be accounted for as a single business combination:

- They are entered 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 the arrangements are economically justified when considered together.

Once an entity concludes that the arrangement must be accounted for as a business combination, it must assess whether any elements must be accounted for separate from the business combination (see Chapter 6).

1.2 WHAT IS NOT IN THE SCOPE OF BUSINESS COMBINATION GUIDANCE

FASB REFERENCES

ASC 805-10-15-4

Business combination guidance does not apply to any of the following:

- The formation of a joint venture
- The acquisition of an asset or a group of assets that does not constitute a business or a nonprofit activity
- A combination between entities, businesses, or nonprofit activities under common control
- Mergers between NFP entities
- Financial assets and financial liabilities of a consolidated variable interest entity that is a collateralized financing entity

1.2.1 Formation of a Joint Venture

Although the term "joint venture" is often applied broadly to describe a business venture in which two or more parties participate together to achieve a common objective, the accounting definition of a joint venture is narrower.

In accordance with the definition of a corporate joint venture in ASC 323, *Investments — Equity Method and Joint Ventures*, the following two criteria must be met:

- All parties to the venture must jointly control all significant decisions.
- The purpose of the entity must be consistent with that of a joint venture.

As such, because none of the investors obtain control, the formation of a joint venture is outside the scope of business combination guidance. See Appendix D for guidance regarding the initial accounting by a joint venture.

1.2.2 Asset Acquisitions

The acquisition of an asset or a group of assets that does not constitute a business is not within the scope of business combination guidance. Rather, it is accounted for in accordance with guidance from ASC 805-50 (see Appendix C).

1.2.3 Common Control Transactions

Common control combinations are transactions in which the combining entities are controlled by the same party before and after the transaction. Such combinations do not result in a change in control, whether the acquiree is a VIE or not; therefore, common control transactions are outside the scope of business combination guidance. Similarly, combinations between entities with a high degree of common ownership may be accounted for like common control transactions if the transactions lack economic substance. Appendix B provides guidance for accounting for common control transactions.

1.2.4 Mergers Between Not-for-Profit Entities

FASB REFERENCES

ASC 805-10-15-4(e), ASC 958-805-15-4(d), ASC 958-805-20: Acquisition by a not-for-profit entity; Merger of not-for-profit entities

ASC 958-805 *Not-for-Profit Entities - Business Combinations*, includes incremental guidance for accounting for mergers and acquisitions between NFP entities and distinguishes between an **acquisition by an NFP entity** and a **merger of not-for-profit entities**.

Acquisition by a Not-for-Profit Entity	"A transaction or other event in which a not-for-profit acquirer obtains control of one or more nonprofit activities or businesses and initially recognizes their assets and liabilities in the acquirer's financial statements."

Merger of Not-for-Profit Entities	"A transaction or event in which the governing bodies of two or more not-for profit entities cede control of those entities to create a new not-for-profit entity."

An acquisition by an NFP entity is within the scope of ASC 805 and is also subject to ASC 958-805, which includes separate guidance for determining which of the combining entities is the acquirer and for determining what information to disclose. Conversely, a merger of NFP entities is not within the scope of ASC 805. Instead, mergers are accounted for solely in accordance with ASC 958-805, which requires that the carryover method be used to account for a merger.

A transaction or other event in which an NFP obtains control of an NFP entity but does not consolidate that entity (because consolidation is optional, as described in ASC 958-810-25-4) is not within the scope of business combination guidance in ASC 805 or ASC 958-805, either at the acquisition date or later (if the acquirer subsequently decides to begin consolidating a controlled entity that it initially chose not to consolidate).

Acquisitions of an NFP business by a for-profit entity are subject to ASC 805 and must therefore apply business combination guidance.

1.2.5 Collateralized Financing Entities

FASB REFERENCES

ASC Master Glossary

Collateralized financing entity

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

Financial assets and financial liabilities of a consolidated VIE that is a collateralized financing entity within the scope of ASC 810-10 are outside the scope of business combinations guidance. Instead, ASC 810-10 provides specialized guidance requiring that they be accounted for at their individual fair values in accordance with ASC 810-10-30-16 or using the measurement alternative specified in ASC 810-10-30-10 through 30-15. The measurement alternative allows entities to measure both the financial assets and financial liabilities of the collateralized financing entity using the more observable of the fair values of the assets or liabilities. Section 7.2.3 of our Blueprint, Control and Consolidation Under ASC 810,includes additional guidance for the initial consolidation of a collateralized financing entity.

1.2.6 Recapitalizations

Although not specifically listed as a scope exception from ASC 805, an acquisition for which the acquired assets primarily consist of cash or investments may be an in-substance capital transaction (a recapitalization). If the acquired entity does not meet the definition of a business, it would be outside the scope of business combination guidance. The recapitalization transaction must be accounted for based on its substance. Appendix C.8 includes guidance for recapitalization transactions.

Chapter 2 — Identifying the Acquirer and the Acquisition Date

2.1 OVERVIEW

The starting point for determining whether a merger or acquisition is a business combination, an asset acquisition, or a recapitalization is identifying the acquirer and determining the acquisition date.

The acquirer is the entity that gains control of a business or group of assets.

The acquisition date is the date the acquirer gains control of the acquiree.

2.2 IDENTIFYING THE ACQUIRER

Sometimes identifying the acquirer is straightforward, but in some cases it may be less clear. In most cases, the entity that transfers consideration (for example, cash, other assets, or equity interests) in exchange for ownership of assets or equity of another entity is the acquirer. However, this is not always true; in some transactions, the legal acquiree gains control of the legal acquirer. In such cases, the legal acquirer would be deemed the acquiree for accounting purposes (the accounting acquiree) and the legal acquiree would be deemed the acquirer for accounting purposes (the accounting acquirer). Such transactions are referred to as "reverse acquisitions" or "reverse mergers". Section 7.3 provides guidance for accounting for reverse acquisitions.

ASC 810 defines the principles for determining which entity obtains controls and provides two primary models for evaluating control – one for variable interest entities and one for voting interest entities. Thus, the legal acquirer must assess whether the legal acquiree is a VIE or a voting interest entity to determine which model to apply.

Legal acquiree is a VIE →	The primary beneficiary of the VIE is deemed the accounting acquirer (see Section 2.2.1).
Legal acquiree is not a VIE →	An analysis of the facts and circumstances is necessary to determine which entity is the acquirer for accounting purposes (see Section 2.2.2).

2.2.1 Identifying the Acquirer if the Legal Acquiree Is a Variable Interest Entity

FASB REFERENCES

ASC 805-10-25-5, ASC 805-30-30-1, and ASC 810-10-15-14

If the legal acquiree is a VIE, the primary beneficiary is always the accounting acquirer. As such, the first step in identifying the acquirer is to assess whether the legal acquiree is a VIE.

A legal acquiree is a VIE if it has **any** of the following characteristics:

Equity at risk	The equity at risk is insufficient to finance the legal entity's activities without additional subordinated financial support.
Power	The holders of the equity at risk **collectively** lack the power, through voting rights or similar rights, to direct the activities that most significantly impact the legal entity's economic performance.
Expected losses	The holders of the equity at risk **collectively** lack the obligation to absorb the legal entity's expected losses.
Expected residual returns	The holders of the equity at risk **collectively** lack the right to receive the legal entity's expected residual returns.
Voting rights are nonsubstantive	The voting rights are nonsubstantive because both criteria are met: ▶ The voting rights of some investors are not proportional to their economic exposure to the legal entity. ▶ Substantially all the legal entity's activities involve or are conducted on behalf of an investor with disproportionately fewer voting rights, including that investor's related parties and specific de facto agents.

If the legal acquiree is a VIE, the legal acquirer must determine whether it is the primary beneficiary; if so, it is the accounting acquirer. Our Blueprint, [Control and Consolidation Under ASC 810], provides guidance for applying ASC 810 and determining whether an entity is a VIE and for identifying the primary beneficiary. Section C.1.1 in Appendix C provides guidance for accounting for the initial consolidation of a VIE.

EITF AGENDA — IDENTIFYING THE ACCOUNTING ACQUIRER IN A BUISNESS COMBINATION WHEN THE LEGAL ACQUIREE IS A VIE

In April 2024, the Emerging Issues Task Force (EITF) added a topic to its agenda on how the accounting acquirer in a business combination is determined when the legal acquiree is a variable interest entity. Readers should monitor developments.

If the legal acquiree is not a VIE, an analysis of all facts and circumstances, as outlined in the following sections, is necessary to determine which entity is the accounting acquirer.

2.2.2 Identifying the Acquirer if the Legal Acquiree Is a Voting Interest Entity

FASB REFERENCES

ASC 805-10-25-5 and ASC 805-10-55-10 through 55-15

If the legal acquiree is not a VIE, the parties must determine which entity is the acquirer under the voting interest model. The guidance in ASC 810-10 is used to identify the acquirer, that is, the entity that obtains control of the acquiree. However, if the application of that guidance does not clearly indicate which entity is the acquirer, the following factors must be considered in that determination.

FACTORS TO EVALUATE WHEN IDENTIFYING THE ACQUIRER	REFERENCE
▶ Business combination effected primarily by transferring cash or other assets or by incurring liabilities	Section 2.2.2.1
▶ Business combination effected primarily by exchanging equity interests	Section 2.2.2.2
• Voting rights	Section 2.2.2.2.1
• Large minority voting interest	Section 2.2.2.2.2
• Composition of governing body	Section 2.2.2.2.3
• Composition of senior management	Section 2.2.2.2.4
• Terms of the exchange	Section 2.2.2.2.5
• Relative size	Section 2.2.2.2.6
• Other factors	Section 2.2.2.2.7

2.2.2.1 Business Combination Effected Primarily by Transferring Cash or Other Assets or by Incurring Liabilities

FASB REFERENCES

ASC 805-10-55-11

Determining the acquirer in some business combinations is relatively straightforward. The entity that transfers cash or other assets or incurs liabilities in exchange for the equity or net assets of another entity is usually the acquirer. Therefore, if the combination is effected primarily by transferring cash or other assets or by incurring liabilities, the legal acquirer likely would be the accounting acquirer. Such transactions are sometimes referred to as “forward acquisitions” or “regular acquisitions.”

However, if a portion of the consideration transferred includes an exchange of equity interests, the identification of the acquirer can be more challenging (see Section 2.2.2.2).

2.2.2.2 Business Combination Effected Primarily by Exchanging Equity Interests

FASB REFERENCES

ASC 805-10-55-12 through 55-13

The acquirer is usually the entity that issues its equity interests; however, in some combinations, more than one party issues equity interests (that is, there is an exchange of equity interests), and it may not be clear which entity is the accounting acquirer. In some transactions, the legal acquirer may be deemed the accounting acquirer (forward acquisitions); in other transactions, the legal acquirer is deemed the accounting acquiree, and the legal acquiree is deemed the accounting acquirer. Such transactions are referred to as “reverse acquisitions” or “reverse mergers.”

For transactions involving the exchange of equity interests, the legal transaction structure is not determinative in identifying the accounting acquirer. Instead, the analysis focuses on the substance of the transaction and identifying which of the pre-transaction shareholder groups controls the combined entity after the transaction. In such transactions, the factors in Sections 2.2.2.2.1 through 2.2.2.2.7 are assessed to determine which entity is the accounting acquirer.

NO SINGLE FACTOR IS DETERMINATIVE

The FASB did not provide a hierarchy for the factors in ASC 805-10-55-12 through 55-13. As such, no single factor is determinative, and professional judgment is required to determine which factors carry the most weight in the analysis based on the facts and circumstances.

2.2.2.2.1 Voting Rights

FASB REFERENCES

ASC 805-10-55-12(a)

The relative voting rights held by each shareholder group in the combined entity may indicate which entity is the acquirer. All else being equal, the entity whose shareholder group has the greatest voting rights in the combined entity after the transaction is more likely to be the acquirer. Further, as the differential in voting rights increases, it may be appropriate to place more weight on this factor. For example, if one shareholder group has 80% of the voting rights compared to 20% held by the other shareholder group, the relative voting rights would be weighted more heavily than if one shareholder group holds 51% of the voting rights compared to 49% held by the other.

In assessing the relative voting rights held by each shareholder group, entities must consider any special voting arrangements as well as all outstanding instruments that hold (or potentially hold) voting rights. In addition to outstanding shares, such instruments may include options, warrants, or convertible securities that hold current or potential voting rights.

All instruments with current voting rights at the acquisition date should be included in the analysis. It might also be appropriate to include some instruments that do not have current voting rights but have potential voting rights. Professional judgment is required for determining which instruments should be included in the assessment.

BDO INSIGHTS —POTENTIAL VOTING RIGHTS COULD AFFECT THE IDENTIFICATION OF THE ACCOUNTING ACQUIRER

Generally, we believe that any instruments that are convertible or immediately exercisable and are in-the-money should be included in the assessment as if they had current voting rights.

For securities that are unvested, contingently exercisable, or out-of-the-money, more judgment is required. Generally, such securities are excluded from the assessment unless it is clear that they will become vested, exercisable, or convertible shortly after the transaction and it is reasonable to assume they will be exercised or converted. Factors to consider may include:

- The extent such instruments are out-of-the-money
- The volatility of the share price of the underlying shares
- The expected time before the instruments will become exercisable or convertible and when such exercise or conversion rights expire
- The attributes of the instrument holders (for example, board members, executive management, or a larger minority voting interest holder)

Reaching a conclusion about how to consider potential voting rights in the analysis requires the use of professional judgment based on the facts and circumstances.

2.2.2.2.2 Large Minority Voting Interest

FASB REFERENCES

ASC 805-10-55-12(b)

The existence of a large minority voting interest held by a single owner or an organized group of owners may indicate which entity is the acquirer. For example, if Entity A and Entity B merge, and a shareholder of Entity A before the transaction holds 30% of the combined entity's voting rights after the transaction, this could point to Entity A being the acquirer if the remaining voting rights in the combined entity are widely dispersed among other shareholders.

USE PROFESSIONAL JUDGMENT TO EVALUATE ORGANIZED GROUPS

An entity must consider all facts and circumstances when assessing whether a group of investors is an organized group. An organized group of investors would include investors in a common control group, but it could also include other related-party groups. Reaching a conclusion about whether a group of investors is an organized group requires the use of professional judgment based on the facts and circumstances.

2.2.2.2.3 Composition of the Governing Body

FASB REFERENCES

ASC 805-10-55-12(c)

In many transactions, the composition of the governing body is negotiated by the combining entities. As a result, acquisition and merger agreements commonly specify which shareholder groups have the right to appoint board members or otherwise specify who the initial board members will be. The acquirer is usually the combining entity whose owners can elect, appoint, or remove the majority of the members of the governing body of the combined entity immediately after the transaction.

When evaluating this factor, it may be appropriate to consider whether the ability to elect, appoint, or remove the majority of the governing body's members could change in the short term. For example, it may be appropriate to consider whether appointed board members are scheduled to retire or could otherwise be replaced shortly after the acquisition date.

Example 2-1 illustrates this concept.

EXAMPLE 2-1: TEMPORARY ABILITY TO APPOINT A MAJORITY OF DIRECTORS

FACTS

Company A and Company B, which are both businesses, agree to merge. After the merger, the shareholders of Company A hold 55% of the voting interests, but the merger agreement specifies that Company A has the right to appoint only two of five board members and that Company B will appoint the remaining members. However, one of the board members appointed by Company B is scheduled to retire within six months of the merger. Company A, as the legal acquirer, determines that Company B is not a VIE.

The articles of incorporation specify that if a board member retires or resigns, a simple majority of shareholders can vote to replace the board member.

CONCLUSION

Company B's shareholders may not control the combined entity's governing board for a sufficient period to conclude that Company B is the acquirer. Reaching a conclusion requires the use of professional judgment based on the facts and circumstances.

ANALYSIS

Although the shareholders of Company B had the right to appoint a majority of the board members at the acquisition date, it may be appropriate to consider that one of the board members is scheduled to retire in the near term. Because Company B does not have the right to appoint a replacement board member, and the former shareholders of Company A control the majority of votes of the combined company, this may indicate that the shareholders of Company B do not have the ability to control the combined entity's governing board for a sufficient period to conclude that Company B is the acquirer.

If the shareholders of one of the combining entities cannot elect a majority of the members of the governing body, the entities must consider whether there are any tie-breaker provisions or other special voting rights that would affect the analysis. For example, if all significant board decisions require a supermajority vote (for example, 67%), and the shareholders from neither of the combining companies have the right to appoint enough members to control the board, having a simple majority of the board seats may be less relevant. Thus, it may be appropriate to place less weight on this factor.

2.2.2.2.4 Composition of Senior Management

FASB REFERENCES

ASC 805-10-55-12(d)

The acquirer is usually the combining entity whose former management dominates the management of the combined entity. When evaluating this factor, it is appropriate to consider the number of key management positions appointed by each of the combining entities; however, the roles and responsibilities of each position are generally more important than the number of positions. Thus, if the C-Suite is dominated by members of management from one entity, this factor would favor that entity as the acquirer. Similarly, if those positions are filled by representatives from more than one of the combining entities, the entity from which the positions with the most seniority were filled is more likely to be the acquirer. For example, if the CEO and CFO come from different combining entities, the entity that appointed the CEO would be more likely to be the acquirer.

As when evaluating the governing body's composition, the composition of senior management may be afforded less weight in the analysis if it is expected to change shortly after the acquisition. For example, an entity may consider employment contracts and the expected retirement dates of the executive team members.

2.2.2.2.5 Terms of the Exchange

FASB REFERENCES

ASC 805-10-55-12(e)

The acquirer is usually the combining entity that pays a premium over the precombination fair value of the equity interests of the other combining entity or entities. In other words, an entity may be willing to pay a premium to gain control of a business (a control premium).

When assessing this factor, it may be difficult to determine whether one party has paid a premium, particularly if one or both the combining entities were not publicly traded or did not have a readily determinable fair value before the transaction. As such, when assessing this factor, the reliability of the fair value measurements must be considered. If it is not clear that one of the combining parties has paid a premium, it may be appropriate to place less weight on this factor.

2.2.2.2.6 Relative Size

FASB REFERENCES

ASC 805-10-55-13

The acquirer is usually the entity whose relative size is significantly larger than the other combining entity or entities. When assessing the entities' relative size, relevant measures may include revenues, assets, earnings, and cash flows. Such measures should generally exclude the effects of non-recurring or unusual transactions. It may also be useful to compare market capitalization.

2.2.2.2.7 Other Factors

BDO INSIGHTS — EVALUATING OTHER FACTORS

If the factors in ASC 805-10-55-11 through 55-13 do not clearly indicate which entity is the acquirer, it may be appropriate to consider other relevant factors, such as:

- Which entity initiated the combination?
- What will be the name of the continuing entity?
- Where will the combined entity's headquarters be located?
- What will be the combined entity's ticker symbol?

While these other factors are not in ASC 805 and are generally not weighted heavily in the analysis, they may be helpful when an evaluation of the factors in ASC 805 is not determinative.

2.2.2.2.8 Identifying the Acquirer – Examples

Examples 2-2 through 2-4 illustrate how to identify the acquirer in various scenarios.

EXAMPLE 2-2: IDENTIFYING THE ACQUIRER: MAJORITY OF VOTING RIGHTS, BOARD SEATS, AND SENIOR MANAGEMENT

FACTS

- Company A and Company B, which are both businesses, agree to merge.
- Company A issues common shares to Company B’s shareholders in exchange for all of Company B’s outstanding equity.
- After the transaction, the shareholders of Company A will hold 60% of the voting interests of the combined company and the shareholders of Company B will hold 40%.
- As the legal acquirer, Company A determines that Company B is not a VIE.
- The former shareholders of Company A have the right to appoint three directors and the former shareholders of Company B have the right to appoint two directors. Staggered board elections will begin one year after the acquisition date and no board members are scheduled to retire in the near term. Removal of board members before the scheduled elections requires the vote of a simple majority of shareholders.
- Senior management of the combined entity will consist of:

FROM COMPANY A	FROM COMPANY B
CEO	CFO
COO	

- Company A and Company B are similar in size in terms of revenues and total assets, but Company A has historically been more profitable and has a higher net income and market capitalization.

CONCLUSION

Company A would be deemed the acquirer. Because Company A is both the legal and accounting acquirer, it must account for the business combination as a forward acquisition and apply the acquisition method to record a new basis for the acquired assets and assumed liabilities of Company B.

ANALYSIS

This conclusion is based on the following factors:

- The former shareholders of Company A control the majority of the voting rights and the differential is significant compared to voting rights controlled by the former shareholders of Company B.
- Company A’s shareholders have the right to designate a majority of the board members. Further, because all board members can be replaced by a simple majority vote, the Company A shareholders can replace the board members if they choose.
- Most senior management positions, including the most key positions of the combined entity, will be filled by Company A.
- There are no indicators that either shareholder group received a premium.
- Company A and Company B are of similar size, although Company A has a larger net income and market capitalization.

EXAMPLE 2-3: IDENTIFYING THE ACQUIRER: MAJORITY OF VOTING RIGHTS; MINORITY OF BOARD SEATS AND SENIOR MANAGEMENT

FACTS

- Company A and Company B, which are both businesses, agree to merge.
- Company A issues common shares to Company B's shareholders in exchange for all of Company B's outstanding equity.
- After the transaction, the shareholders of Company A will hold 51% of the voting interests of the combined company and the shareholders of Company B will hold 49%.
- Company A, as the legal acquirer, determines that Company B is not a VIE.
- The former shareholders of Company A have the right to appoint two directors (including the chair of the board), and the former shareholders of Company B have the right to appoint three directors. Staggered board elections will begin one year after the acquisition date and no board members are scheduled to retire in the near term. Removal of board members before the scheduled elections requires a supermajority vote (at least 67%) of shareholders.
- Senior management of the combined entity will consist of:

FROM COMPANY A	FROM COMPANY B
CFO	CEO
	COO

- Company A and Company B are similar in size in terms of revenues, total assets, net income, and market capitalization.

CONCLUSION

Company B would likely be deemed the acquirer. Because Company A is the legal acquirer and Company B is the accounting acquirer, Company B must account for the business combination as a reverse acquisition and apply the acquisition method to record a new basis for the acquired assets and assumed liabilities of Company A.

ANALYSIS

This conclusion is based on the following factors:

- Although the former shareholders of Company A control the majority of the voting rights, the differential is insignificant compared to voting rights controlled by Company B's former shareholders.
- Although Company A's shareholders have the right to designate the board chair, Company B's shareholders have the right to designate a majority of the board members. Also, because a supermajority vote is required to replace the board members before the scheduled elections, Company A's shareholders cannot replace the board members in the near term.
- Most senior management positions, including the most key positions of the entity's combined operations, will be filled by Company B.
- There are no indicators that either shareholder group received a premium.
- Company A and Company B are of similar size.

EXAMPLE 2-4: IDENTIFYING THE ACQUIRER: MINORITY OF VOTING RIGHTS; LARGE MINORITY INTEREST, MAJORITY OF BOARD SEATS AND SENIOR MANAGEMENT

FACTS

- Company A and Company B, which are both businesses, agree to merge.
- Company A issues common shares to Company B's shareholders in exchange for all of Company B's outstanding equity.
- After the transaction, Company A's shareholders will hold 45% of the voting interests of the combined company (including 40% held by shareholder X) and Company B's shareholders will hold 55%.
- The largest former shareholder of Company B will own 5% of the combined entity. As the legal acquirer, Company A determines that Company B is not a VIE.
- The former shareholders of Company A have the right to appoint three directors (including the chair of the board) and the former shareholders of Company B have the right to appoint two directors. Staggered board elections will begin one year after the acquisition date and no board members are scheduled to retire in the near term. Removal of board members before the scheduled elections requires a supermajority vote (at least 67%) of shareholders.
- Senior management of the combined entity will consist of:

FROM COMPANY A	FROM COMPANY B
CEO	None
COO	
CFO	

- Company A and Company B are similar in size in terms of revenues, total assets, net income, and market capitalization.

CONCLUSION

Company A would likely be deemed the acquirer. As Company A is both the legal and accounting acquirer, it must account for the business combination as a forward acquisition and apply the acquisition method to record a new basis for the acquired assets and assumed liabilities of Company B.

ANALYSIS

This conclusion is based on the following factors:

- Although the former shareholders of Company B control the majority of the voting rights, the differential is small compared to voting rights controlled by the former shareholders of Company A.
- There is a large minority interest in the combined entity that is held by a former shareholder of Company A.
- The shareholders of Company A have the right to designate the majority of board members, including the board chair. Also, because a supermajority vote is required to replace the board members before the scheduled elections, the shareholders of Company B cannot replace the board members in the near term.
- Senior management positions, including the most key positions of the combined entity, will be filled by Company A.
- There are no indicators that either shareholder group received a premium.
- Company A and Company B are of similar size.

2.2.2.3 Business Combination Involving More Than Two Entities

FASB REFERENCES

ASC 805-10-55-14

Combinations that involve more than two businesses are sometimes referred to as "roll-up" or "put-together" transactions. As discussed in Section 1.1.3, such transactions are within the scope of business combination guidance even if no single former shareholder or combining entity gains voting control over the combined entity. As such, the factors discussed in Section 2.2.2.2 must be considered when identifying the acquirer. Further, ASC 805 indicates that determining the acquirer includes considering which entity initiated the combination and the relative size of the combining entities.

BDO INSIGHTS — EVALUATING ROLL-UP TRANSACTIONS WHEN SOME ENTITIES ARE UNDER COMMON CONTROL

When assessing which entity is the acquirer in a roll-up (or similar) transaction, if some (but not all) of the combining entities are under common control, we believe the entities under common control should be considered a single combining entity.

2.2.2.4 Business Combination Involving NewCo

FASB REFERENCES

ASC 805-10-55-15

In many transactions, one of the combining entities forms one or more new entities to facilitate the business combination. Those new entities, referred to as "NewCos," are formed for legal, tax, or other business reasons. The FASB concluded that a transaction that involves a NewCo must be accounted for in the same way as other business combinations. One of the combining entities that existed before the business combination shall be identified as the acquirer, unless the NewCo is substantive.

As discussed in Section 2.2.1, if the legal acquiree is a VIE, the primary beneficiary is always the accounting acquirer. As such, a NewCo that becomes the primary beneficiary of the legal acquiree is the accounting acquirer. Otherwise, regardless of which entity forms the NewCo to effect the business combination, an analysis must be performed to determine whether the NewCo is substantive (and, therefore, may be the accounting acquirer) or if the NewCo is nonsubstantive and should be disregarded (in which case, one of the other entities that existed before the business combination would be the acquirer). A NewCo that has no precombination activities other than issuing its equity interests to effect an acquisition is not considered substantive.

BDO INSIGHTS — FACTORS THAT MAY INDICATE THAT A NEWCO IS SUBSTANTIVE

The following factors may indicate that a NewCo is substantive:

- NewCo has been involved in significant precombination activities (for example, raising capital from third parties, identifying acquisition targets, negotiating transactions).
- NewCo survives the transaction (that is, it is not transitory).
- NewCo has substantive precombination operations or assets.
- NewCo had ownership in the acquiree before the acquisition.
- NewCo transfers cash or other assets or incurs liabilities as consideration in the transaction.
- The reason a NewCo was used to effect the business combination has substance.

Conversely, if the Newco was formed solely to effect the business combination and does not have significant precombination activities, it would not be substantive (and, therefore, would not be the acquirer). Reaching a conclusion about whether a NewCo is substantive requires professional judgment based on the facts and circumstances.

2.2.2.4.1 Multiple Entities Merged into Substantive NewCo

In some business combinations, more than one of the combining entities is merged into a substantive NewCo. In such instances, each entity that is acquired by (or merges into) the substantive NewCo would be considered an acquiree in a business combination, and the assets and liabilities of each acquiree would be recognized at a new basis of accounting using the acquisition method as illustrated in the following example.

EXAMPLE 2-5: SUBSTANTIVE NEWCO ACQUIRES TWO BUSINESSES

FACTS

A private equity group forms a NewCo in connection with a business combination. NewCo raises third-party debt and uses it along with equity financing from the private equity group to fund the acquisitions of two unrelated entities, Company A and Company B (which are both businesses). Company A and Company B are merged into NewCo, which is the surviving entity after the business combination. NewCo, as the legal acquirer, determines that Company A and Company B are not VIEs.

CONCLUSION

NewCo is substantive and is the accounting acquirer; therefore, it must apply the acquisition method to record a new basis for the acquired assets and assumed liabilities of both Company A and Company B.

ANALYSIS

NewCo is substantive (and, therefore, is identified as the accounting acquirer), based on the following factors:

- NewCo was involved in significant precombination activities, including raising third-party debt financing to fund the acquisition.
- NewCo survives the transaction (that is, it is not transitory).
- NewCo transfers cash or other assets or incurs liabilities as consideration in the transaction.
- The reason for creating Newco was substantive.

2.2.2.4.2 Formation of Substantive NewCo in Common Control Transaction

In some business combinations, the formation of a NewCo is accounted for as a common control transaction.

Example 2-6 illustrates this concept.

EXAMPLE 2-6: FORMATION OF SUBSTANTIVE NEWCO IN COMMON CONTROL TRANSACTION

FACTS

A private equity fund forms a NewCo in connection with a business combination. The private equity fund exchanges its 100% equity interest in Company A (which is a business) for 100% of the equity interest of NewCo and merges Company A into NewCo such that NewCo is the surviving entity. Simultaneously, NewCo raises third-party debt and uses the debt along with equity financing from the private equity fund for the acquisition of Company B (which is a business). Company B is merged into NewCo, and NewCo is the surviving entity after the business combination. NewCo, as the legal acquirer, determines that Company B is not a VIE.

CONCLUSION

NewCo is substantive and is the accounting acquirer; therefore, it must apply the acquisition method to record a new basis for the acquired assets and assumed liabilities of Company B. The net assets of Company A continue to be recognized at carryover basis.

ANALYSIS

The exchange of the private equity fund’s equity interests in Company A for the equity interests of NewCo represents a common control transaction that is outside the scope of business combination guidance. As such, the net assets of Company A would continue to be recognized at carryover basis. Appendix B provides guidance for accounting for common control transactions.

NewCo is substantive (and therefore identified as the accounting acquirer), based on the following factors:

- NewCo was involved in significant precombination activities, including raising third-party debt financing to fund the acquisition.
- NewCo survives the transaction (that is, it is not transitory).
- NewCo transfers cash or other assets or incurs liabilities as consideration in the transaction.
- The reason for creating Newco was substantive.

2.2.2.4.3 NewCo Formed to Effect a Merger by Issuing Equity Interests

FASB REFERENCES

ASC 805-10-55-15

If a Newco was formed by issuing equity interests solely to effect the business combination (and does not have significant precombination activities), it would not be substantive and, therefore, would not be the acquirer. One of the combining entities that existed before the business combination must be identified as the acquirer.

Example 2-7 illustrates this concept.

EXAMPLE 2-7: NEWCO ISSUES EQUITY TO FACILITATE A MERGER

FACTS

Company A and Company B, which are both businesses, agree to merge. One of the parties forms NewCo to effect the business combination. NewCo issues all its equity interests to the shareholders of Company A and Company B in exchange for all their outstanding equity. NewCo is not a corporate joint venture. NewCo, as the legal acquirer, determines that Company A and Company B are not VIEs.

CONCLUSION

NewCo is not substantive and, therefore, is not identified as the accounting acquirer. Either Company A or Company B must be identified as the acquirer based on the factors in ASC 805.

ANALYSIS

NewCo is not substantive (and therefor, cannot be identified as the accounting acquirer), based on the following factors:

- NewCo was formed solely to issue its equity interests to effect the business combination.
- NewCo was not involved in significant precombination activities.
- NewCo had no substantive precombination operations or assets.
- NewCo had no ownership of the acquiree before the acquisition.
- NewCo did not transfer cash or other assets or incur liabilities as consideration in the transaction.
- Although NewCo survives the transaction (that is, it is not transitory), the other indicators suggest that NewCo is nonsubstantive.

2.3 DETERMINING THE ACQUISITION DATE

FASB REFERENCES

ASC 805-10-25-6 through 25-7

After the acquirer has been identified, the next step in the acquisition method is determining the acquisition date, or the date on which:

- The consideration transferred in the acquisition is measured (including contingent consideration and equity issued to the sellers).
- The acquired assets, assumed liabilities, and noncontrolling interests are measured.
- Previously held equity interests are remeasured.
- The acquirer begins consolidating the acquiree.

The acquisition date is the date the acquirer gains control of the acquiree. It is generally the date the acquirer legally transfers the consideration, acquires the assets, and assumes the liabilities of the acquiree (the closing date). An acquirer must consider all facts and circumstances in identifying the acquisition date.

BDO INSIGHTS — ACQUISITION DATE RARELY PRECEDES THE CLOSING DATE

Although the guidance in ASC 805-10-25-7 provides for the possibility that the acquisition date may be earlier than the closing date, we believe that will be rare. To conclude that the acquisition date precedes the closing date, a written agreement must be in place that transfers control of the business to the acquirer. Such agreement would need to provide the acquirer with the unilateral ability to make all significant decisions for the acquired business without the approval of the sellers. In other words, the sellers must not have ongoing decision-making or participating rights over any significant activities of the business.

The acquisition date generally cannot precede the date that all required approvals for the transaction have been received. Therefore, if regulatory or shareholder approval is required, the acquisition date would typically be after all approvals are obtained. In rare cases, if management and the board of directors control enough votes to approve the transaction, shareholder approval may be perfunctory. In such cases, if control has been obtained through a written agreement the acquisition date could precede the closing date.

2.3.1 Convenience Date

Statement of Financial Accounting Standards No. 141, *Business Combinations* (FAS 141), previously allowed the use of a convenience date (a date at the end of an accounting period between the dates a business combination was initiated and consummated) in place of the acquisition date if the acquirer also reduced the cost of the acquiree and net income otherwise reported to compensate for recognizing income before consideration was transferred. However, upon the adoption of FAS 141(R), the FASB eliminated that exception, noting that the financial statement effects of eliminating that exception were rarely likely to be material.[4]

BDO INSIGHTS — CONVENIENCE DATE MUST NOT RESULT IN A MATERIAL DIFFERENCE

Despite the elimination of the convenience date exception, if an acquirer wants to use a convenience date (such as a month end rather than the actual acquisition date) to record the acquisition, that is acceptable if doing so does not result in a material difference to the acquirer's financial statements.

2.3.2 Acquisition Date for a Step Acquisition

FASB REFERENCES

ASC 805-10-25-9 and ASC 810-10-45-21A through 45-23

In some business combinations, the acquirer has a previously held equity interest in the acquiree before gaining control. In such cases, the acquisition date is the date the acquirer gains control of the business. This is referred to as a business combination achieved in stages or a step acquisition.

For a business combination achieved in stages, the acquirer remeasures its previously held equity interest in the acquiree at the acquisition-date fair value and recognizes the resulting gain or loss in earnings. Section 5.5 provides additional guidance for measuring previously held equity interests for a step acquisition.

Example 2-8 illustrates the acquisition date for a step-acquisition.

[4] FAS 141(R), paragraph B110

EXAMPLE 2-8 (ADAPTED FROM ASC 805-10-25-9): ACQUISITION DATE FOR STEP-ACQUISITION

FACTS

Entity A holds a 35% noncontrolling equity interest in Entity B, which is a business. On December 31, 20X1, Entity A purchases an additional 40% interest in Entity B, which gives it control of Entity B.

CONCLUSION

The acquisition date is December 31, 20X1.

ANALYSIS

December 31, 20X1, is the date Entity A gained control of Entity B. As such, Entity A must apply the acquisition method to account for the business combination at that date, including remeasuring its previously held equity interests at fair value.

Subsequent changes in the parent's ownership interest after control is obtained do not result in business combination accounting. As long as the parent retains control of a subsidiary that meets the definition of a business, any changes in the parent's ownership interest are accounted for as equity transactions with no gains or losses recognized. Further, the carrying amounts of the assets and liabilities of the subsidiary are not adjusted; instead, the parent adjusts the carrying amount of the noncontrolling interests to reflect the change in ownership if the transaction is in the scope of ASC 810.

2.3.3 Acquisition Date When No Consideration Is Transferred

Some business combinations occur without a transfer of consideration from the acquirer to the seller. For example, the lapse of participating rights held by other investors or share repurchases by an investee could result in one investor gaining control over the investee. In such cases, the acquisition date is the date that the investor gains control as a result of the transaction or other event.

Sections 1.1.4 and 5.4.7 provide guidance on accounting for business combinations with no consideration transferred.

Chapter 3 — Definition of A Business

3.1 OVERVIEW

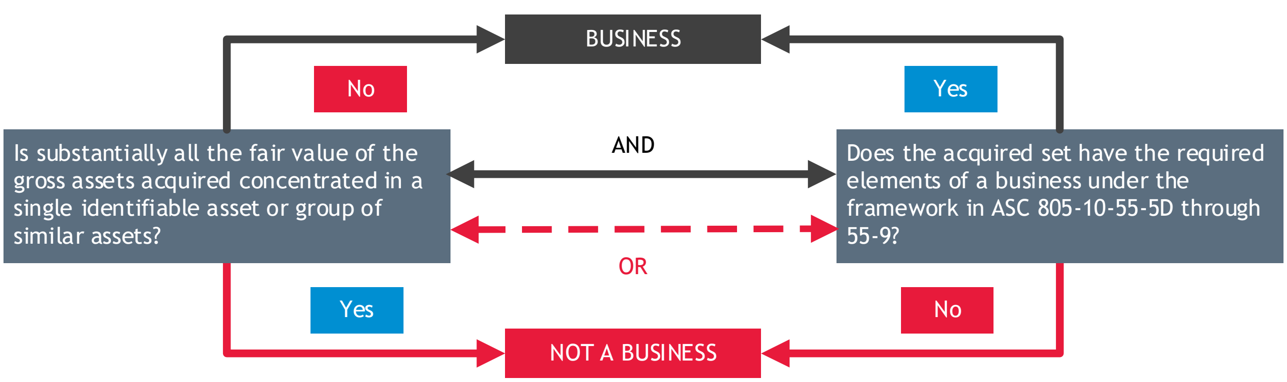
FASB REFERENCES

ASC 805-10-55-5A through 55-9

Once the acquirer has been identified and the acquisition date has been determined (see Chapter 2), the acquirer must evaluate whether the acquired set meets the definition of a business. If so, the transaction is accounted for as a business combination; if not, it must be accounted for as an asset acquisition or recapitalization. This distinction is important because there are several differences in accounting for a business combination and for an asset acquisition or recapitalization. Appendix C provides a summary of differences in accounting for business combinations and asset acquisitions as well as discussing the accounting for recapitalizations.

To determine whether the transaction is accounted for as a business combination, an asset acquisition, or a recapitalization, the acquirer must assess (1) whether substantially all the value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets (the screen test), and (2) whether the acquired set includes the required elements of a business under the framework in ASC 805.

Definition of a Business



Entities can assess these two criteria in whichever order they prefer. If either test indicates that the acquired set is not a business, there is no need to perform the other test. Conversely, even if the acquired set includes all the elements of a business, the screen test must be performed.

DEFINITION OF A BUSINESS FOR SEC REPORTING

The definition of a business for SEC reporting is different than the definition used in ASC 805. As such, registrants must evaluate whether an acquisition constitutes a business under both SEC rules and ASC 805 (see Section 3.7).

3.2 DETERMINING WHAT IS PART OF THE ACQUIRED SET

To assess whether a transaction is a business combination, the acquirer must determine what is part of the acquired set. This is necessary both for performing the screen test and for assessing whether the acquired set includes all the required elements of a business. In many cases, identifying what is part of the set is straightforward; however, it sometimes requires professional judgment.

3.2.1 Contracts and Other Arrangements Between the Acquirer and the Seller

FASB REFERENCES

ASC 805-10-25-20 through 25-22

Even if the acquisition agreement explicitly identifies what is included as part of the acquisition, the acquirer must evaluate which elements of the transaction are part of the business combination and whether any elements must be accounted for separately. Chapter 6 provides guidance for identifying elements that are not part of a business combination. Any elements that are not part of the business combination are accounted for under other U.S. GAAP and are not part of the acquired set.

For example, it is not uncommon for an acquirer and seller to enter into a transition services agreement (TSA) in which the seller agrees to provide services for a defined period following the acquisition date to assist with the transition of the acquired business to the acquirer. Because such agreements compensate the former owners for future services, they are typically accounted for separate from the acquisition transaction (see Section 6.4.2.8.2).

3.2.2 Contracts Between the Acquirer and a Party Other Than the Seller

Contracts that are separately negotiated between the acquirer and a party other than the seller are not typically part of the acquired set as the other party is not party to the business combination. However, if the seller and the other party had a preexisting contract, in some instances it may be appropriate to include the contract in the acquired set. For example, if the seller assigns the preexisting contract to the acquirer as part of the acquisition, that contract would likely be part of the acquired set.

However, if the acquirer had significant involvement in negotiating or modifying the terms of an assumed contract, it would not be appropriate to include the contract as part of the acquired set. In that case, the substance of the transaction is no different than if the acquirer had separately negotiated the contract with the other party.

In some cases, an acquirer and the other party may enter a new contract at the time of an acquisition transaction as a matter of convenience. In such cases, it may be appropriate to include the contract in the acquired set if the substance is that the acquirer has assumed an existing contract from the seller. However, if the terms of the new contract between the acquirer and the party other than the seller are significantly different than the preexisting contract between the seller and the other party, it would not be appropriate to include the new contract in the acquired set.

3.2.2.1 Contracts Between the Acquirer and a Party Other Than the Seller - Examples

Examples 3-1 through 3-4A illustrate how to assess whether a contract is part of the acquired set in various scenarios.

EXAMPLE 3-1: ASSESSING WHETHER A CONTRACT IS PART OF THE SET — SCENARIO 1

FACTS

- ABC owns and manages real estate properties for itself and others. XYZ acquires several commercial properties from ABC.
- Contemporaneously with the acquisition, XYZ enters a contract with Property Manager in which Property Manager agrees to manage the properties for XYZ.

CONCLUSION

The contract between XYZ and Property Manager is not part of the acquired set.

ANALYSIS

ABC did not have a contract with Property Manager before the acquisition; therefore, XYZ did not assume the contract as part of the acquisition.

EXAMPLE 3-2: ASSESSING WHETHER A CONTRACT IS PART OF THE SET — SCENARIO 2

FACTS

- ABC owns real estate properties and outsources the management of its properties to Property Manager. XYZ acquires several commercial properties from ABC.
- The preexisting contract between ABC and Property Manager terminates upon a change in control. However, contemporaneous with the acquisition, XYZ negotiates with Property Manager and enters into a new agreement in which Property Manager agrees to manage the properties for XYZ.

CONCLUSION

The contract between XYZ and Property Manager is not part of the acquired set.

ANALYSIS

ABC’s contract with Property Manager was automatically terminated upon the change in control, and XYZ had to negotiate a new contract with Property Manager; therefore, XYZ did not assume the contract as part of the acquisition.

EXAMPLE 3-3: ASSESSING WHETHER A CONTRACT IS PART OF THE SET — SCENARIO 3

FACTS

- ABC owns real estate properties and outsources the management of its properties to Property Manager. XYZ acquires several commercial properties from ABC.
- ABC assigns the property management agreement with Property Manager to XYZ as part of the acquisition.

CONCLUSION

The contract between XYZ and Property Manager is part of the acquired set.

ANALYSIS

ABC’s contract with Property Manager was assigned to XYZ without having to be renegotiated; therefore, XYZ assumed the contract as part of the acquisition.

EXAMPLE 3-4: ASSESSING WHETHER A CONTRACT IS PART OF THE SET — SCENARIO 4

FACTS

- ABC owns real estate properties and outsources the management of its properties to Property Manager. XYZ acquires several commercial properties from ABC.
- The property management agreement between ABC and Property Manager is assignable to other parties. However, for convenience, XYZ requests that ABC and Property Manager terminate their agreement, and XYZ enters into a new agreement with Property Manager with substantially the same terms as the previous agreement.

CONCLUSION

The contract between XYZ and Property Manager is part of the acquired set.

ANALYSIS

The substance of the transaction is that XYZ assumed the existing property management agreement from ABC. Property Manager and ABC terminated the existing contract only as a matter of convenience for XYZ, and the terms of the agreement were not renegotiated.

EXAMPLE 3-4A ASSESSING WHETHER A CONTRACT IS PART OF THE SET - SCENARIO 5

FACTS

Assume the same facts as Example 3-4, except that the terms of Property Manager's new agreement with XYZ are not substantially the same as the prior agreement with ABC.

CONCLUSION

The contract between XYZ and Property Manager is not part of the acquired set.

ANALYSIS

The substance of the transaction is that XYZ entered into a new property management agreement with Property Manager contemporaneous with the acquisition, rather than assuming an existing agreement. As such, the property management agreement is not part of the acquired set.

3.2.3 Acquired Employees

In many acquisitions, the acquirer obtains control of a legal entity and the acquiree's employees become employees of the acquirer as part of the transaction. In such instances, it is clear that the employees are part of the acquired set.

Other acquisitions are structured as the purchase of assets rather than the purchase of an acquiree's equity. In such cases, the employees (or a subset) may be terminated by the seller and immediately hired by the acquirer. In such cases, the form of the transaction (asset purchase vs. stock purchase) is not determinative. In other words, it is typically appropriate to include employees that were terminated by the seller and immediately hired by the acquirer in connection with an acquisition as part of the acquired set. However, all facts and circumstances must be considered.

BDO INSIGHTS — FACTORS TO CONSIDER WHEN EVALUATING WHETHER THE ACQUISITION INCLUDES EMPLOYEES

When assessing whether employees are included in the acquired set, the acquirer may wish to consider factors such as:

- Was the hiring of the employees in close proximity to the transaction date?
- Was the seller involved in facilitating the acquirer's hiring of the employees (for example, was the hiring of the employees a closing condition)?
- How important are the employees to the acquired set? Do they have specialized knowledge and skills that the acquirer needs to use the other inputs and processes acquired in the set?

Reaching a conclusion about whether employees are part of the acquired set requires judgment based on the facts and circumstances.

3.3 SCREEN TEST

FASB REFERENCES

ASC 805-10-55-5A

ASC 805 requires an entity to evaluate whether substantially all[5] the fair value of the gross assets acquired is concentrated in a single identifiable asset or a group of similar identifiable assets. If the substantially all threshold is met, the set is not a business and does not require further evaluation. For purposes of this test, gross assets acquired excludes cash and cash equivalents, deferred tax assets, and goodwill resulting from the effects of deferred tax liabilities. However, the gross assets acquired includes 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 (goodwill).

Gross Assets Acquired = Identifiable Assets + Goodwill − Cash − DTAs − Goodwill from DTLs

In some cases, the screen test can be performed qualitatively. For example, if an acquisition includes at least two significant dissimilar assets of similar values, the acquirer may be able to qualitatively conclude that the substantially all threshold is not met without knowing the precise values of the acquired assets. Further, the presence of more than an insignificant amount of goodwill may indicate that the acquired set is a business.

In other cases, it may be necessary to complete a valuation of the acquired assets to perform the screen test. For example, if a single identifiable asset (or group of similar assets) makes up a significant portion of the gross assets acquired, but it is not readily apparent whether the substantially al" threshold has been met, an acquirer may need to determine the values of the acquired assets to assess whether the screen test has been met.

[5] While there is no bright line threshold, "substantially" all is generally interpreted to be approximately 90% or greater.

3.3.1 Single Identifiable Asset or Group of Similar Assets

FASB REFERENCES

ASC 805-20-55-6

The starting point for performing the screen test is to identify the assets that are part of the acquired set. For the test, the acquired assets should be identified and measured using the principles for business combinations (including any measurement exceptions). In other words, the acquirer should use the same unit of account for identifying assets in the screen test as it would use for identifying assets recognized in a business combination.

For example, although an assembled workforce would be recognized as a separately identifiable asset in an asset acquisition, ASC 805 prohibits separate recognition of assembled workforce in a business combination and instead requires the value of the assembled workforce to be subsumed into goodwill. As such, assembled workforce is not an identifiable asset for the screen test. Similarly, in-process research and development (IPR&D) is required to be recognized in a business combination, regardless of whether it has an alternative use. Thus, if IPR&D is acquired, it would need to be valued and included as an identifiable asset in the screen test.

3.3.1.1 Groups of Similar Identifiable Assets

FASB REFERENCES

ASC 805-10-55-5B through 55-5C

Once the acquirer has identified and measured the acquired assets in accordance with business combination principles, it must determine whether any of the assets must be combined for the screen test.

The following are considered a single asset for the screen test:

- 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)
- In-place lease intangibles, including favorable and unfavorable intangible assets or liabilities, and the related lease assets

Further, other similar assets must be combined and assessed as a group of similar identifiable assets if they are similar in nature and share similar risks. Conversely, assets cannot be combined if they are not similar in nature or do not share similar risks. Reaching a conclusion about which assets must be combined and assessed as a group of similar identifiable assets requires professional judgment based on the facts and circumstances.

BDO INSIGHTS — INTEGRAL EQUIPMENT

Acquisitions in some industries may include production equipment. Although ASC 842, *Leases*, supersedes the guidance on integral equipment in ASC 360 *Property, Plant, and Equipment*, this guidance may be helpful when determining whether a tangible asset that is attached to another asset cannot be removed and reused without incurring significant cost. Specifically, before being superseded, ASC 360-20-55-59 indicated that if the cost to remove the equipment and use it separately was more than 10% of the fair value of the equipment, the cost was deemed significant, and the equipment represented integral equipment.

BDO INSIGHTS — GROUPING OF ASSETS FOR THE SCREEN TEST DOES NOT AFFECT RECOGNITION AND MEASUREMENT OF ASSETS

Although similar assets must be grouped together for purposes of the screen test, this grouping does not affect the recognition and measurement of the acquired assets in the set. The acquirer must recognize and measure the acquired assets in accordance with business combination principles. For example, although a building and the land it is attached to must be combined for the screen test, the land and building would be recognized on the balance sheet as separately identifiable assets.

The following are not considered similar assets:

- Tangible and intangible assets
- Identifiable intangible assets in different major intangible asset classes (for example, customer-related intangibles, trademarks, and IPR&D)
- Financial and nonfinancial assets
- Different major classes of financial assets (for example, accounts receivable and marketable securities)
- Different major classes of tangible assets (for example, inventory, manufacturing equipment, and automobiles)
- Identifiable assets in the same major asset class that have significantly different risk characteristics

Examples 3-5 and 3-6 illustrate the application of the screen test.

EXAMPLE 3-5 APPLYING THE SCREEN TEST FOR AN ACQUISITION OF A GROUP OF PROVED OIL PRODUCING PROPERTIES

FACTS

- Oil Explorers LLC acquires a 100% operating interest in proved producing properties (several hundred producing wells) in a single geographic area, including the mineral interests and basic lease production facilities.
- The fair value of the basic lease production facilities would decline substantially if removed from the properties.
- No employees or other assets were acquired.

CONCLUSION

Oil Explorers LLC concludes that substantially all the fair value of the gross assets acquired is concentrated in a group of similar identifiable assets (proved producing properties) so the set is not a business.

ANALYSIS

Oil Explorers LLC considers the guidance in ASC 805-10-55-5A through 55-5C and concludes that each proved producing property and the related basic lease production facilities are a single asset in accordance with ASC 805-10-55-5B. That is, the lease production facilities are attached to the proved producing property (and the associated mineral interests) and cannot be removed without a significant decrease in utility to and fair value of the tangible assets. Further, given that the properties are all proved and in the same geographic area, Oil Explorers LLC also concludes that the properties together constitute a group of similar assets.

EXAMPLE 3-6 APPLYING THE SCREEN TEST FOR AN ACQUISITION OF UNPROVED OIL PRODUCING PROPERTIES

FACTS

- O&G Company acquires a 100% operating interest in mostly unproved acreage and a small amount of older, proved producing properties (containing less than 100 producing wells), including the mineral interests and basic lease production facilities for the proved producing properties.
- The fair value of the unproved acreage constitutes approximately 95% of the fair value of the gross assets acquired.
- The basic lease production facilities would decline substantially if removed from the properties.
- No employees or other assets were acquired.

CONCLUSION

O&G Company concludes that substantially all the fair value of the gross assets acquired is concentrated in a single identifiable asset (unproved acreage) so the set is not a business.

ANALYSIS

When considering the screen test in ASC 805-10-55-5A through 55C, O&G Company concludes that the unproved acreage is a single asset in accordance with ASC 805-10-55-5B. That is, the lease(s) associated with the acreage must be combined with the mineral interests and considered one asset.

3.3.1.2 Calculation of the Screen Test

FASB REFERENCES

ASC 805-10-55-5A and ASC 805-10-55-9

The calculation of the screen test requires the acquirer to divide the value of the single identifiable asset or group of similar identifiable assets (the numerator) by the gross assets acquired (the denominator). Gross assets acquired does not include liabilities (either in the numerator or denominator) as the FASB believed that the presence of debt or other liabilities should not affect the analysis of the screen test[6].

Gross Assets Acquired = Identifiable Assets + Goodwill − Cash − DTAs − Goodwill from DTLs

The gross assets acquired includes any consideration transferred (plus the fair value of any noncontrolling interest and previously held interest, if any) in excess of the fair value of the net identifiable assets acquired. In other words, the goodwill that arises from the transaction (except for goodwill resulting from the effects of deferred tax liabilities, as discussed, below) is included in the denominator. In calculating the denominator, the business combination principles are applied. As such, the consideration transferred must include the initial fair value of contingent consideration, if any.

When deciding to include goodwill in the denominator, the FASB reasoned[7] that excluding it from the denominator would be inconsistent with the goodwill indicator in ASC 805-10-55-9, which indicates that the presence of more than an insignificant amount of goodwill may indicate that the acquired set is a business.

However, the gross assets acquired (including both the numerator and denominator) should exclude the following:

- Cash and cash equivalents

[6] ASU 2017-01, *Business Combinations (Topic 805): Clarifying the Definition of a Business,* paragraph BC20
[7] ASU 2017-01, paragraph BC20

- Deferred tax assets
- Goodwill resulting from the effects of deferred tax liabilities

Once the screen test has been calculated, the acquirer must conclude whether substantially all the fair value of the gross assets acquired is concentrated in a single identifiable asset or a group of similar identifiable assets. If the substantially all threshold is met, the set is not a business and does not require further evaluation.

BDO INSIGHTS — SUBSTANTIALLY ALL MEANS APPROXIMATELY 90%

While the term “substantially all” is not defined in U.S. GAAP, it is generally interpreted to mean approximately 90% (or more). Although this is not meant to be a bright line, we believe it would be difficult to conclude that a single identifiable asset or group of similar identifiable assets that has a value greater than 90% has not met the threshold. Similarly, if the value of a single identifiable asset or group of similar identifiable assets is more than a few percentage points below 90%, it may be difficult to conclude that the threshold has been met. Reaching a conclusion about whether substantially all the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets requires professional judgment based on the facts and circumstances.

BDO INSIGHTS —LIABILITIES ARE EXCLUDED FROM THE SCREEN TEST

Acquisitions often include assets that have associated liabilities, such as asset retirement obligations and lease liabilities. Because of the inherent inseparability of an acquired asset and the related asset retirement obligation, or of a right-of-use asset and the associated lease liability, the question arises whether those types of liabilities are included in the value of the acquired asset and the total gross assets acquired when applying the screen test. However, paragraph BC20 of ASU 2017-01 clarifies that when performing the screen test, gross assets acquired must exclude the value of any liabilities assumed to avoid debt or other liabilities from affecting the analysis. As such, all liabilities, including asset retirement obligations and lease liabilities, must be excluded from the screen test.

3.3.2 Screen Test - Examples

Examples 3-7 through 3-10A illustrate the screen test for different scenarios.

EXAMPLE 3-7 (ADAPTED FROM ASC 805-10-55-52 THROUGH 55-54): APPLYING THE SCREEN TEST FOR AN ACQUISITION OF REAL ESTATE — SCENARIO 1

FACTS

- ABC acquires a portfolio of 10 single-family homes that each have in-place leases. There are no other elements in the acquired set.
- Each single-family home includes the land, building, and property improvements. Each home has a different floor plan, square footage, lot, and interior design.

CONCLUSION

ABC concludes that substantially all the fair value of the gross assets acquired is concentrated in a group of similar identifiable assets, so the set is not a business.

ANALYSIS

ABC considers the guidance in ASC 805-10-55-5A through 55-5C and concludes that the land, building, property improvements, and in-place leases at each property are considered a single asset in accordance with ASC 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 leases are combined with the related real estate and considered a single asset.

ABC further concludes that the 10 single assets (the combined land, building, in-place leases, and property improvement) are similar. Each home has a different floor plan, but the nature of the assets (all single-family homes) is 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 the fair value of the gross assets acquired is concentrated in a group of similar identifiable assets.

EXAMPLE 3-8 (ADAPTED FROM ASC 805-10-55-52 THROUGH 55-56): APPLYING THE SCREEN TEST FOR AN ACQUISITION OF REAL ESTATE — SCENARIO 2

FACTS

- ABC acquires a portfolio of 10 single-family homes that have 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.
- ABC also acquires an office park with six 10-story office buildings leased to maximum occupancy, all of which have significant fair value.

CONCLUSION

ABC concludes that the single-family homes and office park are not similar assets. Thus, it must further evaluate whether the acquired set has the minimum requirements to be a business.

ANALYSIS

ABC considers the risks associated with operating the assets, obtaining tenants, and managing tenants for the single-family homes and the 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 the fair value of the gross assets acquired is not concentrated in a single identifiable asset or group of similar identifiable assets.

EXAMPLE 3-9 (ADAPTED FROM ASC 805-10-55-67 THROUGH 55-69): APPLYING THE SCREEN TEST FOR ACQUISITION OF DRUG CANDIDATES

FACTS

- 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. Project 1 and Project 2 have equal fair value.
- No employees, other assets, or other activities are transferred.

CONCLUSION

Pharma Co. concludes that substantially all 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 a business.

ANALYSIS

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 evaluates 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 IPR&D 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 the fair value of the gross assets acquired is not concentrated in a single identifiable asset or group of similar identifiable assets.

EXAMPLE 3-10 (ADAPTED FROM ASC 805-10-55-88 THROUGH 55-89): APPLYING THE SCREEN TEST FOR AN ACQUISITION OF LOAN PORTFOLIO — SCENARIO 1

FACTS

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

CONCLUSION

Bank A concludes that substantially all the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar assets.

ANALYSIS

Bank A considers the guidance in ASC 805-10-55-5A through 55-5C and 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 loans' terms, size, and risk ratings are not significantly different. Because substantially all the fair value of the gross assets acquired is in a group of similar identifiable assets, the set is not a business.

EXAMPLE 3-10A (ADAPTED FROM ASC 805-10-55-90 THROUGH 55-91): APPLYING THE SCREEN TEST FOR AN ACQUISITION OF LOAN PORTFOLIO — SCENARIO 2

FACTS

Assume the same facts as Example 3-10 except that the portfolio of loans acquired by Bank A from Bank Z consists of commercial loans with significantly different terms, sizes, and risk ratings.

CONCLUSION

Bank A concludes that substantially all the fair value of the gross assets acquired is not concentrated in a single identifiable asset or group of similar assets.

ANALYSIS

In this case, although the nature of the assets is similar (they are all commercial loans), because the loans' terms, sizes, and risk ratings are significantly different, Bank A would conclude that substantially all the fair value of the gross assets acquired is not concentrated in a single identifiable asset or group of similar assets. It must further evaluate whether the set has the minimum requirements to be a business.

3.4 ELEMENTS OF A BUSINESS

FASB REFERENCES

ASC 805-10-55-3A through 55-5 and ASC 805-10-55-5D through 55-9

If substantially all the fair value of the gross assets acquired is not concentrated in a single identifiable asset or a group of similar identifiable assets, the acquirer must assess whether the acquired set includes the required elements of a business under ASC 805.

A business is described as *"an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants."* The determination of whether an acquired set meets the definition of a business must be based on market participant assumptions. As such, 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.

At a minimum, 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. However, the criteria for concluding that an acquired set is a business are more stringent when outputs are not present (see Section 3.5).

3.4.1 Inputs

FASB REFERENCES

ASC 805-10-55-4(a)

The determination of whether a set includes inputs is generally straightforward. Inputs include any 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, intangible assets, intellectual property, and employees. However, in some cases, professional judgment must be applied to determine whether inputs have the ability to contribute to the creation of outputs. For example, furniture used for back-office functions likely would not directly contribute to the creation of outputs.

3.4.2 Processes

FASB REFERENCES

ASC 805-10-55-4(b)

Determining whether a set includes a substantive process is sometimes more challenging than identifying inputs. Processes are what turn inputs into outputs, including any system, standard, protocol, convention, or rule. Processes are usually documented, but do not have to be. A process could include the intellectual capacity of an organized workforce having the necessary skills and experience to convert inputs into outputs. Administrative systems, such as accounting, billing, and payroll, are typically not processes used to create outputs.

To be part of the acquired set, a process must be transferred from the seller to the acquirer. Accordingly, contracts entered contemporaneously with the acquisition require additional scrutiny. Oftentimes, contracts between the acquirer and a third-party or contracts between the acquirer and the seller for the provision of ongoing services will be accounted for separate from the acquisition (and thus would not be considered part of the acquired set). Section 3.2 provides guidance for evaluating whether contracts should be included in the acquired set.

If a seller does not transfer a process to the acquirer, the set cannot be a business.

Examples 3-11 and 3-11A illustrate this concept.

EXAMPLE 3-11 (ADAPTED FROM ASC 805-10-55-55 THROUGH 55-61): ASSESSING WHETHER AN ACQUISITION OF REAL ESTATE IS A BUSINESS – SCENARIO 1

FACTS

- ABC acquires a portfolio of 10 single-family homes that each have 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.
- ABC also acquires an office park with six 10-story office buildings leased to maximum occupancy of which all have significant fair value.
- ABC 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 processes and employees with its own internal resources.

CONCLUSION

The acquired set does not include a substantive process; therefore, it is not a business.

ANALYSIS

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 managing tenants for the single-family homes and the 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 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 a business.

The set has continuing revenues through the in-place leases and, therefore, has outputs. However, ABC concludes that the acquired set does not include any substantive processes. As ABC intends to replace the property management and employees with its own internal resources, there is not an acquired process related to the property management function. Additionally, the outsourcing agreements for cleaning, security, and maintenance are ancillary to the creation of outputs and such services are not unique or scarce and can be replaced with little cost or effort. Because the acquired set does not include a substantive process, it is not a business.

EXAMPLE 3-11A (ADAPTED FROM ASC 805-10-55-62 THROUGH 55-64): ASSESSING WHETHER AN ACQUISITION OF REAL ESTATE IS A BUSINESS — SCENARIO 2

FACTS

Assume the same facts as Example 3-11, except that the set includes employees responsible for leasing, tenant management, and managing and supervising all operational processes.

CONCLUSION

The acquired set includes inputs, outputs, and at least one substantive process; therefore, it is a business.

ANALYSIS

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 managing tenants for the single-family homes and the 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 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 a business.

The set has continuing revenues through the in-place leases and, therefore, has outputs. Additionally, the acquired set includes the employees responsible for leasing, tenant management, and managing and supervising all operational processes. As such, the set includes a substantive process (that is, an organized workforce that has the skills, knowledge, and experience to convert the inputs into outputs); therefore, it is a business.

3.4.3 Outputs

FASB REFERENCES

ASC 805-10-55-4(c)

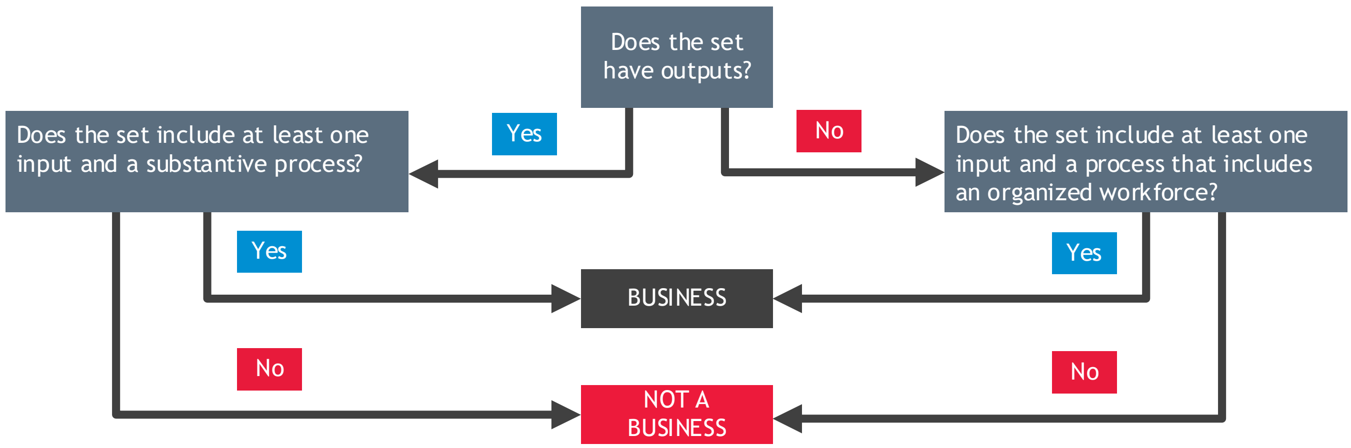
Outputs are *"the result of inputs and processes applied to those inputs that provide goods or services to customers, investment income (such as dividends or interest), or other revenues."* As such, if the acquired set is generating revenues or other income both before and after the transaction, it would be deemed to have outputs.

Additionally, an acquired set does not need to have external revenues or other income both before and after the transaction. For example, a set would be deemed to have outputs if it generates revenues by providing goods or services to external parties or that are used internally (that is, intercompany revenues) by either the seller (prior to the acquisition) or the acquirer (after the acquisition).

In some cases, professional judgment may be required in determining whether an acquired set has a continuation of revenues or other income (and is, therefore, deemed to have outputs). For example, if the amount of revenues or other income generated from an acquired set is insignificant when compared with the value of the assets in the acquired set, it may be appropriate to evaluate the acquired set as if it did not have outputs. In such situations, professional judgment is needed as, in other cases even a small amount of revenues may be enough to conclude that the set has outputs. For example, if the acquired set is a start-up company that has just begun to generate revenues, and such revenues are expected to grow over time, it would likely be appropriate to conclude that the acquired set includes outputs.

An acquirer cannot presume that an acquired set is a business solely because it is generating revenues before and after the transaction. In fact, ASC 805-10-55-5F indicates that assumed contracts that provide for a continuation of revenues (for example, customer contracts, customer lists, and leases (as lessor)) must be excluded from the analysis of whether a process has been acquired. If the acquired set does not include an input and a process it is not a business – even if outputs are present.

As noted in Section 3.4, the criteria for concluding that an acquired set is a business are more stringent when outputs are not present. The presence of outputs is often a key element of a business, so if this element is missing there is a higher bar for concluding that the acquired set is a business. As such, the starting point for the assessment is to determine whether the acquired set includes outputs.



3.5 ELEMENTS OF A BUSINESS IF THE ACQUIRED SET DOES NOT INCLUDE OUTPUTS

FASB REFERENCES

ASC 805-10-55-5D

If an acquired set does not include outputs (for example, a continuation of revenues), the criteria for concluding that it meets the definition of a business are more stringent than for a set that includes outputs. Specifically, if the set does not include outputs, it must include employees that form an organized workforce and another input (that is, an input other than employees) that the workforce could develop or convert into outputs. Therefore, even if other processes are in the acquired set (for example, a contract that outsources production to a contract manufacturer) that could convert inputs into outputs, if there is not an organized workforce of employees, the set would not be a business.

The organized workforce must have the necessary skills, knowledge, or experience to convert the acquired inputs into outputs. For the process to be substantive it must be considered critical to the ability to convert the acquired inputs into outputs. Thus, employees that only perform administrative or back-office tasks, would not be considered part of a critical process. Accounting, billing, payroll, and other administrative systems typically are not processes used to create outputs.

The greater the number of employees acquired, the more likely it is that the acquired set will include an organized workforce. However, an acquired set does not have to include a large number of employees. Even if the acquired set includes only a few employees with the necessary skills, knowledge, or experience to convert the acquired inputs into outputs, it may qualify as an organized workforce.

Examples 3-12 through 3-13 illustrate this concept.

EXAMPLE 3-12 (ADAPTED FROM ASC 805-10-55-70 THROUGH 55-72): ACQUIRED SET INCLUDES AN ORGANIZED WORKFORCE

FACTS

- 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. Project 1 and Project 2 have equal fair value.
- The chief operating officer and chief scientific officer in charge of developing Project 1 and Project 2 and a few administrative employees are transferred from Biotech to Pharma Co. as part of the acquisition.

CONCLUSION

The acquired set includes inputs and an organized workforce that could convert the acquired inputs into outputs, and the acquired set would meet the definition of a business.

ANALYSIS

As the set does not have outputs, Pharma Co. must assess whether the acquired set includes employees that form an organized workforce. The chief operating officer and chief scientific officer will manage and supervise the entities performing research and development and manufacturing processes and are deemed to have the skills, knowledge, or experience that is critical to the ability to convert the inputs (the intellectual property) into outputs (a product that can be sold to a customer). As such, these two individuals would constitute an organized workforce, and the acquired set would meet the definition of a business. The administrative employees would not be part of an organized workforce that could convert the acquired inputs into outputs.

EXAMPLE 3-12A (ADAPTED FROM ASC 805-10-55-70 THROUGH 55-72): ACQUIRED SET DOES NOT INCLUDE AN ORGANIZED WORKFORCE

FACTS

Assume the same facts as Example 3-12, except that there were no employees transferred to Pharma Co. as part of the acquisition.

CONCLUSION

The acquired set is not an organized workforce that could convert the acquired inputs into outputs, so it does not meet the definition of a business.

ANALYSIS

Because there were no employees transferred to Pharma Co. as part of the acquisition, the acquired set would not be a business – even though there are contracts in place for research and development and manufacturing. To be a business, an acquired set without outputs must include employees that form an organized workforce.

EXAMPLE 3-13: ACQUISITION OF UNPROVED AND PROVED OIL PRODUCING PROPERTIES WITH A SMALL AMOUNT OF OUTPUTS – EVALUATING WHETHER IT IS A BUSINESS

FACTS

- Explorers R Us acquires a 100% operating interest in unproved acreage, several hundred proved undeveloped reserves, proved producing properties (containing dozens of producing wells), mineral interests and basic lease producing facilities for the proved producing properties.
- The fair value of the unproved acreage constitutes approximately 80% of the fair value of the gross assets acquired, while the value of the proved undeveloped reserves represents approximately 15% of the fair value of the gross assets.
- The basic lease production facilities would decline substantially if removed from the properties.
- No employees or other assets were acquired.

CONCLUSION

Explorers R Us concludes that substantially all the fair value of the gross assets acquired is not concentrated in a single identifiable asset. It also concludes that the vast majority of the value resides in the unproved properties and proved undeveloped reserves that contain no outputs and thus concludes that this is an acquired set without outputs. Explorers R Us concludes that the criteria in ASC 805-10-55-5D are not met because it did not acquire a work force, so the set is not a business.

ANALYSIS

Explorers R Us first performs the screen test. It concludes that that the unproved acreage is a single asset in accordance with ASC 805-10-55-5B. That is, the lease(s) associated with the acreage are combined with the mineral interests and considered one asset. By the same token, the lease and related mineral interests for each proved undeveloped reserve are combined and considered a single asset.

Explorers R Us concludes that each of the proved producing properties and the basic lease production facilities are a single asset in accordance with ASC 805-10-55-5B. That is, the lease production facilities are attached to the wells and the associated mineral interests and cannot be removed without a significant decrease in utility to the tangible assets.

Explorers R Us also concludes that the unproved acreage, the proved undeveloped reserves and the proved producing properties along with the associated lease production facilities are not similar. It considers the risk characteristics for the unproved acreage and the proved undeveloped reserves and proved producing properties to be significantly different because no test wells have yet been drilled in the unproved acreage, and the unproved acreage covers a different geological zone. Therefore, substantially all the fair value of the gross assets acquired is not concentrated in a single identifiable asset or a group of similar identifiable assets because the unproved properties constitute only 80% of the fair value of the gross assets acquired.

Explorers R Us next analyzes whether the acquired set meets the definition of a business.

it must determine if the acquired set includes both an input and a substantive process that together significantly contribute to the ability to create an output (see ASC 805-10-55-5). Although the set contains outputs, Explorers R Us concludes that the vast majority of the value resides in the unproved properties and proved undeveloped reserves that contain no outputs and thus concludes that this is an acquired set without outputs. It concludes that the criteria in ASC 805-10-55-5D are not met because it did not acquire a work force, so the set is not considered to be a business.

3.6 ELEMENTS OF A BUSINESS IF THE ACQUIRED SET INCLUDES OUTPUTS

FASB REFERENCES

ASC 805-10-55-5E through 55-5F

If an acquired set includes outputs, it is more likely to be a business than a set without outputs, so the criteria for evaluating whether an acquired set is a business is less stringent for a set that includes outputs than for a set without them. However, an acquirer cannot presume that an acquired set is a business solely because it has outputs. If the acquired set does not include one or more inputs and a substantive process, it is not a business – even if outputs are present.

When evaluating whether an acquired set with outputs is a business, **any** of the following would represent a substantive process:

- Employees that form an organized workforce (see Section 3.6.1)
- An acquired contract that provides access to an organized workforce (see Section 3.6.2)
- An acquired process that cannot be replaced without significant cost, effort, or delay (see Section 3.6.3)
- An acquired process that is unique or scarce (see Section 3.6.3)

As a result, if any of the above are present in a set with outputs, the set would be a business.

3.6.1 Employees That Form an Organized Workforce

FASB REFERENCES

ASC 805-10-55-4(b)

The evaluation of whether employees that form an organized workforce represents a substantive process is the same for a set with outputs as for a set without outputs (see Section 3.5).

3.6.2 An Acquired Contract That Provides Access to An Organized Workforce

FASB REFERENCES

ASC 805-10-55-5F and ASC 805-10-25-21(b)

For an acquired set that includes outputs, a substantive process would include an acquired contract that provides access to an organized workforce. This differs from the evaluation of a set without outputs, which requires that an organized workforce consist of employees. However, to be considered substantive, the acquired contract must provide access to an organized workforce that has the necessary skills, knowledge, or experience to convert the acquired inputs into outputs.

The acquirer must evaluate whether the acquired contract is critical to the ability to continue producing outputs, and thus is substantive. A process that is ancillary or minor in the context of all processes acquired is not critical to the ability to continue producing outputs. In performing this assessment, the acquirer must consider the contract's duration and renewal terms. Short-term contracts are less likely to be considered critical to the ability to continue producing outputs, whereas longer-term contracts may be indicative that the process is critical. However, short-term contracts may include renewal options (and long-term contracts may include termination provisions that function similarly to renewal options). If the processes provided by such contracts cannot be replaced without significant cost, effort, or delay, or if the processes are unique or scarce, it may indicate that the acquired contract includes a substantive process. Reaching a conclusion about whether an acquired contract includes a substantive process requires the use of professional judgment based on the facts and circumstances.

Further, certain contracts must be excluded from the analysis when determining whether a substantive process was acquired. ASC 805-10-55-5F specifically excludes assumed contracts that provide for a continuation of revenues (for example, customer contracts, customer lists, and leases (as lessor)) from the assessment as the FASB believes[8] that a continuation of revenues on its own would not be indicative of an acquired process.

Example 3-14 illustrates the concept.

[8] ASU 2017-01, paragraph BC54

EXAMPLE 3-14: ACQUISITION OF GAS PIPELINE AND TRANSPORTATION AGREEMENTS – EVALUATING WHETHER IT IS A BUSINESS

FACTS

- Midstream Pipeline Company (Midco) acquires a gas pipeline that includes firm transportation agreements with two producers for 100% of the pipeline's capacity at a fixed price per month.
- The acquired set includes a pipeline and two customer relationship intangible assets. The fair value of the pipeline is approximately 80% of the total assets acquired and the value of the customer relationships is approximately 20%.
- Midco intends to use its own employees and processes to operate the pipeline.
- No employees or other assets were acquired.

CONCLUSION

Midco concludes that substantially all the fair value of the gross assets acquired is not concentrated in a single identifiable asset. Although the firm transportation agreements provide for a continuation of revenue, Midco does not factor them into its analysis of whether a process was acquired in accordance with ASC 805-10-55-5F. Because Midco did not acquire an organized workforce or other process, it concludes that the acquired set is not a business.

ANALYSIS

Midco first performs the screen test. ASC 805-10-55-5C(a) indicates that tangible and intangible assets are not similar assets. Therefore, the pipeline and the customer relationship intangible assets are not similar assets. Therefore, substantially all the fair value of the gross assets acquired is not concentrated in a single identifiable asset.

Midco next determines if the acquired set includes both an input and a substantive process that together significantly contribute to the ability to create an output. Because the set contains outputs (pipeline revenue), Midco considers the criteria for an acquired set with outputs.

Midco concludes that the criteria in ASC 805-10-55-5E(a-d) are not met because it did not acquire a significant process. Specifically, Midco did not acquire a workforce or a contract that provides access to a workforce as it intends to utilize its own work force to operate the pipeline. Further, no other processes were acquired.

Although the firm transportation agreements provide for a continuation of revenue, Midco does not factor them into its analysis of whether a process was acquired, in accordance with ASC 805-10-55-5F. Midco concludes that the acquired set is not a business.

The evaluation of whether a substantive process has been acquired must also exclude contracts that are not part of the acquired set. Contracts entered contemporaneously with the acquisition require scrutiny. Often, contracts between the acquirer and a third-party or contracts between the acquirer and the seller for the provision of ongoing services will be accounted for separate from the acquisition (and thus are not part of the acquired set). Section 3.2 provides guidance for evaluating whether contracts are included in the acquired set.

For example, a seller may enter into a transition services agreement (TSA) in which it agrees to provide services for a period following the acquisition date to assist with the transition of the acquired business to the acquirer. A TSA typically would not be part of the acquired set because it compensates the former owners for future services; therefore, it must be accounted for separate from the acquisition. Also, TSAs are typically short-term in nature, which further indicates that the process is not critical to continue producing outputs.

Example 3-15 illustrates these concepts.

EXAMPLE 3-15: ASSESSING WHETHER THE ACQUISITION OF A PIPELINE IS A BUSINESS COMBINATION

FACTS

- Company A, an oil refiner, enters into an agreement to acquire two crude oil pipelines (one in the U.S. and one in Canada) from Company B. Company A owns and operates the transfer station that connects the two pipelines. The pipelines are of approximately the same length and value.
- Before the acquisition, Company A was the sole user of these pipelines (it purchased and refined all the crude oil transported through these pipelines). It acquired the pipelines to prevent disruption of the transportation of its oil supply, and it intends to continue to use these pipelines solely to transport its own oil supply to its refinery.
- In connection with the agreement, Company A entered into an operating agreement in which Company B agrees to continue to manage the pipelines for two years.
- Company B retains all its employees and continues to manage the pipelines in accordance with the operating agreement.

CONCLUSION

Company A concludes that the operating agreement is not part of the acquired set and must be accounted for separate from the acquisition because it compensates the seller for future services (as discussed in ASC 805-10-25-21(b)). Therefore, the set is not a business because it does not include any substantive processes.

ANALYSIS

Company A first evaluates whether substantially all the acquired assets are concentrated in a single identifiable asset or group of similar identifiable assets. Although the pipelines are similar, they are subject to different regulatory environments. Also, the U.S. pipeline is not directly connected to the Canada pipeline (there is a transfer station owned and operated by Company A that connects the pipelines). As such, Company A determines that the pipelines are not a group of similar identifiable assets. Therefore, substantially all the fair value of the gross assets acquired is not concentrated in a single identifiable asset or group of similar identifiable assets, and Company A must evaluate whether the set has both an input and a substantive process.

The set has outputs because there is a continuation of revenues before and after the transaction. The pipelines were producing revenues for Company B prior to the acquisition and will continue to generate intercompany revenues for Company A after the acquisition. Further, a market participant would use the pipelines to continue to generate revenues.

Company A concludes that the pipelines represent inputs and evaluates whether there is a substantive process in the acquired set. Company B did not transfer employees or any processes to Company A as part of the transaction (that is, Company B continues to manage the pipeline). Further, the operating agreement is not an assumed contract; rather, it is an agreement entered contemporaneously with the acquisition. Company A concludes that the operating agreement is not part of the acquired set and must be accounted for separate from the acquisition because the operating agreement compensates the seller for future services (as discussed in ASC 805-10-25-21(b)). The set is not a business because it does not include any substantive processes.

3.6.3 An Acquired Process That Cannot Be Replaced Without Significant Cost, Effort, or Delay or Is Unique or Scarce

FASB REFERENCES

ASC 805-10-55-5E

An acquired set that includes outputs does not have to include access to an organized workforce to be a business. For example, if the acquired set includes automated processes (such as, through acquired technology, infrastructure, or specialized equipment) or other significant processes that contribute to the ability to continue producing outputs, it could be a business.

To help evaluate whether a transferred process is substantive without the related workforce, the FASB noted in ASC 805-10-55-5E that if an acquired process (or group of processes) significantly contributes to the ability to continue producing outputs and (1) cannot be replaced without significant cost, effort, or delay in the ability to continue producing outputs, or (2) is unique or scarce, it may indicate that such process is substantive.

Example 3-16 illustrates this concept.

EXAMPLE 3-16 (ADAPTED FROM ASC 805-10-55-85 THROUGH 55-87): ASSESSING WHETHER THE ACQUISITION OF BRANDS IS A BUSINESS COMBINATION

FACTS

- Company A is a global producer of food and beverages. It 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 or manufacturing facilities, nor does it receive all the manufacturing equipment and processes required to produce the product or the distribution facilities and processes.

CONCLUSION

The set includes inputs and substantive processes that together significantly contribute to the ability to create outputs and thus is a business.

ANALYSIS

Company B first evaluates whether substantially all the acquired assets are concentrated in a single identifiable asset or group of similar identifiable assets. The identifiable assets include intellectual property associated with Yogurt Brand F, customer contracts and related relationships, equipment, and finished goods inventory. Company B concludes that substantially all the fair value of the gross assets acquired is not concentrated in a single identifiable asset or group of similar identifiable assets.

The set has outputs through the continuation of revenues, and Company B must 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 ASC 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 equipment, they significantly contribute to the ability to continue producing outputs. As such, the criterion in ASC 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 a business.

3.6.4 Elements of a Business if the Acquired Set Includes Outputs – Examples

Examples 3-17 through 3-19 illustrate various scenarios when an acquired set includes outputs.

EXAMPLE 3-17 (ADAPTED FROM ASC 805-10-55-82 THROUGH 55-84): ASSESSING WHETHER THE ACQUISITION OF A LICENSE OF DISTRIBUTION RIGHTS IS A BUSINESS COMBINATION

FACTS

- Company A is a distributor of food and beverages. It 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 its employees and distribution capabilities.

CONCLUSION

The acquired set is not a business.

ANALYSIS

Company B first evaluates whether substantially all the acquired assets are concentrated in a single identifiable asset or group of similar identifiable assets. It determines that the identifiable assets include the license to distribute Yogurt Brand F, customer contracts, and the supply agreement and concludes that the license and customer contracts will have fair value assigned to them. Because the license and customer contracts are in different major classes of identifiable intangible assets, they are not considered similar assets. Therefore, substantially all 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.

The set has outputs through the continuation of revenues with customers in Latin America. As such, Company B must evaluate whether the set includes an input and a substantive process that together significantly contribute to the ability to create outputs. It evaluates whether the acquired contracts provide access to an organized workforce that performs a substantive process. However, because the contracts do not provide a service that applies a process to another acquired input, Company B concludes that the substance of the contracts is only that of acquiring inputs. Thus, the set is not a business because it does not include any substantive processes.

EXAMPLE 3-18 (ADAPTED FROM ASC 805-10-55-90 THROUGH 55-92): ASSESSING WHETHER THE ACQUISITION OF A LOAN PORTFOLIO IS A BUSINESS COMBINATION

FACTS

- Bank A purchases a loan portfolio from Bank Z. The portfolio of loans consists of commercial loans with term, size, and risk ratings that are 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).

CONCLUSION

The acquired set is not a business.

ANALYSIS

Bank A evaluates whether substantially all the acquired assets are concentrated in a single identifiable asset or group of similar identifiable assets. It 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 substantially all the fair value of the gross assets acquired is not concentrated in a single identifiable asset or group of similar assets. It must further evaluate whether the set has the minimum requirements to be considered a business.

The set has outputs through the continuation of revenues (interest income). Consequently, Bank A evaluates 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 it is not a business.

EXAMPLE 3-19 (ADAPTED FROM ASC 805-10-55-93 THROUGH 55-96): ASSESSING WHETHER THE ACQUISITION OF LOAN PORTFOLIO IS A BUSINESS COMBINATION

FACTS

- Bank A purchases a loan portfolio from Bank Z. The portfolio of loans consists of commercial loans with terms, sizes, and risk ratings that are significantly different.
- Bank A takes over Bank Z's employees that managed the credit risk of the portfolio and the relationship with the borrowers (such as brokers and risk managers).
- The consideration transferred is significantly higher than Bank A's estimate of the fair value of the loan portfolio.

CONCLUSION

The acquired set is a business.

ANALYSIS

Bank A first evaluates whether substantially all the acquired assets are concentrated in a single identifiable asset or group of similar identifiable assets. It concludes that the nature of the assets (commercial loans) is similar; however, because the terms, sizes, and risk ratings of the loans are significantly different, Bank A concludes that substantially all the fair value of the gross assets acquired is not concentrated in a single identifiable asset or group of similar assets. As such, it must further evaluate whether the set has the minimum requirements to be a business.

The set has outputs through the continuation of revenues (interest income). Consequently, Bank A evaluates whether the set includes both inputs and a substantive process that together significantly contribute to the ability to create outputs. 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, the acquired set is a business.

3.6.5 Presence of Goodwill

FASB REFERENCES

ASC 805-10-55-9

The presence of more than an insignificant amount of goodwill may indicate that the acquired process is substantive and, that the acquired set is a business. As such, if an acquired set includes outputs, the presence of a significant amount of goodwill may indicate that there is also a substantive process in the set.

However, the presence of goodwill is not determinative. In other words, an acquirer cannot conclude that there is a substantive process solely because there is goodwill. An acquirer must identify the acquired process first; then, the presence of goodwill may help the acquirer assess whether the identified process is substantive.

Further, there could be situations in which a significant amount of goodwill is present but the acquired set is not a business. For example, if there are no employees in an acquired set that does not include outputs, the set would not be a business, even if there is goodwill.

Ultimately, the accounting will depend on whether the acquisition is accounted for as a business combination or an asset acquisition. Goodwill can be recognized only if the transaction is a business combination. Appendix C discusses the accounting for asset acquisitions and recapitalizations.

3.7 DEFINITION OF A BUSINESS FOR SEC REPORTING PURPOSES

The definition of a business for SEC reporting is different from that in ASC 805, so SEC registrants must evaluate whether an acquisition constitutes a business under both definitions. For SEC reporting, a registrant must apply the following definition of a business to determine whether the financial statements of an entity that has been acquired (or is probable of being acquired) must be filed with the SEC:

SEC GUIDANCE

SEC Regulation S-X, Article 11

Section 2.10.11-01 Presentation Requirements

(*d) For purposes of this rule, the 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 of an entity may also constitute a business. Among the facts and circumstances which should be considered in evaluating whether an acquisition of a lesser component of an entity constitutes a business are the following:*

(1) Whether the nature of the revenue-producing activity of the component will remain generally the same as before the transaction; or

(2) Whether any of the following attributes remain with the component after the transaction:

(i) Physical facilities,

(ii) Employee base,

(iii) Market distribution system,

(iv) Sales force,

(v) Customer base,

(vi) Operating rights,

(vii) Production techniques, or

(viii) Trade names

The definition of a business for SEC reporting focuses on whether the nature of the acquired entity's revenue-producing activities or other attributes will remain the same after the acquisition. As such, if there is *"sufficient continuity of the acquired entity's operations prior to and after the acquisition so that disclosure of prior financial information is material to an understanding of future operations,"* the acquired entity would be a business for SEC reporting even if it is not a business in accordance with ASC 805.

Thus, the registrant may be required to file financial statements and pro forma financial information with the SEC for some acquisitions that do not meet the definition of a business under ASC 805. See BDO's publication, **Financial Statements of Acquired Businesses: A Snapshot**. Additionally, see Section 8.6.6.2 for more information about pro forma financial information required under SEC Regulation S-X, Article 11.

Chapter 4 - Recognizing Assets Acquired, Liabilities Assumed, and Noncontrolling Interests

4.1 OVERVIEW

Once the acquirer has been identified and the acquisition date has been determined, if the acquired set meets the definition of a business, the acquirer must recognize and measure the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree at fair value (with limited exceptions), as well as goodwill or a bargain purchase gain. The acquirer must also determine the appropriate classification of the assets acquired and liabilities assumed and the accounting policies to apply. In some cases, the accounting for a business combination may be incomplete at the end of the interim or annual financial reporting period in which the combination occurs. Business combination guidance allows an acquirer to recognize provisional amounts for which the accounting is incomplete for up to one year after the acquisition date (the measurement period).

If the acquired set does not meet the definition of a business (see Chapter 3), the acquirer must apply other U.S. GAAP to the transaction (see Appendix C).

4.2 RECOGNITION PRINCIPLE

FASB REFERENCES

ASC 805-20-25-1 through 25-3

An underlying principle when accounting for a business combination is that a change in control results in a new basis of accounting. The acquirer recognizes the identifiable assets acquired and liabilities assumed, as well as any noncontrolling interest, at fair value (with limited exceptions as discussed in Section 4.4.1).

To be recognized as part of a business combination, an acquired asset or assumed liability must:

- Meet the definition of an asset or a liability on the acquisition date (see Section 4.2.1)
- Be a part of the business combination, rather than a separate transaction (see Section 4.2.2)

4.2.1 Elements That Meet the Definition of an Asset or Liability at the Acquisition Date

FASB REFERENCES

ASC 805-20-25-2 and ASC 805-20-25-4

To be recognized in a business combination, the identifiable assets acquired and liabilities assumed must exist at the acquisition date.

If an asset or liability does not exist at the acquisition date, it cannot be recognized as part of the business combination. For example, costs the acquirer expects, but is not obligated, to incur in the future 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 the business combination and instead recognizes them in its postcombination financial statements in accordance with other U.S. GAAP.

Further, the acquirer **must** recognize identifiable assets or liabilities that exist at the acquisition date even if such assets and liabilities were not previously recognized by the acquiree. For example, the acquiree may not have recognized assets for internally developed brand names and customer lists, but the acquirer must recognize them as assets that exist at the acquisition date.

4.2.2 Elements That Are Part of the Business Combination

FASB REFERENCES

ASC 805-20-25-2 through 25-3

An acquirer may enter various arrangements with the sellers or the acquiree in connection with a business combination. Such arrangements require analysis to determine whether they must be accounted for as part of, or separate from, the business combination. This is particularly important for transactions entered in close proximity to the business combination.

Determining whether an arrangement between the acquirer and a seller is separate from the business combination is important because business combination accounting does not apply to transactions that are separate from the acquisition. Instead, the acquirer accounts for a transaction that is separate from the business combination in accordance with other relevant U.S. GAAP. It also may be necessary to allocate a portion of the consideration transferred to the separate transaction (see Section 5.4.1).

ASC 805 provides a framework to assist the acquirer in identifying transactions that are separate from the business combination. Generally, arrangements that primarily benefit the acquirer or the combined entity are accounted for as separate transactions. Conversely, transactions that primarily benefit the acquiree or its former owners are typically part of the business combination. Chapter 6 provides guidance for evaluating whether a transaction is part of or separate from a business combination.

THE CONTRACT'S LEGAL FORM IS NOT DETERMINATIVE

The legal form of the agreements (for example, one or multiple agreements) is not determinative when evaluating whether a transaction is part of or separate from the business combination. It is not uncommon for a single legal agreement to include several elements that must be accounted for separately. Similarly, it is not uncommon for multiple agreements to be accounted for together as a single business combination transaction (see Section 1.1.6). Reaching a conclusion about whether a transaction is part of or separate from the business combination requires the application of professional judgment based on the facts and circumstances.

4.3 CLASSIFICATION AND DESIGNATION OF ASSETS ACQUIRED AND LIABILITIES ASSUMED

FASB REFERENCES

ASC 805-20-25-6 through 25-7

The application of U.S. GAAP requires a reporting entity to make assessments and policy choices at the acquisition date.

Examples of determinations that must be made by the acquirer include:

- Classifying debt securities as trading, available for sale, or held to maturity
- Designating a derivative instrument as a hedging instrument
- Assessing whether an embedded derivative is separated from the host contract
- Classifying newly acquired assets as held for sale
- Electing the fair value option for eligible items

The acquirer's classifications and designations are based on the following:

- Contractual terms
- Economic conditions
- The acquirer's accounting policies (see Section 4.3.1.3)
- Other facts and circumstances as of the acquisition date

Because a business combination results in a new basis of accounting at the acquisition date, the acquiree's previous classifications and designations are no longer relevant (with some exceptions; see Section 4.3.1). As a result, the classification and designation of assets acquired and liabilities assumed in the postcombination financial statements may differ from the acquiree's historical treatment.

4.3.1 Exceptions to the Classification and Designation Principle

FASB REFERENCES

ASC 805-20-25-8

As discussed in Section 4.3, generally, an acquirer must determine the appropriate classification or designation of assets acquired, liabilities assumed, and contracts assumed based on the facts and circumstances that exist at the acquisition date. However, there are exceptions to this general principle for the classification of acquired leases and insurance or reinsurance contracts.

4.3.1.1 Classification of Leases

FASB REFERENCES

ASC 805-20-25-8 and ASC 842-10-55-11

The acquirer of a lease in a business combination retains the acquiree's previous lease classification unless the lease is modified, and that modification is not accounted for as a separate contract.

Section 4.4.1.5 provides more guidance on the accounting for leases in a business combination.

4.3.1.2 Classification and Recognition of Insurance and Reinsurance Contracts

FASB REFERENCES

ASC 805-20-25-8 and ASC 944-805-30-1 through 30-2

The classification of an insurance or reinsurance contract acquired in a business combination generally is based on the contractual terms and other facts and circumstances **at the contract's inception** (rather than the acquisition date). However, if the terms were modified in a way that would change the contracts' classification, the contracts are classified based on the terms and other relevant facts and circumstances at the modification date, which may be the acquisition date.

In addition to this exception to the classification and designation principle, ASC 805 provides specific guidance regarding the measurement of assets acquired and liabilities assumed because of acquired insurance and reinsurance contracts. As with other assets acquired and liabilities assumed, an acquirer recognizes the assets and liabilities for insurance and reinsurance contracts acquired in a business combination at their acquisition-date fair values (see Section 4.4).

However, the acquirer separates the fair value of acquired insurance contracts into two components as follows:

- Assets and liabilities measured in accordance with the acquirer's accounting policies for its insurance and reinsurance contracts
- An intangible asset (or occasionally a liability) recognized for the difference between the fair value of the insurance and reinsurance contracts and the amount recognized in accordance with the acquirer's accounting policies

While these two components sum to fair value, separating them lets the acquirer report the results of the acquired business using the same accounting policies as its written business[9] while separately amortizing the second component as an intangible asset.

4.3.1.3 Conforming Accounting Policies

FASB REFERENCES

ASC 810-10-25-15

An acquirer and acquiree's accounting policies and practices often differ before a business combination. Although U.S. GAAP does not prevent a parent (acquirer) and its subsidiary (acquiree) from applying different accounting policies in their separate financial statements, they must apply consistent accounting policies in the consolidated financial statements if there is no justification for differences.

Differences in accounting policies between a parent and subsidiary may be justified in in some circumstances. For example, it may be acceptable for a subsidiary and parent to apply different inventory methods (for example, first-in, first-out (FIFO), last-in, first-out (LIFO)) to different classes of inventory. Further, a substantive subsidiary that is subject to industry-specific guidance must continue to apply that guidance in the consolidated financial statements, even if the parent is not in that industry.

An acquirer can conform the acquiree's accounting policies to its own without regard to the acquiree's previous policies. However, if the acquirer wants to change one or more of its accounting policies (for example, to conform to the acquiree's policies), it represents a voluntary change in accounting principle that must be preferable under ASC 250, *Accounting Changes and Error Corrections*. If an acquirer does not have an existing accounting policy related to one or more of the assets acquired or liabilities assumed, the acquirer is not required to apply the acquiree's policy; rather, it can adopt any accounting policy that is acceptable under U.S. GAAP without justifying preferability.

[9] FAS 141(R), paragraph B192

An acquiree that does not elect pushdown accounting must continue to apply its preacquisition accounting policies in its standalone financial statements. If the acquiree wishes to adopt one or more of the acquirer's accounting policies, it represents a voluntary change in accounting principle that must be preferable under ASC 250.

BDO INSIGHTS — DIFFERING ACCOUNTING POLICIES BETWEEN PARENT AND SUBSIDIARY

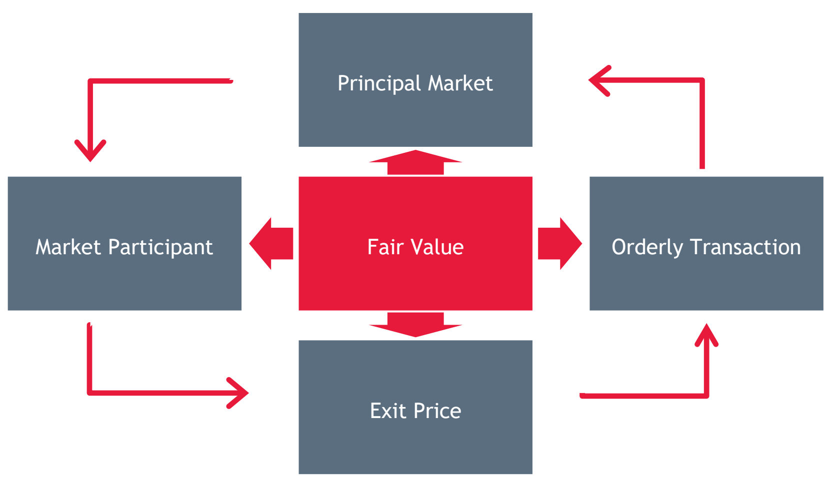
Although U.S. GAAP does not prevent a parent and its subsidiary from applying different accounting policies in their separate financial statements, they must apply consistent accounting policies in the consolidated financial statements if there is no justification for differences. As such, if a subsidiary does not conform its accounting policies for its standalone financial statements to the parent's policies, it would be required to maintain two sets of accounting records (one set using the parent's accounting policies for the consolidated financial statements and one set using the subsidiary's policies for its standalone financial statements). Therefore, the parent must determine whether it will allow its subsidiary to apply different accounting policies for its standalone financial statements.

4.4 MEASUREMENT PRINCIPLE

FASB REFERENCES

ASC 805-20-30-1 through 30-2 and ASC 820-10-20: Fair Value

In a business combination, the acquirer measures identifiable assets acquired, liabilities assumed, and NCI, if any, at their acquisition-date fair values in accordance with ASC 820, *Fair Value Measurement*, with limited exceptions. ASC 820 defines fair value as "*the price that would be received from the sale of an asset or paid to transfer a liability in an orderly transaction between market participants.*"



Fair value is not based on entity-specific assumptions but on assumptions that market participants would use. As a result, the acquirer's intended use of an asset, or its intent regarding the settlement of a liability, is irrelevant. Determining fair value requires the application of professional judgment based on the facts and circumstances, and often requires help from valuation professionals.

4.4.1 Exceptions to the Recognition and Measurement Principles

FASB REFERENCES

ASC 805-20-25-16 through 17 and ASC 805-20-30-10 through 12

Although ASC 805 generally requires an acquirer to recognize the assets acquired and liabilities assumed at their acquisition-date fair values, there are exceptions, as noted in the following table:

	DESCRIPTION	MORE GUIDANCE
Exceptions to the recognition and measurement principles	▶ Assets and liabilities arising from contingencies	Section 4.4.1.1
	▶ Income taxes	Section 4.4.1.2
	▶ Employee benefits	Section 4.4.1.3
	▶ Indemnification assets	Section 4.4.1.4
	▶ Leases	Section 4.4.1.5
	▶ Contract assets and contract liabilities	Section 4.4.1.6
Exceptions to the measurement principle only	▶ Reacquired rights	Section 4.4.1.7
	▶ Share-based payment awards	Section 4.4.1.8
	▶ Assets held for sale	Section 4.4.1.9
	▶ Purchased financial assets with credit deterioration	Section 4.4.1.10

4.4.1.1 Assets and Liabilities Arising From Preacquisition Contingencies

FASB REFERENCES

ASC 805-20-25-18A through 25-20B, ASC 805-20-30-9, and ASC 805-20-30-23

ASC 805-20-20

Contingency

> *An existing condition, situation, or set of circumstances involving uncertainty as to possible gain (gain contingency) or loss (loss contingency) to an entity that will ultimately be resolved when one or more future events occur or fail to occur.*

A contingency assumed by the acquirer as a result of the business combination that arose from events and circumstances that existed before the acquisition date is referred to as a preacquisition contingency.

EXAMPLES OF PREACQUISITION CONTINGENCIES

Product Warranties	Insurance Claims	Asserted or Unasserted Claims	Pending or Threatened Litigation	Environmental Liabilities

For some preacquisition contingencies, an acquirer may have sufficient information to determine the fair value of the liability assumed (or asset acquired) before the measurement period ends (see Section 4.6). For example, the acquisition-date fair value of a warranty obligation can often be determined. However, the fair value of other contingent assets or liabilities (for example, those relating to legal contingencies) may not be determinable at the date of the acquisition or during the measurement period. As a result, ASC 805 provides an exception to the general recognition and measurement principles for preacquisition contingencies (see Section 4.4.1.1.1).

The exception applies to contingencies acquired or assumed in a business combination that meet **both** of the following criteria:

- The contingency would otherwise be in the scope of ASC 450, Contingencies, if it was not acquired or assumed in a business combination.
- The contingency is not otherwise addressed within ASC 805-20.

DISPUTES ARISING FROM THE BUSINESS COMBINATION ARE NOT PREACQUISITION CONTINGENCIES

Litigation or disputes that arise between the acquirer and the acquiree's former owners or between the acquirer and its shareholders in connection with a business combination are not preacquisition contingencies and must be accounted for as transactions separate from the business combination (see Section 4.4.1.1.3.1).

4.4.1.1.1 Initial Measurement of Assets and Liabilities Arising From Preacquisition Contingencies

FASB REFERENCES

ASC 805-20-25-19 through 25-20B, ASC 805-20-30-9, and ASC 805-20-30-23

The accounting for preacquisition contingencies depends on whether the acquisition-date fair value is determinable or estimable before the end of the measurement period, as summarized in the following graphic:

Acquisition-date fair value is determinable during the measurement period	→	The acquirer recognizes the contingency as an asset or liability at the acquisition-date fair value.

Acquisition-date fair value is not determinable during the measurement period →	The acquirer recognizes a contingent asset or liability at the acquisition date if **both** of the following conditions are met: ▶ It is **probable** that an asset or liability existed at the acquisition date. ▶ The acquirer **can reasonably estimate** the amount of the asset or liability. If either condition is not met before the end of the measurement period, the acquirer does **not** recognize a contingent asset or liability at the acquisition date and instead accounts for the contingency in accordance with ASC 450 or other relevant U.S. GAAP.

BDO INSIGHTS — MANY PREACQUISITION CONTINGENCIES ARE NOT RECOGNIZED AT THE ACQUISITION DATE

In many cases, preacquisition contingencies are not recognized by the acquirer at the acquisition date because either:

- Fair value cannot be determined before the end of the measurement period.
- The contingent asset or liability is not probable or reasonably estimable before the end of the measurement period.

In such cases, the contingencies are not recognized as part of the business combination; rather, they are accounted for in accordance with ASC 450 (which would affect the income statement when the contingency is recognized rather than goodwill). Determining the appropriate accounting for preacquisition contingencies requires the application of professional judgment based on the facts and circumstances.

Examples 4-1 through 4-3 illustrate these concepts.

EXAMPLE 4-1: ACQUISITION-DATE FAIR VALUE FOR ASSUMED WARRANTY CLAIMS

FACTS

- An acquirer purchases an acquiree in a business combination.
- The acquiree manufactures and sells widgets with a standard two-year warranty, so it is subject to warranty claims.
- Based on the acquirer’s experience with warranty claims for similar widgets and an evaluation of the acquiree’s historical claims, the acquirer expects to incur warranty costs related to widgets sold by the acquiree before the acquisition date.

CONCLUSION

At the acquisition date, the acquirer recognizes a liability for the fair value of the warranty obligation.

ANALYSIS

Based on the acquirer’s experience with warranty claims for similar widgets and its evaluation of the acquiree’s historical claims, the acquirer concludes that it has sufficient information to determine the acquisition-date fair value of the warranty obligation for widgets sold by the acquiree before the acquisition date. As such, the acquirer recognizes a liability for the fair value of the warranty obligation.

EXAMPLE 4-2: ACQUISITION-DATE FAIR VALUE NOT DETERMINABLE FOR LITIGATION

FACTS

- An acquirer purchases an acquiree in a business combination. The acquiree is a defendant in a lawsuit that was filed before the acquisition date.
- After reviewing the facts and discussing them with its legal counsel, the acquirer determines at the acquisition date that it is reasonably possible that the acquiree is liable and may be subject to an adverse judgment. However, the acquirer is unable to determine the fair value of the potential liability. No additional facts are identified during the measurement period.

CONCLUSION

The acquirer does not recognize a contingent liability as part of the business combination.

ANALYSIS

Sufficient information does not exist for the acquirer to determine fair value before the end of the measurement period. Further, it is only reasonably possible (not probable) that the acquirer has incurred a loss. Therefore, the acquirer does not recognize the contingent liability as part of the business combination. Instead, it will recognize a liability in its postcombination financial statements only if it meets the recognition and measurement criteria in accordance with ASC 450 (which would affect the income statement when the contingency is recognized rather than goodwill).

EXAMPLE 4-3: RECOGNITION CRITERIA MET DURING MEASUREMENT PERIOD FOR LITIGATION

FACTS

- An acquirer purchases an acquiree in a business combination. The acquiree is a defendant in a lawsuit that was filed before the acquisition date.
- After reviewing the facts and discussing them with its legal counsel, the acquirer determines at the acquisition date that it is reasonably possible that the acquiree is liable and may be subject to an adverse judgment. However, the acquirer is unable to determine the fair value of the potential liability at the acquisition date.
- During the measurement period, the acquirer extends a settlement offer to the counterparty to avoid further costs associated with this litigation.

CONCLUSION

The acquirer recognizes the contingent liability as part of the business combination.

ANALYSIS:

Based on its settlement offer, the acquirer determined that the contingent liability is probable and estimable before the end of the measurement period based on information that existed at the acquisition date. Therefore, the acquirer recognizes the contingent liability as part of the business combination as an adjustment to goodwill.

4.4.1.1.2 Subsequent Measurement of Assets and Liabilities Arising From Preacquisition Contingencies

FASB REFERENCES

ASC 805-20-35-3

If an acquirer recognizes a contingent asset or liability at the acquisition date, ASC 805 indicates that the acquirer must use a systematic and rational approach for subsequent measurement of the contingent asset or liability. As such, the subsequent accounting depends on how (or whether) the contingency was initially recognized and measured.

BDO INSIGHTS — SUBSEQUENT ACCOUNTING FOR CONTINGENT ASSETS AND LIABILITIES

The subsequent accounting for contingent assets and liabilities recognized in a business combination depends on how (or whether) the contingency was initially recognized and measured.

- For preacquisition contingencies recognized at fair value, potential systematic and rational approaches may include applying one of the methods used to subsequently account for guarantees that are initially recognized at fair value under ASC 460, *Guarantees*, or applying the method used for accounting for asset retirement obligations under ASC 410, *Asset Retirement and Environmental Obligations*. Determining a systematic and rational approach requires the application of professional judgment based on the facts and circumstances. However, we do not believe either of the following approaches would be appropriate:
  - Applying the principles of ASC 450 to contingencies initially recognized at fair value.
  - Subsequently measuring the contingency at fair value at each reporting period (unless required by other U.S. GAAP)
- For preacquisition contingencies recognized at amounts that are probable and estimable, the acquirer must generally continue to follow the principles in ASC 450 to subsequently measure contingent liabilities. However, if a contingent asset was recognized as part of the business combination based on an amount that was probable and estimable, it would not be appropriate to derecognize the contingent asset solely because it does not meet the requirements for recognizing a gain contingency under ASC 450.
- For preacquisition contingencies that do not meet the recognition criteria before the end of the measurement period, the acquirer does not recognize a contingent asset or liability as part of the business combination. Instead, it accounts for the contingency in accordance with ASC 450 or other relevant U.S. GAAP.

4.4.1.1.2.1 Adjustments to Preacquisition Contingencies During the Measurement Period

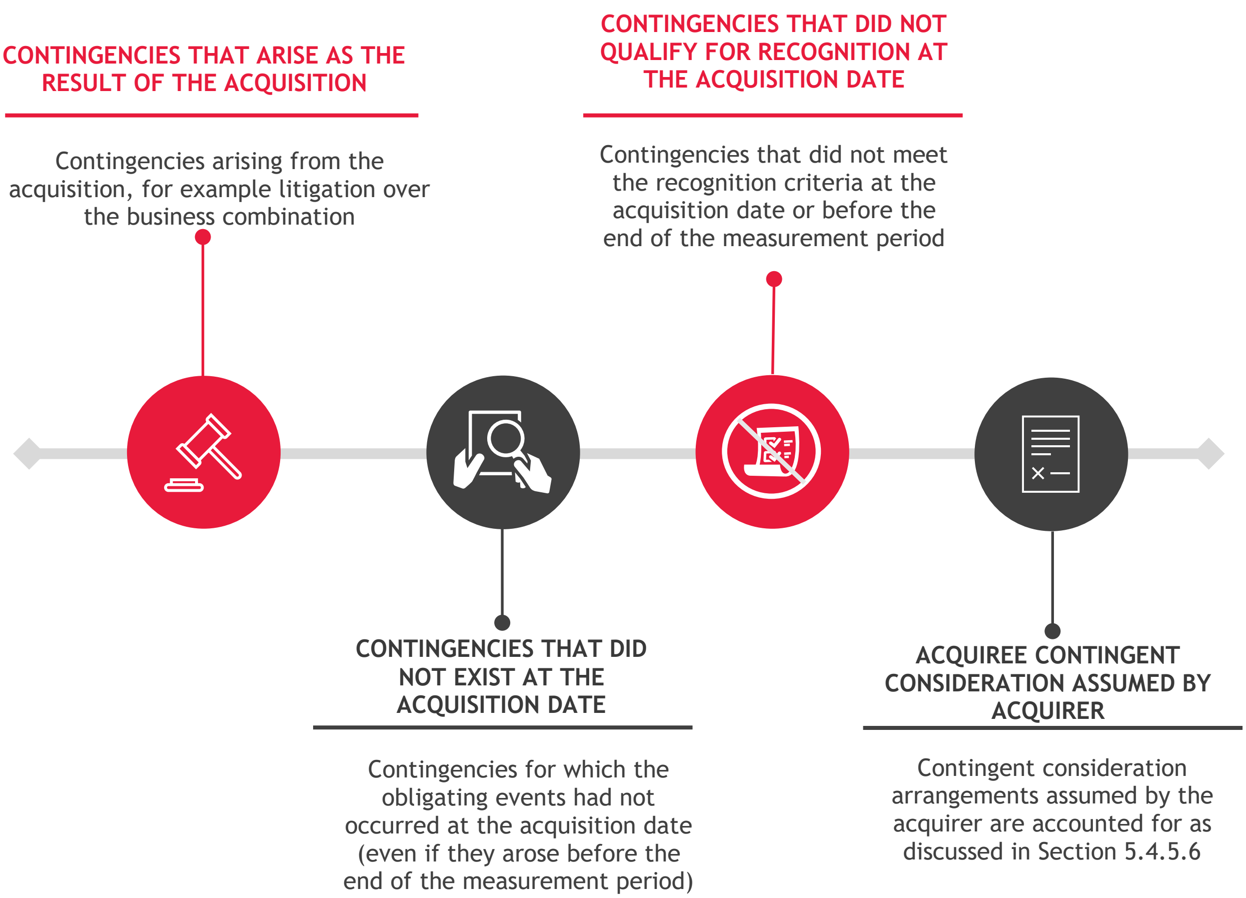
FASB REFERENCES

ASC 805-10-25-14

In some cases, the acquirer may identify a preacquisition contingency after the acquisition date but within the measurement period. ASC 805 does not limit recognition of preacquisition contingencies to those items known by the acquirer at the acquisition date; rather, preacquisition contingencies are recognized if they result from **conditions that existed before the acquisition date**. Thus, contingencies discovered in the measurement period relating to conditions that existed at the acquisition date qualify for recognition in the business combination. Further, during the measurement period, an acquirer can update provisional amounts if it receives new information about conditions that existed at the acquisition date. Section 4.6 provides additional information about measurement period adjustments.

4.4.1.1.3 Contingencies Other Than Preacquisition Contingencies

The following graphic summarizes situations that do **not** qualify for recognition as preacquisition contingencies:



4.4.1.1.3.1 Litigation Regarding the Business Combination

Litigation or disputes may arise between the acquirer and the acquiree’s former owners. Such contingencies arising from a business combination are not preacquisition contingencies and must be accounted for as transactions separate from the business combination. As such, the acquirer generally recognizes any amounts related to litigation or disputes in its postcombination income statement in accordance with ASC 450. It would generally not be appropriate to recognize any adjustments to the consideration transferred for the business combination (even if such resolution occurs within the measurement period) unless there is a clear and direct link to the consideration transferred, as illustrated in the following SEC staff speech:

SEC STAFF GUIDANCE

[Remarks before the 2003 AICPA Conference on Current SEC Developments]

Randolph P. Green, Professional Accounting Fellow, Office of the Chief Accountant

December 11, 2003

> *…contingencies arising from a business combination are not preacquisition contingencies. Accordingly, we have 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.*
>
> *Instances in which we have been persuaded that a settlement of litigation over a purchase is more appropriately reflected as an adjustment to the cost of the acquired business demonstrate a clear and direct link to the purchase price. For example, litigation seeking enforcement of an escrow or escrow-like arrangement, say, specifying a minimum amount of working capital in the acquired business, may establish a clear and direct link to the purchase price.*
>
> *Frequently, claims seeking enforcement of an escrow or escrow-like arrangement also include claims of misrepresentation or otherwise constitute a mixed claim. While more complicated, I believe that the concept is the same. In order to reflect some or all of the settlement of such a claim as an adjustment of the purchase price of the acquired business, the acquirer should be able to persuasively demonstrate that all or a specifically identified portion of the mixed claim is clearly and directly linked to the purchase price. I would not ordinarily expect that the settlement of litigation that does not indicate that the initial allocation of fair value was incorrect to be accounted for as an adjustment of the purchase price.*
>
> *Similarly, claims that assert one party mislead the other or that a provision of the agreement is unclear are not unique to business combination agreements and do not generally establish a clear and direct link to the purchase price and, therefore, should be reflected in the income statement. I say "generally fail to establish a clear and direct link" only because I think we would be persuaded that an adjustment of purchase price is appropriate if the acquirer were able to objectively demonstrate that that the purchase price exceeded the acquired business's agreed-upon fair value at the time of the acquisition. For 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.*
>
> ****
>
> *I have thus far discussed only the effects of litigation over purchase price that involve the former owners of the acquired business. I think it goes without saying that the cost of litigation brought by the acquirer's shareholders should always be reflected in the income statement.* [Footnotes omitted]

In many cases, it may be difficult to establish a clear and direct link to the purchase price. As such, the resolution of most litigation between the acquirer and former owners is recognized in the acquirer's postcombination income statement. Further, even if the acquirer can establish a clear and direct link to the purchase price, we do not believe it would be appropriate to adjust consideration transferred after the measurement period has ended.

Further, costs incurred for litigation or disputes between the acquirer and its owners are transactions separate from the business combination and must be reflected in the acquirer's income statement.

4.4.1.1.3.2 Acquiree Contingent Consideration Assumed by the Acquirer

When an acquiree is party to a contingent consideration arrangement from a previous business combination, the acquirer accounts for the assumption of the contingent consideration liability (or asset) in the current business combination. Because the nature of the contingent consideration does not change as a result of the subsequent business combination, it is typically accounted for in the same manner as other contingent consideration (see Section 5.4.5.6).

4.4.1.2 Income Taxes

FASB REFERENCES

ASC 805-20-30-13 and ASC 805-740

Income taxes are accounted for under an exception to the recognition and measurement principles in ASC 805. Deferred tax assets and liabilities that arise from the assets acquired and liabilities assumed, as well as deductible temporary differences, carryforwards, and any income tax uncertainties of an acquiree that exist at the acquisition date, are not measured at fair value. Instead, they are recognized and measured in accordance with ASC 740, *Income Taxes*, and ASC 805-740.

4.4.1.3 Employee Benefits

FASB REFERENCES

ASC 805-20-25-22 and ASC 805-20-30-14

An acquirer may assume an acquiree's existing pension, postretirement, or other employee benefit plan[10] in a business combination. Employee benefit arrangements are not measured at acquisition-date fair value in accordance with the general recognition and measurement principles in ASC 805. Rather, the acquirer applies other U.S. GAAP to recognize and measure a liability (or asset, if any) for these plans, consistent with the accounting for such plans outside a business combination.

[10] The reference to employee benefit plans in this section excludes share-based compensation plans. See Section 6.4.3 for guidance for accounting for an exchange of share-based payment awards and Section 6.4.3.2.7 for guidance for accounting for an assumption of existing share-based compensation awards in a business combination.

TYPE OF EMPLOYEE BENEFIT	RELEVANT U.S. GAAP
Deferred compensation contracts	ASC 710-10-25
Compensated absences	ASC 710-10-25
Defined benefit pension plans	ASC 715-30 (see Section 4.4.1.3.1)
Settlements, curtailments, and certain termination benefits	ASC 715-30-35 and ASC 715-60-35 (see Section 4.4.1.3.1)
Other postretirement benefit plans	ASC 715-60 (see Section 4.4.1.3.1)
Nonretirement postemployment benefits	ASC 712-10-25 (see Section 4.4.1.3.2)
Multiemployer plans for which withdrawal is probable	ASC 450-20 (see Section 4.4.1.3.3)
One-time termination benefits	ASC 420-10-25 (see Section 4.4.3.2)

4.4.1.3.1 Pension and Other Postretirement Benefits

FASB REFERENCES

ASC 805-20-25-23 through 25-25 and ASC 805-20-30-15 through 30-16

For single employer defined benefit pension plans sponsored by the acquiree, the acquirer recognizes an asset or liability for the plan's funded (or unfunded) status as part of the business combination as follows:

- A pension asset if the fair value of the plan assets exceeds the projected benefit obligation
- A pension liability if the projected benefit obligation exceeds the fair value of the plan assets

Similarly, for other defined benefit postretirement plans (OPEB), the acquirer recognizes an asset or liability for the plan’s funded (or unfunded) status as part of the business combination, depending on whether the accumulated postretirement benefit obligation) is less than or in excess of the fair value of the plan assets.

When determining the projected benefit obligation or accumulated postretirement benefit obligation, the acquirer must use its own policies and assumptions (for example, discount rate, turnover, mortality rate) at the acquisition date. If the acquirer and acquiree use different assumptions, such differences should be explainable, or generally would not be expected to be significant.

In determining the pension or OPEB asset or liability, the acquirer must exclude the effects of planned but unexecuted amendments, terminations, or curtailments that it has no obligation to make at the acquisition date. Rather, the acquirer recognizes such events in the postcombination financial statements once they occur.

As the amounts recorded for the pension or OPEB asset or liability are reset based on the fair value of the plan assets, the acquirer does not carry over any amounts that were previously recognized in accumulated other comprehensive income by the acquiree. Similarly, subsequent net periodic pension cost does not include amortization of the acquiree’s prior service cost, net gain or loss, or transition amount.

4.4.1.3.1.1 Accounting by Target for Planned Employee Terminations in Connection With a Business Combination

FASB REFERENCES

ASC 805-20-55-50 through 55-51

A target entity that has agreed to a business combination may develop a plan to terminate the employment of certain employees if the business combination is completed. Such plan to terminate employment may affect the assumptions used for estimating its obligations for pension and other postemployment benefits (such as triggering curtailment losses or recognizing contractual termination benefits). ASC 805 indicates that the liability for contractual termination benefits or curtailment losses that will be triggered by the business combination are not recognized until the business combination is consummated. As such, the liability is recognized in the postacquisition financial statements rather than in the acquiree's precombination financial statements.

4.4.1.3.2 Postemployment Benefits

FASB REFERENCES

ASC 712-10-20: Nonretirement Postemployment Benefits and ASC 805-20-25-26

Nonretirement postemployment benefits include all types of benefits, except those provided through a pension or other postretirement plan to former or inactive employees, their beneficiaries, and covered dependents. An acquirer in a business combination recognizes and measures nonretirement postemployment benefits in accordance with ASC 712, *Compensation – Nonretirement Postemployment Benefits*, which requires that postemployment benefits that do not meet the recognition criteria in ASC 710-10-25-1 are generally recognized and measured in accordance with ASC 450.

Below are some examples of postemployment benefits:

ACCOUNTED FOR UNDER ASC 712	ACCOUNTED FOR UNDER OTHER U.S. GAAP
▶ Salary continuation ▶ Supplemental unemployment benefits ▶ Severance benefits ▶ Disability-related benefits ▶ Job training and counseling ▶ Continuation of benefits such as health care plans and life insurance coverage	▶ One-time termination benefits in connection with exit or disposal activities (ASC 420) ▶ Deferred compensation contracts (ASC 710)

4.4.1.3.3 Multiemployer Plans

FASB REFERENCES

ASC 805-20-25-23 through 25-25

As discussed in ASC 715-80, *Compensation – Retirement Benefits – Multiemployer Plans*, multiemployer pension plans are accounted for differently than single employer plans. For a multiemployer pension plan, an acquirer recognizes a liability for any unpaid contributions at the acquisition date. Further, if it is probable that the acquirer will withdraw from the multiemployer plan, it recognizes a withdrawal liability at the acquisition date (as part of the business combination) in accordance with ASC 450.

4.4.1.4 Indemnification Assets

FASB REFERENCES

ASC 805-20-25-27

A seller may agree to reimburse the acquirer for the negative outcome of a contingency or uncertainty related to all or part of a specific asset or liability (commonly referred to as "seller indemnification"). For example, a seller might guarantee that the amount the acquirer must pay related to a contingent liability will not exceed a stated amount by agreeing to reimburse the acquirer for any excess. The right to reimbursement as a result of a seller indemnification is an indemnification asset that the acquirer recognizes as part of the business combination (see Section 4.4.1.4.1).

BDO INSIGHTS — GENERAL REPRESENTATIONS AND WARRANTIES DO NOT GIVE RISE TO INDEMNIFICATION ASSETS

General representations and warranties made by the sellers in connection with a business combination do not typically give rise to indemnification assets because they do not relate to contingencies or uncertainties for specific assets or liabilities of the acquired business. Amounts held in escrow to protect against inaccurate representations and warranties made by the seller are generally included as part of consideration transferred for the business combination (see Section 5.4.2.2)

4.4.1.4.1 Initial Accounting for Indemnification Assets

FASB REFERENCES

ASC 805-20-25-27 through 25-28 and ASC 805-20-30-18 through 30-19

Indemnification assets are subject to an exception to the recognition and measurement principles. ASC 805 requires that an indemnification asset be recognized at the same time and measured using the same basis as the indemnified item (subject to the need for a valuation allowance for uncollectible amounts). As such, the accounting for an indemnification asset depends on whether the indemnified item is recognized in the business combination and, if so, how it is measured, as shown in the table below:

Indemnification asset is recognized at the same time as the indemnified item	Indemnification asset is measured using the same basis as the indemnified item
INDEMNIFIED ITEM	**INDEMNIFICATION ASSET**
▶ Recognized at acquisition-date fair value	▶ Recognized at acquisition-date fair value • Collectibility is considered in the fair value measurement; a separate valuation allowance is not necessary
▶ Recognized at other than fair value at the acquisition date (that is, under a measurement exception from the general principles in ASC 805), for example: • Uncertain tax positions (see Section 4.4.1.2) • Preacquisition contingencies recognized in accordance with ASC 450 (see Section 4.4.1.1.1)	▶ Recognized and measured on the same basis as the indemnified item, subject to a valuation allowance for collectibility, if needed
▶ Unrecognized at the acquisition date: • Preacquisition contingencies that do not qualify for recognition at the acquisition date (see Section 4.4.1.1.1)	▶ Recognized and measured at the same time and on the same basis as the indemnified item (that is, when the indemnified item subsequently meets the recognition criteria), subject to a valuation allowance for collectibility, if needed

Examples 4-4 and 4-4A illustrate this concept.

EXAMPLE 4-4: INDEMNIFICATION ASSET – INDEMNIFIED ITEM RECOGNIZED UNDER ASC 450

FACTS

- An acquirer purchases an acquiree in a business combination.
- At the acquisition date, the acquiree is subject to a pending environmental remediation claim, and the sellers agree to indemnify the acquirer for all losses that result from the claim.
- The fair value of the contingent liability could not be determined at the acquisition date or during the measurement period. However, the acquirer determines that it is probable that a liability has been incurred and that the potential loss can be reasonably estimated, so it recognizes a contingent liability of $50 million at the acquisition date under ASC 450.
- There are no collectibility issues for the indemnification asset.

CONCLUSION

The acquirer recognizes an indemnification asset at the acquisition date equal to the amount recognized for the contingent liability.

ANALYSIS

The acquirer recognizes the indemnification asset at the same time and measured on the same basis as the indemnified item, subject to a valuation allowance, if needed. As such, because there are no collectibility issues, the acquirer recognizes a contingent liability of $50 million and an indemnification asset of $50 million at the acquisition date.

EXAMPLE 4-4A: INDEMNIFICATION ASSET - INDEMNIFIED ITEM NOT RECOGNIZED

FACTS

Assume the same facts as in Example 4-4, except that the acquirer is not able to reasonably estimate the liability at the acquisition date. Therefore, the recognition criteria have not been met and the acquirer does not recognize a contingent liability at the acquisition date.

CONCLUSION

The acquirer does not recognize an indemnification asset at the acquisition date.

ANALYSIS

The acquirer recognizes the indemnification asset at the same time and measured on the same basis as the indemnified item, subject to a valuation allowance, if needed. As such, because the contingent liability did not meet the recognition criteria, the acquirer does not recognize a contingent liability or an indemnification asset at the acquisition date.

4.4.1.4.2 Subsequent Accounting for an Indemnification Asset

FASB REFERENCES

ASC 805-20-35-4 and ASC 805-20-40-3

At each subsequent reporting date, the acquirer remeasures the indemnification asset on the same basis as the indemnified item, subject to any contractual limitations and management's assessment of collectibility. This is the case even if the indemnified item does not meet the criteria to be recognized at the acquisition date or during the measurement period. When the indemnified item subsequently is recognized in the acquirer's financial statements, the indemnification asset is recognized at the same time, even if it is outside the measurement period.

The acquirer derecognizes the indemnification asset when **one** of the following occurs:

- It collects the asset.
- It sells the asset.
- It loses the rights to the asset (for example, through cancellation or expiration).

Examples 4-5 and 4-5A illustrate the subsequent accounting for indemnification assets.

EXAMPLE 4-5: INDEMNIFICATION ASSET - INDEMNIFIED ITEM RECOGNIZED UNDER ASC 450 AT THE ACQUISITION DATE

FACTS

- An acquirer purchases an acquiree in a business combination.
- The acquiree is subject to litigation with a customer claiming $150 million in damages from a defective product.
- The acquiree's selling shareholders agree to indemnify the acquirer for losses up to $100 million related to this litigation.
- The fair value of the contingent liability could not be determined at the acquisition date or during the measurement period. However, the acquirer determines that it is probable that a liability has been incurred and that the potential loss can be reasonably estimated, so it recognizes a contingent liability of $75 million at the acquisition date under ASC 450.
- There are no collectibility issues for the indemnification asset.
- The acquirer settles the litigation for $90 million after the measurement period ends.

CONCLUSION

The acquirer recognizes an indemnification asset at the acquisition date equal to the amount recognized for the contingent liability. When the acquirer later recognizes an increase in the contingent liability, it also recognizes an increase in the indemnification asset.

ANALYSIS

The acquirer recognizes the indemnification asset at the same time and measured on the same basis as the indemnified item, subject to a valuation allowance, if needed. As such, because there are no collectibility issues, the acquirer recognizes a contingent liability of $75 million and an indemnification asset of $75 million at the acquisition date. When the acquirer later recognizes a $15 million increase in the contingent liability, it also recognizes a $15 million increase in the indemnification asset.

EXAMPLE 4-5A: INDEMNIFICATION ASSET – INDEMNIFIED ITEM NOT RECOGNIZED AT THE ACQUISITION DATE

FACTS

Assume the same facts as in Example 4-5, except that the acquirer is not able to reasonably estimate the liability at the acquisition date or within the measurement period. Therefore, the recognition criteria have not been met and the acquirer does not recognize a contingent liability at the acquisition date.

CONCLUSION

The acquirer does not recognize an indemnification asset at the acquisition date. When the acquirer later recognizes the contingent liability, it also recognizes an indemnification asset equal to the amount recognized for the contingent liability.

ANALYSIS

The acquirer recognizes the indemnification asset at the same time and measured on the same basis as the indemnified item, subject to a valuation allowance, if needed. As such, because the contingent liability did not meet the recognition criteria, the acquirer does not recognize a contingent liability or an indemnification asset at the acquisition date. When the acquirer later recognizes the $90 million contingent liability, it also recognizes a $90 million indemnification asset.

4.4.1.5 Accounting for Leases in a Business Combination

There are several areas for which the accounting for leases acquired in a business combination differs from the accounting for a new lease. Further, the guidance sometimes differs depending on whether the acquiree is a lessee or lessor. See our Blueprint, [Accounting for Leases Under ASC 842](), for more guidance on the accounting for leases outside a business combination.

4.4.1.5.1 Lease Classification

FASB REFERENCES

ASC 805-20-25-8 and ASC 842-10-55-11

ASC 842 notes that the acquirer of a lease in a business combination retains the acquiree's previous lease classification, unless the lease is modified and that modification is not accounted for as a separate contract. This guidance applies regardless of whether the acquired entity is a lessee or lessor. If there is a modification, and the modification is not accounted for as a separate contract, the acquirer reassesses classification. See Chapter 4 of our Blueprint, **Accounting for Leases Under ASC 842**, for lease classification guidance.

BDO INSIGHTS — MODIFICATIONS TO LEASES THAT ARE ADMINISTRATIVE IN NATURE

An acquired or assumed lease may be amended to change only the names of the parties in the lease. We believe such a change is administrative in nature and is not a modification because it does not change the scope of or consideration for the lease.

4.4.1.5.2 Lease Identification

FASB REFERENCES

ASC 842-10-15-6

While ASC 842 discusses lease classification in a business combination (see Section 4.4.1.5.1), neither ASC 805 nor ASC 842 addresses whether an acquirer must reassess whether a contract is (or contains) a lease at the acquisition date.

BDO INSIGHTS — REASSESSING WHETHER A CONTRACT IS (OR CONTAINS) A LEASE IN A BUSINESS COMBINATION

Although ASC 842 does not discuss whether an acquirer must reassess an acquiree's conclusions about whether a contract is (or contains) a lease, the guidance in ASC 842-10-15-6 indicates that an entity reassesses whether a contract is (or contains) a lease only if the terms and conditions of the contract are changed. Further, reassessing lease identification could potentially result in a conclusion that the contract does not contain a lease at the acquisition date, thereby directly conflicting with the specific requirement to retain the acquiree's lease classification in a business combination. As such, we believe that an acquirer does not reassess the acquiree's previous lease identification determined under ASC 842 unless the contract is modified in connection with the transaction, and that modification is not accounted for as a separate contract.

4.4.1.5.3 Recognition and Measurement (Acquiree Is the Lessee)

FASB REFERENCES

ASC 805-20-25-10A through 25-13, ASC 805-20-25-28A through 25-28B, ASC 805-20-30-24,

ASC 842-10-55-12, and ASC 842-40-30-4

The acquirer recognizes assets and liabilities arising from leases in which the acquiree is a lessee in accordance with ASC 842. That is, the acquirer recognizes a lease liability and right-of-use asset on the balance sheet. However, ASC 805 provides an accounting policy election in which the acquirer may elect not to recognize assets or liabilities for leases that at the acquisition date have a remaining lease term of 12 months or less. This includes not recognizing an intangible asset or liability for favorable or unfavorable market terms. The election to not recognize leases on the balance sheet at the acquisition date is made by asset class and applies to all an entity's acquisitions.

If the acquirer does not make the election for a lease with a remaining lease term of 12 months or less, or if the lease is more than 12 months, the acquirer must measure the acquired lease as follows:

- Even though the classification of a lease acquired in a business combination is not reassessed (absent a modification), the acquirer must measure the lease liability at the present value of the remaining lease payments as if the acquired lease were a new lease of the acquirer at the acquisition date. The FASB explained, in paragraph BC415 of ASU 2016-02, *Leases (Topic 842)*, that measuring the acquired lease as if it were a new lease encompasses reassessing the following assumptions: the lease term, any lessee purchase options, lease payments (such as amounts probable of being owed under a residual value guarantee), and the discount rate.

- The acquirer measures the right-of-use asset at the amount of the lease liability, adjusted for any favorable or unfavorable (off market) terms in the lease. In other words, the acquirer is required to value off-market terms and recognize them as part of the initial measurement of the right-of-use asset rather than as separate intangible assets or liabilities.

The acquirer must also separately recognize the following, if applicable:

- Identifiable intangible assets associated with the lease, usually called an “in-place lease intangible”, representing market participants’ willingness to pay a price for the lease, even if the lease is at market, such as the lease of gates at an airport or of prime location retail space.
- Leasehold improvements owned by the acquiree (see discussion below on subsequent measurement).

The following table summarizes the potential assets and liabilities that may be recognized for leases acquired in a business combination when the acquiree is the lessee:

	OPERATING LEASE / FINANCE LEASE
Assets	▶ Right-of-use asset (equal to lease liability adjusted for above/below market terms) ▶ In-place lease intangible (fair value) ▶ Leasehold improvements owned by the acquiree (fair value)
Liabilities	▶ Lease liability (present value of the remaining lease payments, as if the lease were a new lease of the acquirer at the acquisition date)

BDO INSIGHTS — ACQUIRER ELECTION TO NOT RECOGNIZE LEASES WITH REMAINING LEASE TERM OF 12 MONTHS OR LESS

ASC 805 allows an acquirer to elect an accounting policy to not recognize assets or liabilities (including intangible assets or liabilities for favorable or unfavorable market terms) for any lease that at the acquisition date has a remaining lease term of 12 months or less. This election is made by asset class and applies to all an entity’s acquisitions.

Paragraph BC415 of ASU 2016-02 explains that when the acquiree in a business combination is a lessee, the acquirer must measure the acquiree’s lease liability at the present value of the remaining lease payments as if the acquired lease were a new lease at the acquisition date, which includes reassessing the lease term. Accordingly, while discussed in the context of measurement of an acquired lease to be recognized by an acquirer on its balance sheet, we believe that in assessing whether an acquired lease qualifies for the recognition exception, the acquirer first reassesses the lease term as if it were a new lease at the acquisition date and then applies the policy election (if elected) to those acquired leases that have a remaining (reassessed) terms of 12 months or less at the acquisition date.

BDO INSIGHTS — ACCOUNTING FOR ACQUIRED OPERATING LEASES WHEN ACQUIRER IS REASONABLY CERTAIN TO EXERCISE A PURCHASE OPTION

ASC 842 is clear that in a business combination, the acquirer measures an acquired lease as if it were a new lease of the acquirer at the acquisition date. The acquirer therefore reassesses the lease term, purchase options, lease payments, and discount rate. In doing so, the acquirer may determine at the acquisition date that it is reasonably certain to exercise a purchase option included in the acquired lease, which would result in the lease being classified as a finance lease. The acquiree may have previously determined otherwise and classified the lease as an operating lease. Also, ASC 842 is clear that the acquirer must retain the acquiree’s lease classification. Therefore, even if the acquirer’s assumptions (as compared to the acquiree’s previous assumptions) would result in a change in lease classification if assessed at the acquisition date, the acquiree’s lease classification must be retained (unless the lease is modified, and that modification is not accounted for as a separate contract). In those situations, the measurement of the lease liability must include the payment related to exercise of the purchase option. Additional complexities may arise in subsequent accounting, including the period and method for amortizing the right-of-use asset, so, entities are encouraged to discuss those situations with their accounting consultants and auditors.

BDO INSIGHTS — RECOGNITION AND MEASUREMENT OF ACQUIRED LEASES WHEN ACQUIREE'S AND ACQUIRER'S POLICY ON NONSEPARATION DIFFER

As discussed in Chapter 3 of our Blueprint, Accounting for Leases Under ASC 842, a lessee may elect a practical expedient by asset class not to separate nonlease component(s) from the associated lease component. Electing the practical expedient may in some situations change classification from operating to finance when performing the present value test in ASC 842-10-25-2(d). Also, an acquiree and acquirer may have made different elections regarding nonseparation of lease and non-lease components. For example, the acquirer may have elected the nonseparation practical expedient while the acquiree did not, or vice versa, potentially resulting in different conclusions on classification of the acquiree's leases if the acquirer's policy had been applied. Therefore, questions have arisen regarding how the acquirer must classify and measure acquired leases when conforming the acquiree's accounting policies to those of the acquirer.

As discussed, ASC 842 is clear that lease classification is retained in a business combination, with the only exception being for modifications not accounted for as a separate contract. Therefore, we believe the acquirer should retain the acquiree-lessee's previous classification, even if the accounting policy between the acquiree and acquirer on nonseparation differs. However, we believe that the acquirer should conform the acquiree's policies to its own and measure the acquired lease consistent with the acquirer's own policy. Specifically:

- If the acquirer elected the nonseparation practical expedient but the acquiree did not, the acquirer should combine the acquiree's nonlease components with the associated lease component when initially measuring the acquiree's leases in its business combination accounting.
- If the acquirer did not elect the nonseparation practical expedient but the acquiree did, the acquirer should separate the acquiree's nonlease components from the associated lease component when initially measuring the acquiree's leases in its business combination accounting. One acceptable approach to separate the components would be to use standalone prices at the business combination date.

BDO INSIGHTS — MEASUREMENT OF RELATED PARTY LEASES WITH OFF-MARKET TERMS ACQUIRED IN A BUSINESS COMBINATION

ASC 842-10-55-12 requires leases between related parties to be accounted for based on their legally enforceable terms and conditions. ASC 842-40-30-4 also notes that for sale and leaseback transactions between related parties, the entity does not adjust the sale price for off-market terms. As a result, entities typically do not adjust their lease accounting for off-market terms in related party leases. However, we believe an exception may apply for acquired related party leases in a business combination. Specifically, the acquirer in a business combination applies ASC 805-20-25-12 (for acquired operating leases) and ASC 805-20-30-24 (for all leases of an acquiree-lessee) to account for all leases. Those paragraphs indicate that the acquirer should measure the right-of-use asset at the same amount as the lease liability, adjusted to reflect favorable or unfavorable lease terms as compared with market terms.

4.4.1.5.4 Recognition and Measurement (Acquiree Is the Lessor)

FASB REFERENCES

ASC 805-20-25-10A, ASC 805-20-25-12, ASC 805-20-30-5, and ASC 805-20-30-25

The recognition and measurement of assets and liabilities related to an acquired lease in which the acquiree is the lessor depends on lease classification.

- For a sales-type or direct financing lease, the acquirer measures the net investment in the lease as the sum of the following:

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:

- The remaining lease payments
- 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

+

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

The net investment in the lease is therefore equal to the fair value of the underlying asset at the acquisition date. 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, the acquirer should take into account the terms and conditions of the lease.

- For an operating lease, the underlying asset is recognized and measured at fair value, which is not affected by the lease (the fair value would be the same whether or not there is an operating lease in place). Also, if the contract terms are favorable or unfavorable as compared to market terms, the acquirer must recognize an intangible asset or liability, respectively, for those off-market terms.
- Also, for all types of acquired leases for an acquiree-lessor, it may be appropriate to recognize identifiable intangible assets such as in-place leases or customer relationships (see Section 4.4.2.7). Any such intangible assets are recognized at fair value following the general measurement principles of ASC 805.

The following table summarizes the potential assets and liabilities that may be recognized for leases acquired in a business combination when the acquiree is the lessor:

	SALES-TYPE OR DIRECT FINANCE LEASE	OPERATING LEASE
Assets	▸ Net investment in the lease (lease receivable + unguaranteed residual asset) ▸ In-place lease intangible (fair value) ▸ Customer relationship intangible (fair value)	▸ Underlying asset (fair value) ▸ Favorable lease terms (fair value) ▸ In-place lease intangible (fair value) ▸ Customer relationship intangible (fair value)
Liabilities	▸ Not applicable	▸ Unfavorable lease terms (fair value)

4.4.1.5.5 Leasehold Improvements Acquired in a Business Combination

FASB REFERENCES

ASC 805-20-35-6 and ASC 842-20-35-13

The acquirer must recognize the fair value of leasehold improvements acquired in the business combination, consistent with other fixed assets (see Section 4.4.2.6). ASC 842-20-35-13 requires leasehold improvements acquired in a business combination to be amortized over the shorter of the useful life of the assets or the remaining lease term at the date of acquisition. However, as discussed in ASC 805-20-35-6, if the lease transfers ownership of the underlying asset to the lessee, or the lessee is reasonably certain to exercise a purchase option, the lessee must amortize the leasehold improvements to the end of their useful life.

4.4.1.5.6 Prepaid or Accrued Rent (Deferred Rent)

FASB REFERENCES

ASC 805-20-25-2

Regardless of whether the acquiree is the lessor or the lessee, an acquirer in a business combination does not recognize assets or liabilities for prepaid or accrued rent because such items do not meet the definition of an asset or liability.[11]

Instead, the acquirer considers the remaining lease payments when assessing whether the lease terms are favorable or unfavorable compared to market terms. For example, if lease payments were prepaid, the remaining lease payments at the acquisition date would typically be less than those for a comparable lease. Thus, at acquisition date, the lease would generally be unfavorable (below market) from the lessor's perspective, or favorable (above market) from the lessee's perspective.

4.4.1.5.7 Leveraged Leases

FASB REFERENCES

ASC 842-50-25-2, ASC 842-50-30-2, and ASC 842-50-35-1

A lessor can no longer classify a lease as a leveraged lease under ASC 842. However, existing leveraged leases that commenced before the effective date of ASC 842 are grandfathered and continue to be accounted for by the lessor as they would be under ASC 840, *Leases*, until they expire or are modified (see ASC 842-50). If a leveraged lease is modified on or after the effective date, it must be accounted for as a new lease as of the effective date of the modification in accordance with ASC 842. A lessor also applies the legacy leases guidance to a leveraged lease that commenced before the effective date and is acquired in a business combination unless the lease is modified.

4.4.1.5.8 Sale and Leaseback Transactions

FASB REFERENCES

ASC 842-40

A sale and leaseback transaction is a financing method in which an entity (the seller-lessee) sells an asset to another entity (the buyer-lessor) and then leases it back. If the transfer of the asset does not meet the criteria to be accounted for as a sale in accordance with ASC 606, *Revenue From Contracts With Customers*, it is treated as a financing transaction (a "failed sale") in which the seller-lessee keeps the asset on its balance sheet and records the cash received as a financing liability. The buyer-lessor also accounts for a failed sale-leaseback as a financing transaction and does not recognize the purchased asset, but instead records the cash paid for the asset as a receivable.

If the asset transfer meets the criteria to be accounted for as a sale, the transaction is accounted for as a sale and leaseback under ASC 842 by both the seller-lessee and the buyer-lessor. The seller-lessee derecognizes the underlying

[11] ASU 2016-02, paragraph BC415

asset and recognizes any gain (or loss) on the sale and accounts for the leaseback as an operating lease. The buyer-lessor recognizes the underlying asset and accounts for the lease as an operating or direct financing lease.

BDO INSIGHTS — ACCOUNTING FOR SALE-LEASEBACKS IN A BUSINESS COMBINATION

If an acquiree was involved in a sale and leaseback transaction before the acquisition, we believe the business combination is not a triggering event to reevaluate the accounting for the sale and leaseback transaction. Rather, the acquirer must retain the acquiree's accounting (for example, as a failed sale-leaseback) and apply ASC 842 to determine the subsequent accounting. See Section 7.2 of our Blueprint, Accounting for Leases Under ASC 842, for more guidance on sale and leaseback transactions.

4.4.1.5.9 Preexisting Leases Between the Acquirer and Acquiree

FASB REFERENCES

ASC 805-10-55-20 through 55-21

An acquirer may have a preexisting lease with the acquiree that is effectively settled as part of the business combination (because the acquirer consolidates the acquiree after the acquisition). The settlement of a preexisting relationship is a transaction separate from the business combination. As such, the acquirer recognizes a gain or loss equal to the lesser of the following:

- The amount by which the lease is favorable or unfavorable from the perspective of the acquirer when compared to market terms
- The amount of any stated settlement provisions in the lease available to the counterparty to whom the contract is unfavorable

Section 6.5.2 provides more guidance on effective settlement of preexisting contractual relationships.

4.4.1.6 Contract Assets and Contract Liabilities (After Adoption of ASU 2021-08)

FASB REFERENCES

ASC 805-20-25-28C and ASC 805-20-30-27 through 30-30

ASU 2021-08, *Business Combinations (Topic 805): Accounting for Contract Assets and Contract Liabilities from Contracts with Customers*, provided an exception to the recognition and measurement principles in ASC 805. Rather than recognizing and measuring contract assets and contract liabilities at fair value, the acquirer recognizes and measures them in accordance with ASC 606 as if it had originated the acquired contract. Thus, the contract assets and contract liabilities recognized by the acquirer at the acquisition date will generally be comparable with those recognized by the acquiree immediately before the acquisition date (assuming that the acquiree's preacquisition financial statements were prepared in accordance with U.S. GAAP).

This exception applies to contract assets and liabilities arising from:

- Contracts with customers
- Other contracts to which the provisions of ASC 606 apply (for example, sales of nonfinancial assets within the scope of ASC 610-20, *Other Income — Gains and Losses From the Derecognition of Nonfinancial Assets*)

The recognition and measurement exception for contract assets and contract liabilities does not apply to other assets or liabilities that may arise from contracts with customers, such as refund liabilities, customer-related intangible assets (see Section 4.4.2.7.5.2), off-market intangible assets (see Section 4.4.2.7.5.4), or costs to acquire or fulfill a contract (see Section 4.4.1.6.1). As such, the acquirer recognizes and measures those other assets and liabilities at fair value. For example, if revenue contracts have favorable or unfavorable terms, the acquirer recognizes an asset or liability at the acquisition-date fair value for the off-market contract terms.

The acquirer is responsible for determining whether the contract assets and contract liabilities are appropriately recognized in accordance with ASC 606. In many cases, the acquirer will be able to recognize and measure acquired contract assets and contract liabilities in a manner consistent with the way they were recognized by the acquiree (that is, at carryover basis). However, carryover basis is not always appropriate. For example, the acquirer should not rely on the amounts recognized by the acquiree if:

- The acquiree did not recognize the contract assets and contract liabilities in accordance with U.S. GAAP.
- The acquirer's estimates (such as for variable consideration or for measures of progress) differ from the acquiree's estimates.
- The acquirer's accounting policies do not align with the acquiree's policies.

When evaluating the amounts to recognize for contract assets and contract liabilities at the acquisition date, an acquirer applies the provisions of ASC 606 as if it had originated the contract. In other words, the acquirer applies its own accounting policies, estimates, and judgments to determine the accounting for the contract at its inception and subsequent modification dates. However, ASC 805 provides the following practical expedients that can be elected:

PRACTICAL EXPEDIENT	DESCRIPTION
Standalone selling price	▶ The acquirer may determine the standalone selling price at the acquisition date (instead of at the contract inception date) of each performance obligation in the contract.
Modifications	▶ For contracts that were modified before the acquisition date, the acquirer may reflect the aggregate effect of all modifications that occur before the acquisition date when: • Identifying the satisfied and unsatisfied performance obligations • Determining the transaction price • Allocating the transaction price to the satisfied and unsatisfied performance obligations

An acquirer may elect to apply either or both practical expedients on an acquisition-by-acquisition basis; however, once elected, they must be applied consistently for all contracts acquired in the same business combination. Further, an acquirer that elects either or both practical expedients must disclose the expedients that have been used and, to the extent reasonably possible, a qualitative assessment of the estimated effect of applying each of those expedients. See our Blueprint, **Revenue Recognition Under ASC 606**, for revenue recognition guidance.

4.4.1.6.1 Costs to Obtain or Fulfill Customer Contracts

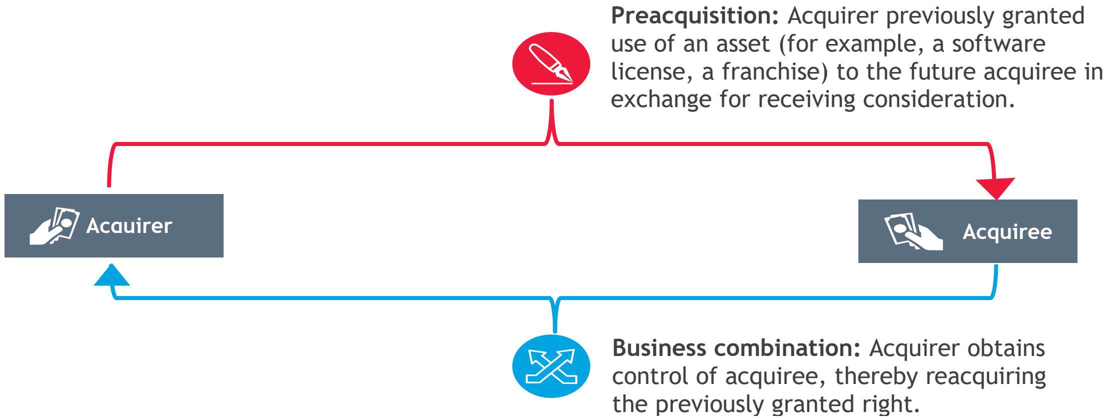
ASC 340-40, *Other Assets and Deferred Costs — Contracts With Customers*, requires recognizing incremental costs incurred to obtain or fulfill a customer contract as an asset if specific criteria are met. Therefore, an acquiree may have previously recognized an asset for costs to obtain or fulfill a customer contract. Such deferred costs typically do not meet the definition of an asset to the acquirer and would not be recognized separately in a business combination; however, the fair value of these costs may be considered when determining the value of customer-related intangible assets (see Section 4.4.2.7.5.2).

4.4.1.7 Reacquired Rights

FASB REFERENCES

ASC 805-20-25-14

If, before the business combination, the acquirer had granted rights to use its assets, the reacquisition of those rights in a business combination results in the acquirer's recognition of an intangible asset (a reacquired right). Examples 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 licensing agreement.



4.4.1.7.1 Initial Measurement of Reacquired Rights and Settlement Gain or Loss

FASB REFERENCES

ASC 805-10-55-23 and ASC 805-20-30-20

A reacquired right because of a business combination results in the recognition of an intangible asset by the acquirer. Also, because the reacquired right settles a preexisting relationship, the acquirer may need to recognize a settlement gain or loss separate from the business combination (see Section 6.5.2). If the contract that gives rise to the reacquired right is favorable or unfavorable when compared to pricing for current market transactions, the acquirer must recognize a settlement gain or loss measured as noted in the following graphic:

Settlement gain or loss is the lesser of:

The amount by which the contract is favorable or unfavorable from the perspective of the acquirer

or

The amount of any stated settlement provisions in the contract available to the counterparty to whom the contract is unfavorable

4.4.1.7.2 Measuring a Reacquired Right

FASB REFERENCES

ASC 805-20-30-20

As discussed in Section 4.4.1, the initial measurement of a reacquired right in a business combination is an exception to the fair value measurement principle; therefore, the valuation of a reacquired right is not based on market participant assumptions. Whereas a market participant would generally include expected renewal periods when measuring the fair value of an asset, ASC 805 requires that the acquirer measure a reacquired right based on the remaining contractual term without considering the effect of potential renewals. The FASB limited the inclusion of estimated cash flows to the remaining contract term because a reacquired right is different from a contractual right traded in the market. Without this limit, an acquirer might assume unlimited renewals of a reacquired right and assign an indefinite life to the intangible asset, potentially inflating the intangible asset's value.[12]

Example 4-6 illustrates the accounting for a reacquired right.

EXAMPLE 4-6: REACQUIRED RIGHT WITH A GAIN ON SETTLEMENT OF PREEXISTING RELATIONSHIP

FACTS

- Before the business combination, ABC Company had provided XYZ Company a license to use its tradename to operate a car wash franchise in an adjacent state for renewable five-year terms.
- ABC Company acquires XYZ Company for $35 million in a business combination, thereby reacquiring the previously granted license rights.
- The value of the reacquired right, excluding any potential contract renewals, is $5 million.
- The contract terms for the license are favorable to ABC Company compared to market terms at the acquisition date by $2 million.
- The license agreement does not include any cancellation or settlement provisions.
- The other identifiable assets (excluding the reacquired right) total $10 million.

CONCLUSION

ABC Company recognizes an identifiable intangible asset of $5 million for the reacquired right and a gain on settlement of the preexisting relationship of $2 million.

ANALYSIS

ABC Company recognizes an identifiable intangible asset of $5 million for the reacquired right. The value of the reacquired right is determined without including any potential contract renewals. Further, because the contract terms of the license are favorable (from the acquirer's perspective) compared to market terms at the acquisition date, and there are no stated settlement provisions in the license agreement, ABC Company recognizes a settlement gain of $2 million (the amount that is favorable from the acquirer's perspective).

The Company recognizes the following journal entry:

Debit	Reacquired right	$ 5 million	
Debit	Other identifiable net assets	10 million	
Debit	Goodwill	22 million	
Credit	Gain on reacquired right		$ 2 million
Credit	Cash		35 million

[12] FAS 141(R), paragraphs B308 – B309

4.4.1.7.3 Subsequent Measurement of Reacquired Rights

FASB REFERENCES

ASC 805-20-35-2

An acquirer amortizes a reacquired right over the existing contract's remaining term, excluding any contractual renewals, consistent with the period used by the acquirer for initial measurement. If the acquirer later sells a reacquired right to a third party, it derecognizes the carrying amount of the reacquired right when recognizing a gain or loss on the sale.

4.4.1.8 Share-Based Payment Awards

FASB REFERENCES

ASC 805-20-30-21

As discussed in Section 5.4, an entity generally measures the consideration transferred at fair value; however, the portion of share-based replacement awards that are included in the consideration transferred is measured in accordance with ASC 718, *Compensation - Stock Compensation*. When an acquirer is obligated to issue replacement awards, at the acquisition date it must determine the values of both the original acquiree awards and the replacement awards in accordance with ASC 718.

Section 6.4.3 provides more information on the accounting for share-based payment awards in a business combination.

4.4.1.9 Assets Held for Sale

FASB REFERENCES

ASC 805-20-30-22 and ASC 360-10-45-12

An acquirer may plan to dispose of assets acquired in a business combination. Assets held for sale are accounted for under an exception to the recognition and measurement principles in ASC 805. Assets (or disposal groups) classified as held for sale at the acquisition date are measured at fair value less cost to sell in accordance with ASC 360. Costs to sell include broker commissions, legal and title transfer fees, and other incremental direct costs incurred to complete the sale.

To qualify as assets held for sale on the acquisition date, the acquirer must meet **both** of the following conditions:

The sale of an asset (or disposal group) is probable of being completed within one year of the acquisition date (except as permitted by ASC 360-10-45-11)

+

Any other held-for-sale criteria that are not met as of the acquisition date are probable of being met within a short period after the acquisition (generally three months).

The other held-for-sale criteria (which must be met within three months) are:

- Management, having the authority to approve an action, commits to a plan to sell the assets.

- The asset (or disposal group) is available for immediate sale in its present condition (subject only to usual and customary terms).
- An active program to locate a buyer and other actions required to complete the plan to sell the asset (or disposal group) have been initiated.
- The asset (or disposal group) is being actively marketed for sale at a price that is reasonable in relation to its current fair value.
- Actions required to complete the plan indicate that it is unlikely that there will be significant changes to the plan or that the plan will be withdrawn.

Acquired assets that do not meet the held-for-sale conditions on the acquisition date are recognized and measured in accordance with the principles in ASC 805.

4.4.1.10 Purchased Financial Assets With Credit Deterioration

FASB REFERENCES

ASC 805-10-20: Purchased Financial Assets with Credit Deterioration, ASC 805-20-30-4 through 30-4B, and ASC 805-20-30-26

The recognition of financial assets purchased in a business combination depends on whether those assets have experienced a more-than-insignificant deterioration in credit quality since origination.

Purchased financial assets that **have not** experienced a more-than-insignificant deterioration in credit quality are recognized at fair value at the acquisition date. Separately, expected credit losses are measured under the credit impairment model in ASC 326, *Financial Instruments – Credit Losses*, and recognized in the income statement.

On the other hand, purchased financial assets that **have** experienced a more-than-insignificant deterioration in credit quality are recognized under an exception to the measurement principle. Although, an acquirer typically does not recognize a separate valuation allowance at the acquisition date for acquired assets measured at their acquisition-date **fair values** (because the effects of uncertainty of future cash flows are included in the fair value measurement as discussed in Section 4.4.2.2), an exception exists for purchased financial assets with credit deterioration (PCD assets), which are defined in ASC 805 as follows:

> *Acquired individual financial assets (or acquired groups of financial assets with similar risk characteristics) that as of the date of acquisition have experienced a more-than-insignificant deterioration in credit quality since origination, as determined by an acquirer's assessment. See paragraph 326-20-55-5 for more information on the meaning of similar risk characteristics for assets measured on an amortized cost basis.*

For PCD assets the acquirer estimates the expected credit losses at the acquisition date, adds that amount to the fair value of the PCD asset, and recognizes an offsetting valuation allowance. As such, no credit loss expense is recognized at the acquisition date. This gross-up approach is intended to make the subsequent measurement of PCD assets consistent with other financial assets the acquirer purchases or originates.

FASB PROJECT: FINANCIAL INSTRUMENTS — CREDIT LOSSES (TOPIC 326) — PURCHASED FINANCIAL ASSETS

In June 2023, the FASB published a proposed accounting standards update that would require the gross-up approach to be applied to all financial assets acquired in a business combination (not just those that have experienced significant credit deterioration). Comments were due in August 2023. Readers should monitor developments.

4.4.2 Assets Acquired in a Business Combination

FASB REFERENCES

ASC 805-20-30-1

As discussed in Section 4.4, in a business combination, the acquirer measures the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree at their acquisition-date fair values, unless a recognition or measurement exception applies.

The following sections address common questions and challenges in determining the fair values of assets acquired in a business combination:

TOPIC	SECTION
Highest and best use	Section 4.4.2.1
Assets with uncertain cash flows	Section 4.4.2.2
Prepaid expenses	Section 4.4.2.3
Inventories	Section 4.4.2.4
Financial instruments	Section 4.4.2.5
Property, plant, and equipment	Section 4.4.2.6
Intangible assets	Section 4.4.2.7
In-process research and development	Section 4.4.2.8
Defensive intangible assets	Section 4.4.2.9
Private company and not-for-profit accounting alternative	Section 7.2

4.4.2.1 Highest and Best Use

FASB REFERENCES
ASC 805-20-30-6 and ASC 820-10-35-10A through 35-10D

As discussed in Section 4.4, in a business combination, the acquirer measures identifiable assets acquired, liabilities assumed, and NCI, if any, at their acquisition-date fair values in accordance with ASC 820 (with limited exceptions). Fair value is not based on entity-specific assumptions but on assumptions that market participants would use. As a result, the acquirer's intended use of an asset, or its intent regarding the settlement of a liability, is irrelevant.

For competitive or other reasons, an acquirer may intend to use an acquired asset differently from how other market participants would use it. Under ASC 820, the asset's fair value is determined based on its highest and best use by market participants.

The highest and best use of a nonfinancial asset considers the following:

Physically Possible	The asset's physical characteristics that market participants would consider when pricing the asset (for example, a property's location or size)
Legally Permissible	Any legal restrictions on the asset's use that market participants would consider when pricing the asset (for example, the zoning regulations applicable to a property)
Financially Feasible	Whether a use of the asset that is physically possible and legally permissible generates adequate income or cash flows (considering the costs of converting the asset to that use) to produce an investment return that market participants would require from an investment in that asset put to that use

Alternatively, an acquirer may intend to not use an acquired asset. For example, an acquirer may shelve an acquiree's IPR&D or retire the brand name of an acquired competitor. See Section 4.4.2.9 for more guidance on the accounting for defensive intangible assets.

4.4.2.2 Assets With Uncertain Cash Flows (Valuation Allowances)

FASB REFERENCES
ASC 805-20-30-4

An acquirer typically does not recognize a separate valuation allowance at the acquisition date for acquired assets measured at their acquisition-date fair values because the effects of uncertainty of future cash flows are included in the fair value measurement. An exception exists for purchased financial assets with credit deterioration, as discussed in Section 4.4.1.10.

However, if necessary, a valuation allowance may be recognized for an acquired asset recognized under an exception to the fair value principle. For example, deferred tax assets (see Section 4.4.1.2) and indemnification assets (see Section 4.4.1.4) may require a valuation allowance because they are not recognized at fair value at the acquisition date.

4.4.2.3 Prepaid Expenses

FASB REFERENCES

ASC 805-20-30-1

Acquired assets may include amounts prepaid for future expenses, such as insurance coverage for a specified period after the acquisition date. However, costs related to periods before the business combination are not prepaid expenses and must be expensed in the acquiree's preacquisition financial statements.

Examples 4-7 and 4-7A illustrate this concept.

EXAMPLE 4-7: COSTS INCURRED FOR DIRECTORS AND OFFICERS (D&O) LIABILITY INSURANCE

FACTS

- Company A acquires 100% of Company B in a business combination for $10 million in cash.
- Before the closing of the business combination, the sellers of Company B purchased and paid for a D&O insurance policy that provides coverage for matters related to the directors' and officers' service at the acquiree before the closing date of the acquisition. The decision to purchase the insurance policy was made by the sellers, for their benefit, to make Company B more marketable to potential buyers.
- Claims under the D&O insurance policy can be made for up to three years following the closing date.

CONCLUSION

Company B recognizes the expense in its precombination financial statements. Company A does not recognize a prepaid expense as part of the business combination.

ANALYSIS

The D&O policy insures matters that occur in periods before the business combination. Even though the policy allows claims to be made for up to three years after the closing date, it does not provide any insurance coverage for matters that occur after the date of the business combination. Therefore, the cost of the insurance policy does not represent an asset as of the acquisition date and must be expensed as incurred in the acquiree's preacquisition financial statements.

EXAMPLE 4-7A: COSTS INCURRED FOR D&O LIABILITY INSURANCE

FACTS

Assume the same facts as in Example 4-7, except that the insurance policy is not purchased until after the acquisition date, when the acquirer decides to terminate some of the acquiree's officers. As such, the purchase of the insurance policy was for the benefit of the acquirer or the combined entity after the acquisition date.

CONCLUSION

Company A recognizes the expense as incurred in its postacquisition financial statements.

ANALYSIS

The D&O policy insures matters that occur in periods before the business combination. Even though the policy allows claims to be made for up to three years after the closing date, it does not provide any insurance coverage for matters that occur after the date of the business combination. Therefore, the cost of the insurance policy does not represent a prepaid expense. Because the costs were incurred for the acquirer's benefit, such costs must be expensed as incurred (immediately) in the acquirer's postacquisition financial statements.

4.4.2.4 Inventories

FASB REFERENCES

ASC 805-20-30-1

Acquired assets may include inventory in various stages of production on the acquisition date: raw materials, work-in-process (WIP), and finished goods. An acquirer does not carry over the cost basis of the acquiree's inventory. Instead, the acquirer must recognize inventory at fair value in accordance with ASC 820, which bases fair value on the exit price (the price that would be received if the asset is sold). Thus, the fair value of inventory is the amount that would be received if the acquirer were to sell the inventory in its existing condition to a market participant at the acquisition date. Usually, the fair value of inventory is higher than the acquiree's carrying value. However, recording inventory at fair value does not eliminate all profit in subsequent sales, as discussed below.

The fair value of the acquired inventory is not affected by the acquiree's or acquirer's selected accounting method. In other words, fair value of the acquired inventory is the same, whether the acquiree or acquirer applies FIFO, LIFO, average cost, or another accounting method to inventory.

Two approaches are generally used to value inventory:

- The top-down approach is often used for valuing WIP inventory and finished goods.
- The bottoms-up approach is often used for valuing raw materials.

The fair value should be the same regardless of which approach is used.

4.4.2.4.1 Raw Materials Inventory

An acquirer generally measures raw material inventory using a bottoms-up approach, meaning that it measures the raw materials at the price a market participant would pay to buy them in the principal (or most advantageous) market (replacement cost).

Example 4-8 illustrates this concept.

EXAMPLE 4-8: DETERMINING THE FAIR VALUE OF RAW MATERIALS

FACTS

An acquirer purchases an acquiree in a business combination. The acquiree has raw materials used in the production process with a historical cost of $10 per pound. On the acquisition date, the replacement cost of the raw materials in the principal market is $11 per pound.

CONCLUSION

Acquirer recognizes the acquired raw material inventories at fair value ($11 per pound).

ANALYSIS

An acquirer measures raw material inventory at the price a market participant would pay to buy the materials in the principal (or most advantageous) market. The replacement cost of the raw materials at the acquisition date is $11 per pound.

4.4.2.4.2 Work-In-Process Inventory

To determine the fair value of WIP inventory, an acquirer generally applies a top-down approach that uses the estimated selling price for the finished product adjusted for the costs to complete the manufacturing process, selling costs, and a reasonable profit for both the selling and manufacturing efforts.

Fair Value of Acquired WIP = Estimated Selling Price + Estimated Costs to Complete − Selling Costs − Reasonable Profit

4.4.2.4.3 Finished Goods Inventory

Finished goods inventory is generally measured using a similar approach as used for measuring the fair value of acquired WIP (see Section 4.4.2.4.2), except that the estimated selling price is not adjusted for estimated costs to complete the inventory (because the manufacturing process is complete). Thus, a reasonable profit for finished goods would not include any profit for manufacturing efforts and, as such, would be less than a reasonable profit for WIP.

Fair Value of Acquired Finished Goods = Estimated Selling Price − Selling Costs − Reasonable Profit

4.4.2.4.4 Supply Inventory

An acquirer measures supplies used in the manufacturing process at their acquisition-date fair values, similar to how raw materials inventory is measured (see Section 4.4.2.4.1).

4.4.2.4.5 Acquired LIFO Inventory

FASB REFERENCES

ASC 330-10-S99-1

In a business combination, inventory is measured at fair value. The fair value of the acquired inventory is not affected by the acquiree's or acquirer's selected accounting method. In other words, fair value of the acquired inventory is the same, whether the acquiree or acquirer applies FIFO, LIFO, average cost, or another accounting method to its inventory. If the acquiree used LIFO, the fair value adjustments to the acquired inventory will typically result in a significant increase to the carrying value.

When an acquirer combines the acquired inventory with an existing LIFO pool, it includes the fair value of the acquired inventory in that period's purchases for calculating inventory increments or decrements. However, if the acquirer creates a new pool or initially adopts the LIFO method for the acquired inventory, the fair value of the acquired inventory is the LIFO base inventory layer.

4.4.2.5 Financial Instruments

4.4.2.5.1 Equity Method Investments

An acquirer recognizes an acquired equity method investment at fair value at the acquisition date. Any resulting basis differences between the acquirer's share of the fair values and the carrying amounts of the underlying assets in the equity method investee's financial statements are subsequently recognized as part of the equity method earnings or loss. See ASC 323 for more guidance on the application of the equity method.

4.4.2.5.2 Investments in Debt and Equity Securities

FASB REFERENCES

ASC 805-20-25-6 through 25-7

An acquirer recognizes acquired investments in debt securities at fair value at the acquisition date. Subsequently, investments in debt securities are accounted for under ASC 320, *Investments – Debt Securities*. The acquirer classifies the debt securities as held-to-maturity, available-for-sale, or trading securities in accordance with ASC 320. The acquirer is not constrained by the acquiree's previous classification of such investments; rather, classification is based on the intent and ability of the acquirer at the acquisition date (see Section 4.3).

Similarly, an acquirer recognizes acquired investments in equity securities at fair value at the acquisition date. Subsequently, investments in equity securities (other than those for which consolidation or equity method accounting applies) are accounted for under ASC 321, *Investments – Equity Securities*.

4.4.2.5.3 Derivatives and Hedging Instruments

FASB REFERENCES

ASC 805-20-25-6 through 25-7

An acquirer recognizes derivatives at fair value at the acquisition date. If it wants to designate any instruments as hedging instruments, it must evaluate whether they qualify under the requirements of ASC 815, *Derivatives and Hedging*. The acquiree's previous designations are not relevant (see Section 4.3). Similarly, acquired contracts must be assessed to determine whether any embedded derivatives must be bifurcated from their host contracts.

4.4.2.6 Property, Plant, and Equipment

An acquirer recognizes acquired property, plant, and equipment (PP&E) at fair value at the acquisition date; as such, the acquiree's accumulated depreciation does not carry over to the acquirer's financial statements. The acquirer determines the estimated remaining useful life and depreciation method for the acquired assets consistent with its accounting policies and depreciates the new basis of the PP&E beginning at the acquisition date in accordance with ASC 360.

If an acquirer plans to sell assets acquired in the business combination, it measures the acquired PP&E at fair value less cost to sell (see Section 4.4.1.9). However, if an acquirer intends to abandon acquired PP&E, it must recognize the acquired PP&E at fair value (see Section 4.4.2.1)

4.4.2.6.1 Asset Retirement Obligations

FASB REFERENCES

ASC 410-20-15-2

Acquired long-lived tangible assets may be subject to legal obligations associated with their retirement, such as a requirement to dismantle an asset and restore the site to its original condition. Such asset retirement obligations are recognized at fair value as a separate unit of account from the acquired asset under ASC 410. Therefore, the future cash flows used to determine the fair value of the acquired PP&E do not include the future cash flows related to the asset retirement obligations.

4.4.2.6.2 Mineral Rights and Mining Assets

FASB REFERENCES

ASC 805-20-55-37 and ASC 930-805-30-1 through 30-2

An acquirer recognizes mining assets, including mineral rights, at fair value in accordance with ASC 820. Fair value is determined using market participant assumptions that consider all available information including anticipated fluctuations in the future market price of minerals based on current prices, historical averages, and forward pricing curves. Similarly, the acquirer includes value beyond the proven and probable reserves if a market participant would include that value in determining the fair value of the mining assets.

4.4.2.7 Intangible Assets

FASB REFERENCES

ASC 805-20-25-10 and ASC 805-10-20: Identifiable, Intangible Assets

Intangible assets are assets (not including financial assets) that lack physical substance. The term “intangible assets” refers to intangible assets other than goodwill. Identifiable intangible assets are recognized at fair value in a business combination, unless they qualify for a measurement exception (for example, reacquired rights or an asset held for sale). Section 7.2 discusses an accounting alternative for intangible assets available for private companies and not-for-profit entities.

An intangible asset is identifiable if it satisfies **either** of two criteria:

Contractual-legal criterion	Separability criterion
It arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations (see Section 4.4.2.7.1).	It is separable, that is, capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, identifiable asset, or liability, regardless of whether the entity intends to do so (see Section 4.4.2.7.2).

Some intangible assets that meet the contractual-legal criterion also meet the separability criterion, but only one criterion must be met for an intangible asset to be identifiable. As such, an intangible asset that meets the separability criterion is identifiable even if it does not meet the contractual-legal criterion.

4.4.2.7.1 Contractual-Legal Criterion

FASB REFERENCES

ASC 805-20-55-2

Contractual or legal rights originate from contracts, statutes, or similar means and give the holder the right to future economic benefits. An intangible asset that arises from contractual or legal rights must be recognized separately from goodwill, even if the acquirer is contractually prohibited from transferring the asset to another party. Although transfer restrictions do not affect the recognition of an intangible asset that meets the contractual-legal criterion, they may affect the fair value.

ASC 805 includes the following examples of acquired intangible assets that satisfy the contractual-legal criterion:

- 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.
- 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 if the useful lives of those assets are similar.
- 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.

4.4.2.7.2 Separability Criterion

FASB REFERENCES

ASC 805-20-55-3 through 55-5

An intangible asset meets the separability criterion if it is capable of being separated from the acquired business and sold or exchanged, regardless of the acquirer’s intent. However, unlike with the contractual-legal criterion, if the acquirer is legally or contractually prohibited from transferring the intangible asset (for example, through sale, license, rent, or exchange), it would not meet the separability criterion (although it could still meet the contractual-legal criterion). For instance, customer lists are commonly sold or licensed, and thus are generally separable; however, if the terms of confidentiality or other agreements prohibit an acquirer from selling, leasing, or otherwise exchanging customer information, the separability criterion would not be met.

CUSTOMER LIST IS SEPARABLE	CUSTOMER LIST IS NOT SEPARABLE
▶ Acquiree is a retailer with a customer list, and is not restricted from selling, leasing, or otherwise exchanging customer information. ▶ The customer list meets the separability criterion because it could be sold separately, even if the acquiree has never licensed its customer list in the past and does not intend to sell or license the customer list in the future.	▶ Acquiree is a healthcare facility with a customer list. Federal laws prohibit the acquiree from selling, leasing, or exchanging customer information without their express written permission. The acquiree has not obtained such permission. ▶ The customer list does not meet the separability criterion, because the acquirer cannot sell or license the customer information.

Some intangible assets are closely tied to a contract, another asset, or liability and cannot be separated from that item. However, the intangible asset would still meet the separability criterion if the acquirer can sell or transfer it with the related contract, asset, or liability. ASC 805 includes the following examples:

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

4.4.2.7.3 Intangible Assets That Are Not Identifiable

FASB REFERENCES

ASC 805-20-55-6 through 55-7

An intangible asset that does not meet either the contractual-legal criterion or the separability criterion is not recognized separately; instead, its value is subsumed into goodwill. Similarly, any value attributable to other items that do not meet the definition of an asset at the acquisition date is subsumed into goodwill.

For example, if the acquiree is negotiating potential contracts with new customers at the acquisition date, the acquirer may attribute value to them. However, because these potential contracts are not assets at the acquisition date, the acquirer does not recognize them separately from goodwill. Further, even if the contracts are executed later, the acquirer cannot reclassify their values from goodwill after the acquisition date.

4.4.2.7.3.1 Assembled Workforce

FASB REFERENCES

ASC 805-20-55-6

An assembled workforce is a *"an existing collection of employees that permits the acquirer to continue to operate the acquired business after the acquisition date."* The assembled workforce represents the value attributable to having a group of employees already assembled (that is, not having to individually hire a group of new employees on the acquisition date).

An assembled workforce is not identifiable because it does not meet the separability or contractual-legal criterion. The workforce is not separable because the acquirer cannot sell, transfer, license, rent, or otherwise exchange it. Further, the workforce does not meet the contractual-legal criterion because it does not arise from contractual or legal rights (although individual employees might have employment contracts, the group of employees as a whole does not have a contract).

Because an assembled workforce is not an identifiable intangible asset, the acquirer subsumes the value of the acquired assembled workforce into goodwill.

Conversely, in an asset acquisition that does not qualify as a business combination, an assembled workforce is recognized as a separate asset (see Appendix C, Section C.4.4.1).

4.4.2.7.4 Complementary Intangible Assets — Unit of Account

FASB REFERENCES

ASC 805-20-55-2, ASC 805-20-55-18, and ASC 805-20-55-30

ASC 805 does not provide guidance for determining the unit of account for recognizing intangible assets. In some cases, an acquirer may wish to account for intangible assets that complement each other as a single intangible asset. It would be appropriate to group intangible assets together only if their useful lives and patterns of economic benefits are similar. ASC 805 provides the following examples in which it may be acceptable to group similar assets together (assuming that they have similar useful lives):

- A license to operate a nuclear power plant and the power plant itself
- A trademark and its related tradename, formulas, recipes, and technological expertise
- An artistic copyright intangible asset and any related assignments or license agreements

4.4.2.7.5 Examples of Identifiable Intangible Assets

FASB REFERENCES

ASC 805-20-55-11 through 55-45

ASC 805 provides examples of identifiable intangible assets and indicates whether they meet the contractual-legal or separability criterion. These examples are not exhaustive; other acquired intangible assets may also meet one of the criteria for recognition apart from goodwill.

CATEGORY	INTANGIBLE ASSET	CONTRACTUAL-LEGAL CRITERION	SEPARABILITY CRITERION
Marketing-Related	Trademarks, trade names, service marks, collective marks, certification marks	✓	
	Trade dress (unique color, shape, package design)	✓	
	Newspaper mastheads	✓	
	Internet domain names	✓	
	Noncompetition agreements	✓	
Customer-Related	Customer lists		✓
	Order or production backlog	✓	
	Customer contracts and related customer relationships	✓	
	Noncontractual customer relationships		✓
Artistic-Related	Plays, operas, ballets	✓	
	Books, magazines, newspapers, other literary works	✓	
	Musical works, such as compositions, song lyrics, advertising jingles	✓	
	Pictures, photographs	✓	
	Video and audiovisual material, including motion pictures or films, music videos, television programs	✓	
Contract-Based	Licensing, royalty, standstill agreements	✓	
	Advertising, construction, management, service, or supply contracts	✓	
	Lease agreements (whether the acquiree is the lessee or lessor)	✓	
	Construction permits	✓	
	Franchise agreements	✓	
	Operating and broadcast rights	✓	
	Servicing contracts, such as mortgage servicing contracts	✓	
	Employment contracts	✓	
	Use rights, such as drilling, water, air, timber cutting, and route authorities	✓	
Technology-Based	Patented technology	✓	
	Computer software and mask works	✓	
	Unpatented technology		✓
	Databases, including title plants		✓
	Trade secrets, such as secret formulas, processes, recipes	✓	

4.4.2.7.5.1 Marketing-Related Intangible Assets

FASB REFERENCES

ASC 805-20-55-14

Marketing-related intangible assets are used primarily in marketing or promoting products or services. In many cases marketing-related intangible assets are provided legal protection, so they generally meet the contractual-legal criterion. Even if such assets are not legally protected, they would typically meet the separability criterion.

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

FASB REFERENCES

ASC 805-20-55-16 through 55-18

Trademarks, trade names, and other marks may be protected legally through registration with government agencies or by other means and thus meet the contractual-legal criterion. Even if they are not legally protected, they would typically meet the separability criterion.

The terms “brand” and “brand name” are general marketing terms that typically refer to a group of complementary assets such as a trademark, trade name, formula, recipe, and technological expertise. ASC 805 allows an acquirer to recognize a group of complementary intangible assets as a single asset separate from goodwill if the assets in the group have similar useful lives (see Section 4.4.2.7.4).

4.4.2.7.5.1.2 Internet Domain Names

FASB REFERENCES

ASC 805-20-55-19

An internet domain name is a unique name used to identify a specific internet address. Registering a domain name creates an association between that name and a designated computer on the internet for the registration period. A registered domain name acquired in a business combination meets the contractual-legal criterion.

4.4.2.7.5.1.3 Noncompete Agreements

FASB REFERENCES

ASC 805-20-55-14

Noncompetition agreements prohibit a person or business from competing with a company in a particular market or industry for a specified period of time.

An acquiree’s preexisting noncompete arrangements that are assumed by the acquirer would typically meet the contractual-legal criterion for recognition as intangible assets in a business combination.

Alternatively, an acquirer may enter noncompete agreements with the selling shareholders in connection with a business combination. Because noncompete agreements with selling shareholders are primarily for the benefit of the acquirer, they are often accounted for as transactions separate from a business combination (see Section 6.4.2.8.1).

However, in paragraph BC 19 of ASU 2014-18, *Business Combinations (Topic 805): Accounting for Identifiable Intangible Assets in a Business Combination (A Consensus of the Private Company Council)*, the FASB acknowledged that there may be diversity in views regarding whether noncompete agreements should be accounted for as part of the business combination or as a separate transaction, but that such diversity has not resulted in significantly different outcomes.

See Section 7.2.4.2 for additional guidance for entities that elect the private company alternative to not recognize specified intangible assets separately from goodwill.

4.4.2.7.5.2 Customer-Related Intangible Assets

FASB REFERENCES

ASC 805-20-55-20 and ASC 805-55-20-24

Customer-related intangible assets include items such as customer lists, order or production backlogs, customer contracts and related customer relationships, noncontractual customer relationships, and employee loyalty programs.

Relationships with customers are often multifaceted. For example, an acquiree may have a single customer that is on its customer list, is included on its order backlog, and is a part of its loyalty program. Determining which future economic benefits are attributable to each asset is important to avoid double-counting; a discussion with a valuation professional may be helpful in this regard. Further, if the useful lives for each type of customer-related intangible asset are dissimilar, it would not be appropriate to combine them into a single unit of account (see Section 4.4.2.7.4).

4.4.2.7.5.2.1 Customer Lists

FASB REFERENCES

ASC 805-20-55-21

A customer list consists of information about customers, such as their names and contact information. Entities often sell, buy, or otherwise exchange customer lists. As such, if the acquiree is not prohibited from transferring that information, the customer list meets the separability criterion, and is therefore recognized by an acquirer in a business combination.

A CUSTOMER BASE IS OFTEN NOT RECOGNIZABLE

A customer base is a group of potential customers (sometimes referred to as “walk-up” customers) that are not known or identifiable by the acquirer. For example, some customers are repeat customers of retailers; however, if the retailer does not collect and maintain specific demographic data about the customers, the separability criterion would not be met.

4.4.2.7.5.2.2 Order or Production Backlog

FASB REFERENCES

ASC 805-20-55-22

Acquirees in industries like manufacturing and construction may have significant backlog, or unfulfilled purchase or sales orders, at the acquisition date. When acquired in a business combination, an order or production backlog is recognized as an intangible asset, even if the contract is cancelable, because it arises from a contractual right. However, the fact that the contract is cancelable may affect the fair value of the intangible asset.

4.4.2.7.5.2.3 Customer Contracts and the Related Customer Relationships

FASB REFERENCES

ASC 805-20-55-23 through 55-27 and ASC 805-20-55-52 through 55-57

A customer relationship exists between an acquiree and its customer if the acquiree has information about the customer and has regular contact with the customer (for example, through sales or service representatives), and the customer has the ability to make direct contact with the acquiree.

Customer relationships can be contractual or noncontractual:

- If the acquiree has a practice of establishing contracts with its customers, the customer relationship meets the contractual-legal criterion, regardless of whether a contract exists at the acquisition date (see Example 4-11).
- If the acquiree does not have a practice of establishing contracts, the customer relationship would not meet the contractual-legal criterion. However, the customer relationship may still be identifiable because it meets the separability criterion (see Section 4.4.2.7.2).

An acquirer recognizes a customer relationship that meets either the contractual-legal or separability criterion. The value of customer relationships that do not meet either criterion is subsumed within goodwill.

Examples 4-9 through 4-13 illustrate customer contract and customer relationship intangible assets acquired in a business combination:

EXAMPLE 4-9 (ADAPTED FROM ASC 805-20-55-54): FIVE-YEAR SUPPLY AGREEMENT

FACTS

- Acquirer purchases Acquiree in a business combination.
- Both Acquiree and Acquirer believe that Customer will renew the agreement at the end of the current contract.
- The agreement is not separable; however, whether cancelable or not, it meets the contractual-legal criterion.

CONCLUSION

The customer relationship intangible assets meet the contractual-legal criterion; therefore, Acquirer recognizes an intangible asset.

ANALYSIS

Because Acquiree establishes its relationship with Customer through contracts, Acquiree's customer relationship with Customer meets the contractual-legal criterion.

EXAMPLE 4-10 (ADAPTED FROM ASC 805-20-55-55): ONE CUSTOMER, CONTRACT IN ONE OF TWO LINES OF BUSINESS

FACTS

- Acquirer purchases Acquiree in a business combination.
- Acquiree manufactures goods in two distinct lines of business: sporting goods and electronics.
- Customer purchases both sporting goods and electronics from Acquiree.
- Acquiree 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 Acquiree and Acquirer believe that only one overall customer relationship exists between Acquiree and Customer.
- The contract to be Customer's exclusive supplier of sporting goods, whether cancelable or not, meets the contractual-legal criterion.

CONCLUSION

The customer relationship intangible asset meets the contractual-legal criterion; therefore, the acquirer recognizes an intangible asset.

ANALYSIS

Because Acquiree has only one customer relationship with Customer, the fair value of that relationship incorporates assumptions about Acquiree's relationship with Customer related to both sporting goods and electronics.

Alternatively, if Acquirer determines that the customer relationships with Customer for sporting goods and for electronics are separate, Acquirer would assess whether the customer relationship for electronics meets the separability criterion for identification as an intangible asset.

EXAMPLE 4-11 (ADAPTED FROM ASC 805-20-55-56): PRODUCTION BACKLOG

FACTS

- Acquirer purchases Acquiree in a business combination.
- Acquiree does business with its customers solely through purchase and sales orders.
- At the acquisition date, Acquiree has a backlog of customer purchase orders from 60% of its customers, all of whom are recurring customers.
- The other 40% of Acquiree's customers also are recurring customers, but as of the acquisition date, Acquiree has no open purchase orders or other contracts with them.

CONCLUSION

The customer relationship intangible assets meet the contractual-legal criterion; therefore, Acquirer recognizes an intangible asset.

ANALYSIS

Acquirer recognizes customer relationship intangible assets as follows:

- Regardless of whether they are cancelable, the purchase orders from 60% of the acquiree's customers meet the contractual-legal criterion. Further, because Acquiree has established its relationship with those customers through contracts, both the purchase orders and the Acquiree's customer relationships meet the contractual-legal criterion.
- Because the Acquiree has a practice of establishing contracts with the remaining 40% of its customers, its relationship with those customers also arises through contractual rights. Therefore, the relationship meets the contractual-legal criterion even though Acquiree does not have contracts with those customers at the acquisition date.

EXAMPLE 4-12 (ADAPTED FROM ASC 805-20-55-57): CANCELABLE CONTRACTS

FACTS

- Acquirer purchases Acquiree in a business combination.
- Acquiree has a portfolio of one-year motor insurance contracts that are cancelable by policyholders.

CONCLUSION

The customer relationship intangible asset meets the contractual-legal criterion; therefore, Acquirer recognizes an intangible asset.

ANALYSIS

Because Acquiree 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.

EXAMPLE 4-13: CONTRACTUAL-LEGAL AND SEPARABILITY CRITERIA NOT MET

FACTS

- Acquirer purchases Acquiree, a diagnostic imaging company, in a business combination.
- Acquiree provides imaging services to patients based on referrals from physicians.
- Acquiree does not have contractual relationships with the patients.
- Acquiree maintains a database with each patient's information, such as name, address, telephone number, doctor's name, insurer's name, and policy number.
- Acquiree is prohibited from selling, transferring, licensing, or exchanging patient information under privacy rules.

CONCLUSION

Acquirer does not recognize a separate intangible asset for Acquiree's customer relationships or customer lists.

ANALYSIS

Acquiree's customer relationships do not meet the contractual-legal criterion. Further, the customer list does not meet the separability criterion because privacy rules prohibit selling, transferring, licensing, or exchanging patient information separately from the acquired entity.

4.4.2.7.5.2.4 Overlapping Customers

When an acquirer has customers that overlap with the acquiree's customers, some have questioned whether a customer relationship intangible asset should be recognized for the acquiree's customers. The SEC staff addressed that topic in the following speech:

SEC STAFF GUIDANCE

[Remarks Before the 2005 AICPA National Conference on Current SEC and PCAOB Developments]

Pamela R. Schlosser, Professional Accounting Fellow, Office of the Chief Accountant

December 5, 2005

> *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 apparel 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.* [Footnotes omitted]

The acquirer must recognize an intangible asset for customer relationships that meet the contractual-legal or separability criterion, even if the acquirer already has relationships with those customers. The fair value of the acquired customer relationships is based on the incremental cash flows a market participant would expect to generate from those customers as a result of a business combination.

4.4.2.7.5.2.5 Customer Loyalty Programs

Businesses often provide customer loyalty programs that offer rewards, points, discounts, and other incentives to attract and retain customers. Loyalty programs also provide the sponsor with valuable consumer information.

Loyalty programs meet the contractual-legal criterion to be recognized as an identifiable intangible asset, because the parties have agreed to the terms and conditions or have a previous contractual relationship (or both). Accordingly, an acquirer must recognize the fair value of a customer-related intangible asset for a loyalty program at the acquisition date. The terms and conditions of a loyalty program often affect the recognition and measurement of such assets and liabilities. Also, the acquirer must separately recognize the liabilities assumed for the customer loyalty program (see Section 4.4.1.6).

4.4.2.7.5.3 Artistic-Related Intangible Assets

FASB REFERENCES

ASC 805-20-55-29 through 55-30

Acquired artistic-related intangible assets are identifiable if they arise from contractual or legal rights, such as a copyright. Examples include the following:

EXAMPLES OF ARTISTIC-RELATED INTANGIBLE ASSETS				
Plays, Operas, Ballets	Books, Magazines, Newspapers, Other Literary Works	Musical Works: Compositions, Song Lyrics, Advertising Jingles	Pictures, Photographs	Video and Audiovisual Material: Motion Pictures, Films, Music Videos, Television Programs

An acquirer is not precluded from recognizing a copyright intangible asset and any related assignments or license agreements as a single asset if they have similar useful lives (see Section 4.4.2.7.4).

4.4.2.7.5.4 Contract-Based Intangible Assets

FASB REFERENCES
ASC 805-20-55-31

Contract-based intangible assets represent the value of rights that arise from 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. If the terms of an executory contract are favorable or unfavorable compared to market terms, the acquirer must recognize an intangible asset or liability for the off-market terms. Further, it may sometimes be appropriate to recognize an intangible asset for an at-market contract if a market participant would pay a premium for the contract, such as the lease of gates at an airport or of prime location retail space. The recognition of a contract-based intangible asset is not affected by the ability to cancel a contract; however, the fair value of the intangible asset must consider any cancellation rights.

ASC 805 provides the following examples of contract-based intangible assets:

- Licensing, royalty, standstill agreements
- Advertising, construction, management, service, or supply contracts
- Operating lease agreements of a lessor
- Construction permits
- Franchise agreements
- Operating and broadcast rights
- Servicing contracts, such as mortgage servicing contracts
- Employment contracts
- Use rights such as drilling, water, air, timber cutting, and route authorities

Acquired contract assets and contract liabilities that were originated under ASC 606 by an acquiree are not contract-based intangible assets; rather, they are accounted for under an exception to fair value accounting (see Section 4.4.1.6).

4.4.2.7.5.4.1 Servicing Contracts

FASB REFERENCES
ASC 805-20-55-33 through 55-35

A contract to service financial assets is a distinct asset or liability when it meets either of the following criteria:

- The transfer of the servicer's financial assets met the requirements for sale accounting.
- The acquirer separately acquires or assumes a servicing obligation that does not relate to combined entity's financial assets.

If mortgage loans, credit card receivables, or other financial assets are acquired in a business combination with the servicing obligation, the related servicing rights are not a separate intangible asset because their fair value is included in the fair value of the acquired financial asset.

ASC 860, *Transfers and Servicing*, includes guidance on the accounting for servicing contracts.

4.4.2.7.5.4.2 Employment Contracts

FASB REFERENCES

ASC 805-20-55-36

Employment contracts acquired as part of a business combination meet the contractual-legal criterion. As such, if an employment contract has favorable or unfavorable terms compared to market terms, the acquirer recognizes an intangible asset (or in some cases, a liability). When deciding whether to record intangible assets for employment contracts, an entity must determine whether the contracts are enforceable and whether employees can choose to leave employment with short notice periods.

Sometimes it is appropriate to recognize a separate intangible asset for employment contracts. For example, professional sports contracts generally have clauses that limit a player's ability to move to another team and generally can be enforced. In these (or similar) circumstances, the acquirer would recognize an intangible asset (or liability) for favorable (or unfavorable) contracts.

Preexisting employment contracts acquired in a business combination may include noncompete provisions, which are recognized and measured separately by the acquirer (see Section 4.4.2.7.5.1.3).

4.4.2.7.5.4.3 Use Rights

FASB REFERENCES

ASC 805-20-55-37

Use rights, such as drilling, water, air, timber cutting, and route authorities, are contract-based intangible assets. Because use rights may have characteristics of tangible or intangible assets, they are recognized based on their nature; 106or example, mineral rights are tangible assets.

4.4.2.7.5.4.4 Franchise Rights

A franchise agreement is a contract in which the franchisor grants the franchisee the right to operate a franchised business for a specified period.

Franchise agreements meet the contractual-legal criterion. As such, the acquirer recognizes an intangible asset or liability based on favorable or unfavorable terms in a franchise agreement compared to market terms. There also may be other identifiable intangible assets that should be recognized, such as customer lists, customer contracts, or customer relationship intangible assets, if the applicable recognition criteria are met (see Section 4.4.2.7.5.2).

4.4.2.7.5.5 Technology-Based Intangible Assets

FASB REFERENCES

ASC 805-20-55-38 through 55-39

Technology-based intangible assets are often protected by contractual or legal rights.

ASC 805 provides the following examples of technology-based intangible assets:

- Patented and unpatented technology
- Computer software and mask works
- Databases, including title plants
- Trade secrets, such as secret formulas, processes, and recipes

4.4.2.7.5.5.1 Patented and Unpatented Technology

Patented technology is protected legally and therefore meets the contractual-legal criterion for separate recognition as an intangible asset.

Although unpatented technology is not legally or contractually protected, it is often sold with other intangible assets, such as trade names or secret formulas. Thus, if there are no prohibitions on transferring the technology, it would meet the separability criterion for separate recognition as an intangible asset. However, the fact that the technology is unpatented may affect its fair value measurement.

4.4.2.7.5.5.2 Computer Software and Mask Works

FASB REFERENCES

ASC 805-20-55-40 through 55-41

Computer software and mask works (which are used to produce semiconductor chips) that are legally protected meet the contractual-legal criterion to be recognized as identifiable intangible assets. Even if not legally protected, computer software and mask works would likely meet the separability criterion to be recognized as identifiable intangible assets if they can be sold, licensed, rented, or exchanged.

4.4.2.7.5.5.3 Databases

FASB REFERENCES

ASC 805-20-55-42 through 55-43

Databases are electronic collections of information and title plants are databases that contain historical records of matters affecting title to parcels of land in a particular geographic area. If a database is acquired in a business combination and is protected by copyright or other legal means, it meets the contractual-legal criterion to be recognized as an identifiable intangible asset. Even if not legally protected, databases are often sold, licensed, rented, or exchanged, and therefore meet the separability criterion to be recognized as an identifiable intangible asset.

4.4.2.7.5.5.4 Trade Secrets, Such as Secret Formulas, Processes, and Recipes

FASB REFERENCES

ASC 805-20-55-44 through 55-45

A trade secret is information, including a formula, pattern, recipe, compilation, program, device, method, technique, or process, that both:

- Derives economic value from not being generally known by others
- Is the subject of efforts that are reasonable under the circumstances to maintain its secrecy

If the future economic benefits from a trade secret are legally protected, the trade secret meets the contractual-legal criterion. Otherwise, trade secrets acquired in a business combination often meet the separability criterion. In either case, the acquirer must recognize trade secrets as an identifiable intangible asset.

4.4.2.8 In-Process Research and Development

FASB REFERENCES

ASC 730-10-55-1 through 55-2

ASC 730-10-20:

Research

> *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

> *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. Development includes the conceptual formulation, design, and testing of product alternatives, construction of prototypes, and operation of pilot plants.*

In a business combination, acquired IPR&D generally meets the separability criterion and is therefore recognized as an identifiable intangible asset, measured at its acquisition-date fair value. ASC 730, *Research and Development*, provides the following examples of activities that are typically included in or excluded from research and development:

TYPICALLY INCLUDED IN R&D	TYPICALLY EXCLUDED FROM R&D
▶ Laboratory research aimed at discovering 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 ▶ Modifying the formulation or design of a product or process ▶ Designing, constructing, and testing of preproduction prototypes and models ▶ Designing tools, jigs, molds, and dies involving new technology ▶ Designing, constructing, and operating 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 ▶ Designing and developing tools used to facilitate research and development or components of a product or process that are undergoing research and development activities	▶ Engineering follow-through in an early phase of commercial production ▶ Quality control during commercial production, including routine testing of products ▶ Troubleshooting in connection with breakdowns during commercial production ▶ Routine, ongoing efforts to refine, enrich, or otherwise improve upon the qualities of an existing product ▶ Adapting 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: • Pilot plants • Facilities or equipment whose sole use is for a particular research and development project ▶ Legal work in connection with patent applications or litigation, and the sale or licensing of patents

Although ASC 730 typically requires that research and development costs be expensed as incurred (unless they have an alternative use), ASC 805 does not provide a measurement exception for recognizing IPR&D in a business combination. Therefore, IPR&D acquired in a business combination must be recognized at its acquisition-date fair value even if it does not have an alternative use.

There is no authoritative source in U.S. GAAP for determining the fair value of IPR&D; however, the AICPA Accounting and Valuation Guide, *Assets Acquired to Be Used in Research and Development Activities* (AICPA IPR&D Guide) provides guidance to assist practitioners. Although the AICPA IPR&D Guide is nonauthoritative under U.S. GAAP, it provides widely accepted methodologies that are applied when recognizing and measuring IPR&D assets as well as interpretive guidance on other aspects of accounting for IPR&D.

The AICPA IPR&D Guide indicates that to qualify as IPR&D, the acquired research and development project must have substance (the acquiree must have performed more than an insignificant amount of research and development efforts that result in the creation of value before the acquisition), and the project must be incomplete at the acquisition date.

If the acquired project is complete at the acquisition date it would not be classified as IPR&D, but it would generally still be considered a separately identifiable intangible asset that is recognized at fair value on the acquisition date.

If an acquirer acquires IPR&D in a business combination that it does not intend to use, or that it intends to use in a manner other than its highest and best use, the acquirer must still recognize an intangible asset at fair value considering the highest and best use from a market participant perspective (see Section 4.4.2.1).

Research and development activities conducted for others under a contractual arrangement are not recognized as part of acquired IPR&D. Instead, the acquirer evaluates such contracts as executory contracts (see Section 4.4.2.7.5.4).

4.4.2.8.1 Subsequent Accounting for In-Process Research and Development

FASB REFERENCES

ASC 350-30-35-17A through 35-18

An acquirer applies ASC 350, *Intangibles — Goodwill and Other*, to subsequently account for IPR&D, which indicates that IPR&D assets are considered indefinite-lived until the project is completed or abandoned. Thus, these assets are not amortized but are instead subject to impairment testing annually or more frequently if events or changes in circumstances indicate that it is more likely than not that the asset is impaired. Recognizing an impairment for IPR&D immediately after being acquired in a business combination is rare.

Research and development costs incurred after the acquisition date are accounted for under ASC 730, even if those costs relate to IPR&D that was acquired in a business combination. Under ASC 730, research and development costs are expensed as incurred unless they have an alternative future use.

Upon successful completion of an IPR&D project, the acquirer determines the asset's useful life in accordance with ASC 350. If IPR&D is abandoned, the costs are expensed in the period of abandonment.

ACCOUNTING FOR IPR&D IN AN ASSET ACQUISITION

The requirement to account for IPR&D acquired in a business combination as an indefinite-lived intangible asset, even if it does not have an alternative future use, is different from the accounting for IPR&D in an asset acquisition. Acquired IPR&D in an asset acquisition is accounted for under ASC 730, which indicates that the amounts allocated to IPR&D are capitalized as an intangible asset and amortized as research and development expense only if the acquired IPR&D has an alternative future use. Conversely, if the IPR&D does not have an alternative future use, the amounts allocated to it must be immediately expensed (see Appendix C, Section C.4.4.2). See Appendix C for additional differences between business combinations and asset acquisitions.

4.4.2.9 Defensive Intangible Assets

FASB REFERENCES

ASC 350-30-25-5, ASC 350-30-55-1 through 55-1B, and ASC 350-30-55-28H through 55-28L

An intangible asset acquired in a business combination that the acquirer does not intend to use, but instead acquires to prevent others from using it, is referred to as a "defensive asset" or a "locked-up asset." For example, an acquirer may shelve an acquiree's IPR&D or retire the brand name of an acquired competitor. Although the asset is not being actively used, it likely contributes to an increase in the value of other assets owned by the acquirer.

A defensive asset is recognized at fair value, which considers its highest and best use by market participants using an appropriate valuation methodology in accordance with ASC 820.

The FASB provided the following examples regarding the assessment of defensive intangible assets:

EXAMPLE 4-14: TRADE NAME - DEFENSIVE INTANGIBLE ASSET

(Quoted from ASC 350-30-55-28H through 55-28I**)**

ASC 350-30-55-28H

> *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.*

ASC 350-30-55-28I

> *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.*

EXAMPLE 4-15: BILLING SOFTWARE - NOT A DEFENSIVE INTANGIBLE ASSET

(Quoted from ASC 350-30-55-28K through 55-28L**)**

ASC 350-30-55-28K

> *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.*

ASC 350-30-55-28L

> *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.*

4.4.2.9.1 Subsequent Accounting for Defensive Intangible Assets

FASB REFERENCES

ASC 350-30-25-5 and ASC 350-30-35-5A though 35-5B

As with other intangible assets, an acquirer assigns a useful life for defensive intangible assets in accordance with ASC 350 based on the period over which the acquirer consumes the asset's expected benefits. The benefit the acquirer receives from holding a defensive asset is the direct and indirect cash flow resulting from the acquirer preventing others from realizing any value from the asset (defensively or otherwise). A defensive asset's useful life is determined by estimating the period over which the asset will diminish in value. An acquired defensive asset cannot be considered immediately abandoned. Conversely, a defensive intangible asset typically does not have an indefinite useful life because its value will diminish over time.

BDO INSIGHTS — DEFENSIVE ASSETS USED TO DEFEND ANOTHER RESEARCH AND DEVELOPMENT PROJECT

As discussed in paragraphs 2.29 through 2.33 of the AICPA IPR&D Guide, if a defensive intangible asset is acquired IPR&D being used to defend another ongoing research and development project, we believe it would be appropriate to assign it an indefinite life until the research and development project that is being defended is completed or abandoned (see Section 4.4.2.8.1). When a project is completed or abandoned, the entity must determine the useful life of the defensive IPR&D asset. Conversely, if defensive IPR&D is being used to defend a developed product, it would be amortized over its useful life (the period over which it will diminish in value).

4.4.3 Liabilities Assumed in a Business Combination

FASB REFERENCES

ASC 805-20-30-1

In a business combination, the acquirer measures identifiable assets acquired, liabilities assumed, and any noncontrolling interest at their acquisition-date fair values, unless a recognition or measurement exception applies.

The following sections address common questions and challenges in determining the fair values of assumed liabilities in a business combination:

TOPIC	SECTION
Payables and Debt	Section 4.4.3.1
Restructuring Costs	Section 4.4.3.2
Guarantees	Section 4.4.3.3
Legal Form Equity Instruments Classified as Liabilities	Section 4.4.3.4
Acquiree Contingent Consideration Assumed by the Acquirer	Section 5.4.5.6
Deferred Income Tax Liabilities and Income Tax Uncertainties	Section 4.4.1.2

4.4.3.1 Payables and Debt

FASB REFERENCES

ASC 805-20-30-1

An acquirer recognizes assumed payables and debt at fair value in a business combination. The acquiree's debt issuance costs do not affect the fair value measurement of the liabilities; further, they do not meet the definition of an asset and are not recognized in a business combination.

The acquiree's carrying amounts for short-term payables often approximate fair value. As such, they are usually recognized at their stated amounts. However, the acquiree's carrying amounts for long-term payables and debt may not approximate fair value, which may need to be determined using valuation techniques.

An acquirer may incur debt in connection with a business combination (for example, to fund the acquisition). Such debt is not part of the consideration transferred or an assumed liability; rather, it is accounted for as a transaction separate from the business combination (see Section 5.4.3).

4.4.3.1.1 Acquiree Debt and Other Liabilities Settled at the Acquisition Date

An acquirer may pay cash to settle all or a portion of the acquiree's outstanding debt on (or shortly after) the acquisition date. If the acquirer does not legally assume the acquiree's debt, the settlement of debt is accounted for as part of the consideration transferred, rather than as an assumed liability. Conversely, if the acquirer legally assumes the acquiree's debt, the debt is accounted for as an assumed liability.

BDO INSIGHTS — DEBT ASSUMED FOR ADMINISTRATIVE CONVENIENCE AND IMMEDIATELY REPAID

If an acquiree's debt is legally assumed for administrative convenience but immediately repaid (that is, within one day of the business combination), we believe it is acceptable to include the settlement of the debt as part of the consideration transferred, rather than as an assumed liability.

Whether the settlement of acquiree's debt is accounted for as part of consideration transferred or as an assumed liability that is subsequently settled, the effect on goodwill (or bargain purchase gain) is the same. However, the presentation in the statement of cash flows differs (see Section 8.4.3). An entity's presentation in the cash flow statement must be consistent with its determination of whether the settlement of debt is part of consideration transferred or an assumed liability.

4.4.3.1.2 Effective Settlement of Liabilities Between the Acquirer and Acquiree

A business combination may result in the effective settlement of debt or other liabilities between the acquirer and acquiree. In that case, the acquirer accounts for it as the settlement of a preexisting relationship (see Section 6.5.2.1).

4.4.3.1.3 Debt Modification in Connection with a Business Combination

An acquirer may amend its existing debt in connection with a business combination. In that case, the acquirer accounts for the amendment as a transaction separate from the business combination and performs an assessment to determine whether the amendment must be accounted for as a modification or an extinguishment in accordance with ASC 470, *Debt*. See BDO's Publication, **Troubled Debt Restructuring, Debt Modification and Extinguishment**, for guidance for assessing debt amendments.

An acquirer may amend, or direct the acquiree to amend, the acquiree's debt in connection with a business combination. In substance, the acquirer first assumes the acquiree's existing debt and then amends it. As such, the acquirer recognizes the assumed liability as part of the business combination at its acquisition-date fair value and then immediately assesses whether the amendment should be accounted for as a modification or an extinguishment in accordance with ASC 470.

Examples 4-16 and 4-17 illustrate this concept.

EXAMPLE 4-16: DEBT AMENDMENT IN CONNECTION WITH A BUSINESS COMBINATION

FACTS

- Acquirer purchases Acquiree in a business combination.
- Before the acquisition, Acquiree had $100 million of outstanding term loans with a lender.
- To partially fund the business combination, Acquirer directs Acquiree to amend the existing credit facility to borrow an additional term loan of $50 million at the acquisition date. The acquiree incurs lender fees and third-party costs in connection with the debt amendment.

CONCLUSION

Acquirer accounts for the assumption of Acquiree's term loan balances at fair value as part of the business combination and then immediately performs an assessment to determine whether the amendment must be accounted for as a modification or extinguishment in accordance with ASC 470-50. See BDO's Publication, **Troubled Debt Restructuring, Debt Modification and Extinguishment**, for guidance for assessing debt amendments.

ANALYSIS

Although Acquiree's term loan was amended at the date of the business combination, in substance, Acquirer first assumes Acquiree's existing debt and then amends it. As such, Acquirer recognizes the assumed $100 million liability as part of the business combination at its acquisition-date fair value and then immediately assesses whether the amendment (which includes new term loan borrowings of $50 million) must be accounted for as a modification or extinguishment in accordance with ASC 470-50, which will determine the treatment of third-party fees incurred for the amendment.

EXAMPLE 4-17: LINE OF CREDIT AMENDMENT IN CONNECTION WITH A BUSINESS COMBINATION

FACTS

- Acquirer purchases Acquiree in a business combination.
- Acquirer has a line of credit to borrow up to $60 million with Bank A with an outstanding balance of $40 million and a remaining term of one year. Acquirer has $1 million of unamortized debt issuance costs.
- Acquiree also has a line of credit with Bank A for up to $150 million with an outstanding balance of $150 million and a remaining term of four years. Acquiree has $2 million of unamortized debt issuance costs.
- In connection with the acquisition, Acquirer and Acquiree want to consolidate their outstanding borrowings into a single line of credit. As such, at the acquisition date, Acquiree and Bank A amend Acquiree's line of credit to increase the available borrowing amount to $200 million. Acquiree borrows $40 million, which was used to extinguish Acquirer's outstanding line of credit balance and terminate Acquirer's line of credit. The term of the Acquiree's line of credit was not amended.

CONCLUSION

Acquirer accounts for the assumption of Acquiree's line of credit balances at fair value as part of the business combination and then immediately performs a borrowing capacity test in accordance with ASC 470-50 to determine how to account for the amendment to the combined company's line of credit. See BDO's Publication, **Troubled Debt Restructuring, Debt Modification and Extinguishment**, for guidance for assessing amendments to revolving lines of credit.

ANALYSIS

Although Acquiree's line of credit was amended at the date of the business combination, in substance, Acquirer first assumes Acquiree's existing debt and then amends it. As such, Acquirer recognizes the assumed liability as part of the business combination at its acquisition-date fair value and then immediately performs a borrowing capacity test in accordance with ASC 470-50.

Even though the Acquirer's line of credit was legally extinguished, because the Acquirer and Acquiree each had a line of credit with the same Bank, the combined company considers both lines of credit, together, in the borrowing capacity test as follows:

ENTITY	LINE OF CREDIT	TERM	BORROWING CAPACITY
Acquirer	$60 million	1 year	$60 million
Acquiree	$150 million	4 years	$600 million
Pre-amendment borrowing capacity			$660 million
Post-amendment borrowing capacity	$200 million	4 years	$800 million

The $2 million of unamortized debt issuance costs related to the Acquiree's line of credit do not meet the definition of an asset and are not recognized by the Acquirer in the business combination.

Although the Acquirer's line of credit was legally extinguished, Acquirer does not recognize a loss on extinguishment for the $1 million of unamortized debt issuance costs related to its line of credit. Because there is an increase in borrowing capacity of the combined company's line of credit, the Acquirer continues to defer its unamortized debt issuance costs and will amortize them over the term of the new arrangement in accordance with ASC 470-50-40-21.

4.4.3.2 Restructuring Costs

FASB REFERENCES

ASC 805-20-25-2

An acquirer may plan to restructure the acquiree's operations in connection with a business combination. For example, the acquirer may expect to incur costs for exiting an activity or terminating or relocating the acquiree's employees. Such costs that an acquirer expects, but is not obligated, to incur do not meet the definition of a liability at the acquisition date. Therefore, the acquirer cannot recognize these costs when applying the acquisition method and instead must account for these costs in accordance with ASC 420, *Exit or Disposal Cost Obligations,* in its postcombination financial statements. The inclusion of a plan for restructuring in the purchase agreement is not enough to create an obligation to be recognized by the acquirer at the acquisition date.

An acquirer recognizes a liability for restructuring or exit activities at the acquisition date only if it was a liability of the acquiree before the acquisition date (that is, the acquiree satisfied the requirements of ASC 420 before the acquisition).

If an acquiree undertakes an exit or disposal activity after negotiations for the business combination have begun, it must determine whether the restructuring activities were done in contemplation of the acquisition for the acquirer's benefit. If so, the restructuring transactions should be evaluated to determine whether they must be accounted for as transactions separate from the business combination in the postacquisition period (see Section 6.2).

Restructuring activities related to the acquirer's operations are not part of the business combination. Such costs are accounted for separately in accordance with other applicable U.S. GAAP (for example, ASC 420).

Example 4-18 illustrates the accounting for restructuring costs in a business combination.

EXAMPLE 4-18: ACCOUNTING FOR RESTRUCTURING COSTS

FACTS

- Acquirer purchases Acquiree in a business combination.

- During due diligence activities, Acquirer identified a supply agreement of Acquiree that would be redundant in the combined entity after the transaction and asked Acquiree to undertake restructuring activities to eliminate the redundancy. Acquiree agreed to do so, contingent upon the closing of the business combination.
- At the closing date, Acquiree's supply agreement was terminated. As a result, Acquiree incurred contract termination costs of $8 million in accordance with ASC 420.
- Acquiree also had an existing restructuring liability under ASC 420 that was initially recognized by the acquiree six months before negotiations for the business combination began. The restructuring liability had a fair value of $2 million at the acquisition date.

CONCLUSION

Acquirer recognizes a $2 million assumed liability as part of the business combination for Acquiree's restructuring liability that was incurred before the negotiations for the business combination. The $8 million of restructuring costs related to terminating a redundant contract are accounted for separate from the business combination in Acquirer's postcombination financial statements.

ANALYSIS

An acquirer recognizes a liability for restructuring or exit activities at the acquisition date only if it was a liability of the acquiree before the acquisition date (that is, the acquiree satisfied the requirements of ASC 420 before the acquisition).

As such, Acquirer recognizes a $2 million assumed liability as part of the business combination for Acquiree's restructuring liabilities that were incurred before negotiations for the business combination and were not undertaken for Acquirer's benefit.

For the restructuring costs incurred because of the business combination, Acquirer must determine whether the restructuring activities were done in contemplation of the acquisition for its benefit. Because Acquirer initiated the transaction, and the restructuring is intended to benefit the combined entity after the acquisition date, Acquirer concludes that the remaining $8 million of restructuring costs must be accounted for separate from the business combination in the postcombination period in accordance with ASC 420.

4.4.3.3 Guarantees

FASB REFERENCES

ASC 805-20-30-1 and ASC 460-10-35-1 through 35-2

An acquirer recognizes assumed liabilities for guarantees at their acquisition-date fair value in a business combination. Subsequently, an assumed guarantee liability is accounted for under ASC 460, which requires the guarantor to relieve the liability through earnings using a systematic and rational manner as it is released from risk.

4.4.3.4 Legal Form Equity Instruments Classified as Liabilities

FASB REFERENCES

ASC 805-20-30-1

An acquiree may have previously issued legal form equity instruments that are classified and accounted for as liabilities in accordance with U.S. GAAP; for example, under ASC 480 *Distinguishing Liabilities From Equity*. Regardless of legal form or accounting classification, if the instruments remain outstanding, they are recognized at their acquisition-date fair value in the business combination. As discussed in Section 4.5, equity instruments classified as liabilities are not noncontrolling interests.

4.4.4 Foreign Currency Translation

FASB REFERENCES

ASC 830-30-45-11 and ASC 350-20-35-41

The assets acquired and liabilities assumed in a business combination, including goodwill, must be translated using the guidance in ASC 830 *Foreign Currency Matters*. As a result, for the acquirer's consolidated financial statements, the assets acquired and liabilities assumed must be measured in the functional currencies of the acquired entities and subsequently translated to the reporting currency of the parent. The acquirer can either record the stepped-up basis in the foreign entity's books (actual pushdown accounting) or maintain separate records to adjust the consolidated amounts to what they would have been had they been actually recorded in the foreign entity's records (notional pushdown accounting).

BDO INSIGHTS — NAVIGATING COMPLEXITIES IN FOREIGN CURRENCY TRANSLATION FOR MULTI-TIERED BUSINESS COMBINATIONS

In a business combination that involves the acquisition of multiple entities with different functional currencies, the application of ASC 830 may be complex. We believe that for foreign currency translation, the goodwill and other basis differences resulting from the business combination must be allocated to the distinct and separable domestic and foreign entities of the acquiree, even if the reporting units for goodwill impairment testing are at a higher level. Although there is no specific guidance on how to perform this allocation, we believe that the methodology must be reasonable, supportable, and consistently applied.

Because ASC 350 requires that goodwill be assigned to the acquirer's reporting units that are expected to benefit from the synergies of the combination, the allocation of goodwill for foreign currency translation may differ from the assignment of goodwill to reporting units for impairment testing. That is, for impairment testing, goodwill may be assigned to reporting units that do not include the acquiree, whereas for foreign currency translation, all goodwill must be allocated to the acquiree's distinct and separable domestic and foreign entities.

Example 4-19 illustrates this concept.

EXAMPLE 4-19: GOODWILL — FOREIGN CURRENCY TRANSLATION

FACTS

- Company A, whose reporting currency is the U.S. Dollar, acquires 100% of Company B, whose functional currency is the euro (€).
- Company A recognized €40 million of goodwill, which was the equivalent of $50 million based on the acquisition date exchange rate of €1 to $1.25.
- Company B does not elect to apply pushdown accounting for its separate financial statements.
- Company A assigns Company B to Reporting Unit 2, but because Company B is synergistic to Company A's existing Reporting Unit 1, Company A assigns €10 million of goodwill to Reporting Unit 1 and €30 million of goodwill to Reporting Unit 2 at the acquisition date. The functional currency of both reporting units is the euro.
- At period end, the exchange rate was €1 to $1.15.

CONCLUSION

Company A must recognize a cumulative translation adjustment of $4 million at period end. The resulting change in goodwill balances must be assigned to the reporting units where the goodwill resides for impairment testing.

ANALYSIS

When preparing Company A's consolidated financial statements, Company B's assets and liabilities at period end must be translated using the period end exchange rate. As a result, the €40 million of goodwill determined at the acquisition date would be translated as $46 million at period end, resulting in a charge to other comprehensive income for the cumulative translation adjustment of $4 million ($50 million less $46 million).

After the goodwill allocated to foreign entities has been translated to the reporting currency, the changes to goodwill must be assigned to the reporting units where the goodwill resides for impairment testing. Company A determines that a pro rata allocation based on the respective carrying values of the goodwill is a reasonable and supportable approach and allocates $1 million (25%) of the decrease in goodwill to Reporting Unit 1 and $3 million (75%) to Reporting Unit 2.

4.5 NONCONTROLLING INTERESTS

FASB REFERENCES

ASC 805-20-30-7 through 30-8, ASC 805-30-30-1, and ASC 810-10-45-15 through 45-17A

When an acquirer obtains less than 100% of the equity interests of an acquiree, it creates NCI in the acquiree. For example, if the acquirer obtains 85% of the acquiree's common stock, the remaining 15% is presented as NCI in the acquirer's consolidated financial statements.

By definition, NCI must be classified as equity in accordance with U.S. GAAP. Legal equity instruments that are classified as liabilities in accordance with U.S. GAAP are not NCI.

The acquirer must recognize any NCI at its acquisition-date fair value. In some cases, the acquirer can measure the fair value of NCI based on quoted share prices in an active market. However, when the acquiree's equity does not have an active market, the acquirer must determine the NCI's fair value using other valuation techniques. Sometimes the fair value of the acquirer's controlling interest in the acquiree is greater than the fair value of the NCI on a per-share basis. If so, the difference is likely attributable to a control premium in the acquirer's per-share value or, conversely, the inclusion of a discount for lack of control in the per-share value of the NCI if market participants would consider such a premium or discount when pricing the NCI.

4.6 MEASUREMENT PERIOD ADJUSTMENTS

FASB REFERENCES

ASC 805-10-25-13 through 25-18 and ASC 805-10-30-1 through 30-3

In some cases, the accounting for a business combination may be incomplete at the end of the interim or annual financial reporting period in which the combination occurs. ASC 805 allows an acquirer to recognize provisional amounts for which the accounting is incomplete for up to one year after the acquisition date (the measurement period). The measurement period allows the acquirer a reasonable amount of time to obtain information necessary to identify and measure the various elements needed to account for the business combination (including the identifiable assets acquired, liabilities assumed, noncontrolling interests, equity interests previously held by the acquirer, and the consideration transferred).

During the measurement period, the acquirer adjusts the provisional amounts (with corresponding adjustments to increase or decrease goodwill or bargain purchase gain) to reflect new information about facts and circumstances that existed at the acquisition date. The measurement period ends when the acquirer receives the information it was seeking about facts and circumstances that existed at the acquisition date or learns that the information is not obtainable. However, the measurement period cannot exceed one year from the acquisition date.

The acquirer recognizes measurement period adjustments with a corresponding adjustment to goodwill in the reporting period in which it identifies the adjustments. The acquirer recognizes in current-period earnings the full effect of changes in depreciation, amortization, or other income effects, by line item, that resulted from the change to the provisional amounts, calculated as if the accounting had been completed at the acquisition date.

Conversely, if information obtained after the acquisition date reflects circumstances that did not exist at the acquisition date, the accounting for the business combination is not adjusted. Such changes are accounted for in accordance with other U.S. GAAP. 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.

The measurement period guidance applies to business combinations. While we believe it can be applied by analogy in pushdown accounting, it does not apply to other transactions, including asset acquisitions or recapitalizations.

If the initial accounting for a business combination is incomplete, and the amounts recognized in the financial statements have been determined only provisionally, the acquirer must include additional disclosures in its financial statements (see Section 8.8).

4.6.1 Adjustments After the Measurement Period

FASB REFERENCES

ASC 805-10-25-19

Once the measurement period ends, the accounting for a business combination is not adjusted except to correct an error in accordance with ASC 250.

4.6.2 Correction of an Error vs. Change in Estimate

FASB REFERENCES

ASC 250-10-20: Change in Estimate; Error in Previously Issued Financial Statements

It can be challenging to determine whether a change to the initial accounting for a business combination during the measurement period is a change in estimate (a measurement period adjustment) or the correction of an error. However, making this determination is important because it affects the manner and timing for recognizing the adjustments, as well as required disclosures, as noted in the following SEC staff speech:

SEC STAFF GUIDANCE

[Remarks before the 2016 AICPA Conference on Current SEC and PCAOB Developments]

Jonathan Wiggins, Associate Chief Accountant, Office of the Chief Accountant

December 5, 2016

Measurement Period Adjustments in Business Combinations

> *My next topic relates to the accounting for a business combination. An acquirer in a business combination is required to report provisional amounts if the initial accounting for the business combination is incomplete by the end of the reporting period covering the business combination (for example, when the valuation of an intangible asset is incomplete). The acquirer must recognize adjustments to those provisional amounts to reflect new information obtained within the measurement period about facts and circumstances that existed as of the acquisition date. I would like to remind registrants that the measurement period is not one year, but rather 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, and shall not exceed one year.*
>
> *In 2015, the FASB issued guidance that eliminates the requirement to retrospectively reflect these measurement period adjustments, with such adjustments now recorded in the current reporting period and separately reported or disclosed. I think it is important to note that this guidance does not change the measurement period or apply when an adjustment represents the correction of an accounting error. While it has never been appropriate to include a correction of an error as part of a measurement period adjustment, prior to adoption of this new guidance both accounting errors and measurement period adjustments were retrospectively reflected. Under the new guidance, the timing of recognition differs, since only accounting errors, where material, require restatement of prior periods. Accordingly, I believe that registrants should ensure they have sufficient internal control over financial reporting to identify and account for measurement period adjustments appropriately and separately identify accounting errors. Finally, I'd like to remind registrants that if the initial accounting for a business combination is incomplete at the reporting date, the disclosures regarding provisionally recorded amounts are required.* [Footnotes omitted]

The glossary in ASC 250 indicates that a change in accounting estimate results from new information. In contrast, an error results from mathematical mistakes, mistakes in the application of U.S. GAAP, or oversight or misuse of facts that existed at the time the financial statements were prepared. As such, if the information was known, or was reasonably knowable, as of the acquisition date, it generally indicates an error in the initial accounting for the business combination rather than a measurement period adjustment.

Determining whether a change to the initial accounting for a business combination during the measurement period is a change in estimate (a measurement period adjustment) or the correction of an error requires the application of professional judgment based on the facts and circumstances.

Chapter 5 — Recognizing Goodwill or a Bargain Purchase Gain and Consideration Transferred

5.1 OVERVIEW

After the acquirer and the acquisition date have been identified and the identifiable assets acquired and liabilities assumed have been measured, the final step in accounting for a business combination is to recognize and measure goodwill or a gain from a bargain purchase.

If the acquired set does not meet the definition of a business (see Chapter 3), the acquirer must apply other applicable U.S. GAAP to the transaction. Appendix C compares the accounting for business combinations and asset acquisitions and discusses the accounting for recapitalizations.

5.2 GOODWILL

FASB REFERENCES

ASC 805-30-30-1

The acquirer recognizes goodwill if the consideration transferred (plus the fair value of any noncontrolling interest in the acquiree and the fair value of previously held equity interests, if applicable) exceeds the acquired net assets (assets acquired less liabilities assumed) as illustrated in the following graphic:

Most business combinations result in the recognition of goodwill. Goodwill is not a separately identifiable asset; rather, it is an asset representing the future economic benefits that are not directly attributable to other identifiable assets.

In its deliberations for FASB 141(R)[13], the FASB indicated its belief that goodwill is an asset that theoretically includes two core components:

- The fair value of the going-concern element of the acquired business, which represents the ability of the acquired business to earn a higher rate of return on an assembled collection of net assets than would be expected if those net assets had to be acquired separately
- The fair value of the expected synergies to be achieved from the business combination

As such, in most business combinations, the acquirer is willing to pay a premium over the amounts it would pay for the separately identifiable net assets if it were to purchase them individually.

The FASB also acknowledged that in some cases an acquirer might overpay for its interest in the acquiree (which conceptually should be recognized as a loss at the acquisition date rather than included in goodwill)[14]. However, it concluded that any potential overpayment would not likely be detectable or known at the acquisition date and would be difficult, if not impossible, to quantify. Further, the FASB indicated that it was not aware of instances in which a buyer knowingly overpays or is compelled to overpay a seller to acquire a business; therefore, it concluded that potential overpayments would not be accounted for separately from other goodwill at the acquisition date but are instead addressed through subsequent impairment testing.

Because goodwill is not a separately identifiable asset, it cannot be measured directly. Rather, it is measured as a residual, meaning it is the remaining amount to be recognized after all the other elements of the transaction are recognized. Goodwill represents the difference between the fair value of the acquired business as compared to the amounts recognized for the identifiable assets acquired and liabilities assumed.

Guidance for recognizing and measuring each of the elements that affect the calculation of goodwill is included in this Blueprint as follows:

Consideration transferred	Section 5.4
Non-controlling interests in the acquiree	Section 4.5
Previously held equity interests	Section 5.5
Identifiable assets acquired and liabilities assumed	Chapter 4

Goodwill acquired in a business combination is recognized as an asset and is not amortized (except for private companies or not-for-profit entities that elect the goodwill alternative – see Section 7.2). Instead, goodwill is subject to annual impairment testing (or more frequently, if there are impairment indicators) as prescribed by ASC 350.

5.3 BARGAIN PURCHASE GAIN

FASB REFERENCES

ASC 805-30-25-2 through 25-4, ASC 805-30-30-4 through 30-6, and ASC 805-30-55-14 through 55-16

As discussed in Section 5.2, in most business combinations the acquirer pays a premium over the acquired net assets, resulting in the recognition of goodwill. However, occasionally the aggregate of the consideration transferred, the

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[13] FAS 141(R) Basis for Conclusions, paragraph B316
[14] FAS 141(R) Basis for Conclusions, paragraph B382

noncontrolling interests, and the acquirer's previously held equity interest in the acquiree is less than the values assigned to the identifiable assets acquired and liabilities assumed. In such cases, the acquisition represents a bargain purchase, and the acquirer recognizes a gain at the acquisition date.

Bargain purchases are rare because an owner typically does not willingly sell its business at a price below fair value. As such, if an acquirer believes a bargain purchase has occurred, it should understand and evaluate the circumstances that led to the bargain purchase. For example, a bargain purchase could result from:

- A forced or distressed sale, including instances in which the seller was required to sell the business quickly
- A transaction that did not involve a competitive bidding process
- A transaction for which the fair value of the net assets acquired increased between the date the consideration was fixed and the acquisition date

Bargain purchase gains may also occur because not all assets acquired or liabilities assumed are recognized or measured at their fair values. For example, some contingent liabilities may be factored into the price that the acquirer is willing to pay, but may not be recognized at the acquisition date, resulting in a mismatch between the consideration transferred and the net assets recognized.

Before recognizing a bargain purchase gain, ASC 805-30 requires the acquirer to reassess whether it has correctly identified and measured all elements of the transaction, including:

- The identifiable assets acquired and liabilities assumed
- The noncontrolling interest in the acquiree
- The acquirer's previously held equity interest in the acquiree
- The consideration transferred

BDO INSIGHTS — REASSESS TRANSACTIONS SEPARATE FROM THE BUSINESS COMBINATION

Although not specifically listed in ASC 805-30, we believe the acquirer should also reassess the recognition and measurement of any transactions that are accounted for separate from the business combination because such arrangements can affect the calculation of goodwill or bargain purchase gain. See Chapter 6 for more guidance on transactions accounted for separate from the business combination.

The purpose of the reassessment is to determine whether the measurements appropriately reflect all available information as of the acquisition date. If after reassessing all the elements of the transaction the acquirer still concludes there is a bargain purchase, it must recognize a gain in earnings at the acquisition date. If a bargain purchase gain is recognized, there can be no goodwill because there can be only one residual amount calculated.

BARGAIN PURCHASE GAIN IS NOT ALLOCATED TO NONCONTROLLING INTEREST

If the acquiree obtains less than a 100% interest in the acquiree (a partial acquisition), the bargain purchase gain must be attributed entirely to the acquirer. That is, the acquirer does not attribute any portion of the gain to the noncontrolling interest when allocating the income (loss) of subsidiaries between a parent and NCI.

Example 5-1 illustrates the accounting for a bargain purchase.

EXAMPLE 5-1 (ADAPTED FROM ASC 805-10-55-14 THROUGH 55-16): BARGAIN PURCHASE

FACTS

- On January 1, 20X5, Acquirer acquires 80% of the equity interests of Acquiree, a private entity, in exchange for $150 in cash.
- Because the former owners of Acquiree needed to dispose of their investments in Acquiree by a specified date, they did not have sufficient time to market Acquiree to multiple potential buyers.
- Acquirer initially measures the separately recognizable identifiable assets acquired and the liabilities assumed as of the acquisition date in accordance with ASC 805. The initial measurements are as follows:
  - Identifiable assets: $250
  - Liabilities assumed: $50
  - Fair value of the 20% noncontrolling interest in Acquiree - $42

CONCLUSION

Acquirer recognizes a bargain purchase gain of $8 at the acquisition date.

ANALYSIS

Acquiree's identifiable net assets ($200) exceed the fair value of the consideration transferred ($150) plus the fair value of the NCI ($42) in Acquiree. 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 NCI in Acquiree 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% interest as follows:

Identifiable net assets acquired		$ 200
Less: Fair value of the consideration transferred for Acquirer's 80% interest in Acquiree; plus	$150	
Fair value of NCI in Acquiree	42	192
Gain on bargain purchase of 80% interest		8

Acquirer records the following journal entry to account for the acquisition of Acquiree:

Debit	Identifiable assets acquired	$	250		
Credit	Cash			$	150
Credit	Liabilities assumed				50
Credit	Equity - NCI in Acquiree				42
Credit	Gain on bargain purchase				8

5.3.1 Provisional Bargain Purchase Gain During the Measurement Period

FASB REFERENCES

ASC 805-10-25-13, ASC 805-30-30-5, ASC 805-20-50-4A, and ASC 805-30-50-1(f)

As part of its initial accounting for a business combination, an acquirer may preliminarily calculate a bargain purchase gain based on incomplete information. In such circumstances, some have questioned whether it is appropriate to recognize a provisional bargain purchase gain or whether to defer recognition of any gain until the accounting for all other elements of the business combination is complete.

BDO INSIGHTS — ACCEPTABLE APPROACHES FOR RECOGNIZING A PROVISIONAL BARGAIN PURCHASE GAIN

As noted in Section 4.6, ASC 805 allows the acquirer to report provisional amounts for which the accounting is incomplete during the measurement period. This provides a basis for recognizing a provisional bargain purchase gain. Conversely, the acquirer must reassess whether it has correctly identified all the elements of a business combination before recognizing a gain. This provides a basis for deferring recognition of the gain (recognizing a deferred credit) until the business combination accounting is complete. As such, we believe that either approach is acceptable.

Under either approach, the acquirer must make all the disclosures required when the initial accounting for a business combination is incomplete (see Section 8.8). The acquirer must also disclose the provisional 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 bargain purchase gain (see Section 8.6.5.7).

5.4 DETERMINING THE CONSIDERATION TRANSFERRED

FASB REFERENCES

ASC 805-30-30-7 through 30-8

Most business combinations involve the transfer of consideration from the acquirer to the seller. Therefore, identifying the consideration transferred is a critical step for accounting for most business combinations. Such consideration includes the sum of the following at the acquisition-date:

Fair Value of Assets Transferred by the Acquirer + Fair Value of Liabilities Incurred to Former Owners + Fair Value of Equity Interests Issued by the Acquirer = Consideration Transferred

The consideration transferred in a business combination is measured at fair value with two exceptions:

- Share-based payment awards included in consideration transferred are measured in accordance with ASC 718.
- Transferred assets or liabilities that remain with the combined entity (the acquirer retains control of them) are measured at their carrying amounts immediately before the acquisition date.

ASC 805-30 provides the following examples of potential forms of consideration for a business combination:

- Cash
- Other assets
- A business or subsidiary of the acquirer
- Contingent consideration
- Common or preferred equity instruments
- Options
- Warrants
- Members of interests of mutual entities

5.4.1 Allocating Consideration to Transactions Accounted for Separate From the Business Combination

Not all amounts transferred by the acquirer to the seller are consideration for a business combination. In some cases, an acquirer and acquiree may enter transactions that must be accounted for separate from the business combination. For example, an acquirer may enter an agreement that compensates the seller for future services or that settles a preexisting relationship. As such, ASC 805 requires the acquirer to identify any amounts that are not part of the exchange for the acquiree and recognize them separate from the business combination.

BDO INSIGHTS — ALLOCATING CONSIDERATION TO TRANSACTIONS SEPARATE FROM THE BUSINESS COMBINATION

ASC 805 does not provide guidance for allocating the consideration transferred between the business combination and the separate transactions. Absent specific guidance, there may be more than one reasonable approach. We believe that it would be acceptable to account for the transactions that are separate from the business combination at fair value. Alternatively, a relative fair value allocation would also be acceptable.

Chapter 6 provides guidance for identifying elements that are not part of the business combination, including evaluating whether payments to selling shareholders represent contingent consideration or compensation for services.

Example 5-2 illustrates the allocation of consideration to a transition services agreement.

EXAMPLE 5-2: ALLOCATING CONSIDERATION TO A TRANSITION SERVICES AGREEMENT

FACTS

- Company A acquires 100% of Company B in a business combination for $100 million.
- In connection with the business combination, Company A enters into a transition services agreement (TSA) under which the selling shareholder of Company B agrees to provide certain services to Company A for six months after the acquisition at no cost to Company A.
- Company A estimates the fair value of the services to be provided under the TSA to be $2 million.

CONCLUSION

The TSA is a transaction separate from the business combination. Company A allocates $2 million to the TSA and $98 million to consideration for the business combination.

ANALYSIS

Although the agreement specifies that the transition services will be provided at no cost to Company A, in substance, a portion of the consideration relates to the TSA. Because the TSA is an agreement that compensates the former owner of the acquiree for future services, it is a transaction separate from the business combination (see Section 6.4.2.8.2).

5.4.2 Assets Transferred by the Acquirer to Former Owners

FASB REFERENCES

ASC 805-30-30-8

As discussed in Section 5.4, assets and liabilities transferred to the sellers as consideration in the business combination are generally recognized at their acquisition-date fair values. For some business combinations, the consideration transferred may include the acquirer’s assets and liabilities that have carrying amounts that differ from their fair values. If so, such assets and liabilities must be remeasured at fair value at the acquisition date with the resulting gain or loss recognized in the acquirer’s income statement. This provides the same accounting result as if the acquirer sold the assets and liabilities for cash equal to fair value and then transferred the resulting cash to the former owners as part of the business combination. However, as discussed in the next section, this is not the case for assets or liabilities that remain with the combined entity after the business combination.

5.4.2.1 Assets or Liabilities That Remain With the Combined Entity

FASB REFERENCES

ASC 805-30-30-8

In some business combinations, the acquirer transfers assets or liabilities to the acquiree rather than to the sellers. As a result, such assets or liabilities remain with the combined entity after the business combination. Because the acquirer does not lose control over those assets and liabilities, it continues to measure them at their carrying amounts immediately before the acquisition date. This is consistent with the treatment of other common control transactions. Appendix B provides guidance for accounting for common control transactions.

5.4.2.2 Consideration Held in Escrow

It is not unusual for acquisition agreements to require a portion of the consideration to be held in escrow to protect the acquirer against inaccurate representations and warranties made by the sellers. Such representation and warranty provisions often lapse shortly after the acquisition date. It is generally appropriate to include amounts held in escrow as part of the consideration transferred because representations and warranties are typically deemed accurate at the closing date.

However, an acquirer must evaluate the terms and conditions of the escrow agreement. If the assets in escrow are legally owned by the acquirer, it would be appropriate to continue to recognize the assets on the acquirer's balance sheet and recognize a corresponding liability to the seller. Conversely, if the assets in escrow are legally owned by the seller, it would not be appropriate for the acquirer to recognize the assets and a corresponding liability on its acquisition date balance sheet.

BDO INSIGHTS — AMOUNTS IN ESCROW AND CONTINGENT CONSIDERATION

Amounts held in escrow for general representations and warranties would not typically represent contingent consideration because they are not contingent upon future events; rather, they relate to conditions that existed at the acquisition date. However, amounts held in escrow that will be released contingent upon the outcome of an uncertain future event, such amounts must be evaluated as contingent consideration. Section 6.4.2 provides guidance for evaluating whether payments to selling shareholders represent contingent consideration or compensation for services.

5.4.2.3 Working Capital Adjustments

Acquisition agreements commonly include provisions that require an adjustment to the consideration transferred if the working capital balances of the acquiree are above or below a targeted amount. Because working capital is determined at the acquisition date and does not depend upon the outcome of an uncertain future event, working capital adjustments do not represent contingent consideration. Instead, such adjustments affect the consideration transferred if an adjustment is made after the acquisition date but before the end of the measurement period. Working capital adjustments that occur after the measurement period are recognized in the income statement.

5.4.3 Liabilities Incurred to Former Owners

FASB REFERENCES

ASC 805-30-30-7

As noted in Section 5.4, liabilities incurred by the acquirer to the sellers are part of the consideration transferred. Such liabilities must be recognized at fair value at the acquisition date. This includes any liability-classified contingent consideration. Section 5.4.5 discusses the accounting for contingent consideration in a business combination.

Liabilities assumed by the acquirer are not part of consideration transferred; instead, they are accounted for as assumed liabilities on the acquisition date balance sheet. However, the effect of recognizing an assumed liability is similar to recognizing a liability as part of the consideration transferred. In both cases, a liability is recognized and goodwill is increased (or a bargain purchase gain is decreased).

It is also common for an acquirer to issue debt to one or more third parties in connection with a business combination. Such debt is often used to finance the transaction. However, because the debt is not payable to the seller, it is not part of the consideration transferred. Rather, the issuance of debt to a third party is a financing transaction that is accounted for separate from the business combination (see Chapter 6).

For any debt instruments, the acquirer must consider all embedded features (such as conversion and redemption features) when determining fair value. Additionally, the acquirer must evaluate the debt instruments under ASC 480 and ASC 815-15 to determine the appropriate accounting. BDO's publication, **Understanding Complex Financial Instruments**, provides guidance for evaluating the accounting for such instruments.

5.4.3.1 Deferred Consideration

FASB REFERENCES

ASC 805-30-30-7

In some business combinations, part of the consideration may be payable at a future date. If the future payment is not contingent upon a future event or condition being met (other than the passage of time, which is not deemed a contingency), it would not represent contingent consideration; rather, it would represent deferred consideration. The acquirer must recognize deferred consideration at fair value as part of the consideration transferred at the acquisition date. Subsequently, the acquirer would follow other applicable U.S. GAAP (for example, ASC 835, *Interest*) to account for the liability.

Example 5-3 illustrates the accounting for deferred consideration in a business combination.

EXAMPLE 5-3: DEFERRED CONSIDERATION IN A BUSINESS COMBINATION

FACTS

- Company A acquires 100% of Company B in a business combination for $100 million.
- The acquisition agreement requires Company A to make a $60 million payment at the acquisition date and two additional payments of $20 million (one after 15 months and one after 18 months). Such additional payments are not contingent upon a future event or condition being met (other than the passage of time).

CONCLUSION

Company A recognizes the fair value of all the consideration transferred at the acquisition date, which includes the initial payment of $60 million and the fair value of the two additional payments of $20 million each.

ANALYSIS

The passage of time is not a contingency, so the two additional payments of $20 million are not contingent consideration because they are not contingent upon a future event or condition being met. Rather, this is deferred consideration (seller financing), which is accounted for at the acquisition-date fair value of the future payments. After the acquisition date, the acquirer applies the interest method under ASC 835 to account for the deferred consideration liability.

An acquirer may enter a noncontingent forward contract to issue equity to the sellers that will be settled after the acquisition date. In that case, the acquirer must measure the deferred consideration arrangement at fair value at the acquisition date. The subsequent accounting depends on whether the equity-linked instrument is classified as equity or a liability in accordance with ASC 480 and ASC 815-40. BDO's publication, Understanding Complex Financial Instruments, provides guidance for evaluating the accounting for equity-linked instruments.

5.4.4 Equity Interests Issued by the Acquirer

FASB REFERENCES

ASC 805-30-30-7

In general, if the acquirer issues equity interests to the sellers as consideration for the business combination, those equity interests must be recognized at their acquisition-date fair values using the principles of ASC 820. However, this may not be the case for rollover-equity or share-based payment awards. Sections 5.4.4.3 and 6.4.3 provide guidance for the evaluation of share-based payment awards exchanged for awards held by the acquiree's grantees.

For equity instruments issued, the acquirer must consider all embedded features (such as conversion and redemption features) in determining fair value. Additionally, the acquirer must evaluate the equity instruments under ASC 480 and ASC 815-15 to determine the appropriate accounting for the instruments. BDO's publication, Understanding Complex Financial Instruments, provides guidance for evaluating the accounting for such instruments.

5.4.4.1 Fair Value of Acquiree's Equity Interests Is More Reliably Measurable

FASB REFERENCES

ASC 805-30-30-2

For some business combinations that involve the exchange of equity interests, the fair value of the acquiree's equity interests may be more reliably measurable than the fair value of the acquirer's equity interests. For example, this may occur if a private company acquires a public company with a quoted market price. In such cases, the acquirer uses the acquisition-date fair value of the acquiree's equity interests, rather than the fair value of the acquirer's equity interests, to determine the amount of goodwill (or bargain purchase gain) in the transaction.

5.4.4.1.1 Business Combinations Between Mutual Entities

FASB REFERENCES

ASC 805-30-55-2 through 55-5 and ASC 805-30-20: Mutual Entity

A mutual entity is 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.

When mutual entities combine, the transaction is within the scope of business combination guidance, so the combining entities must apply the acquisition method to account for the business combination. If the fair value of the acquiree is more reliably measurable than the fair value of the member interests transferred by the acquirer, the acquirer must use the acquisition-date fair value of the acquiree's equity interests instead of the acquisition-date fair value of the acquirer's equity interests transferred to determine the amount of goodwill (or bargain purchase gain). Further, the acquirer recognizes the acquiree's net assets as a direct addition to capital or equity in its balance sheet, not as an addition to retained earnings, which is consistent with the way other types of entities apply the acquisition method.

5.4.4.2 Subsidiary Shares Issued as Consideration

FASB REFERENCES

ASC 810-10-45-23

If the acquirer issues shares of a consolidated subsidiary as consideration in a business combination, the shares are measured at the acquisition-date fair value under the principles of ASC 820. Because the acquirer retains its controlling interest in the subsidiary, the carrying amount of the noncontrolling interest must be adjusted to reflect the change in ownership, as discussed in ASC 810. Any difference between the fair value of the consideration received or paid and the amount by which the NCI is adjusted is recognized in equity attributable to the parent (for example, additional paid-in capital).

5.4.4.3 Rollover Equity

FASB REFERENCES

ASC 805-30-30-7 and ASC 805-10-55-25

In many business combinations, members of management receive equity of the acquirer in exchange for their previously held equity interests in the acquiree. Such previously held equity interests may have been purchased by management or received as share-based payment awards. Similarly, selling shareholders may also agree to receive equity in the acquirer in exchange for all or a portion of their previously held equity interests in the acquiree. This exchange of equity in the acquiree for equity in the acquirer is often referred to as "rollover shares" or "rollover equity."

When rollover shareholders receive equity in the acquirer at the same price per share as received by other selling shareholders, the acquirer typically includes the value of the rollover equity in the consideration transferred for the business combination.

However, if either the previously held equity interests in the acquiree or the rollover equity in the acquirer are unvested, the acquirer must evaluate the rollover equity as an exchange of share-based payment awards to determine whether any amount is attributable to postcombination compensation. Similarly, if the acquirer issues rollover equity with a value greater than the value received by other selling shareholders, it must recognize the excess value as compensation in its postcombination financial statements. Section 6.4.3 provides guidance for evaluating how to account for the exchange of share-based payment awards.

Example 5-4 illustrates the treatment of rollover equity in a business combination.

EXAMPLE 5-4: ROLLOVER EQUITY IN A BUSINESS COMBINATION

FACTS

- Company A acquires 100% of Company B in a business combination for $100 million.
- Company B's shares were fully vested before the business combination and have a value of $100 per share at the acquisition date.
- The $100 per-share purchase price was paid with a combination of cash and fully vested equity of Company A as follows:

	COMPANY B SHARES BEFORE TRANSACTION	CASH CONSIDERATION	ROLLOVER EQUITY	TOTAL
Investor A	600,000	$ 60,000,000	$ -	$ 60,000,000
Investor B	300,000	18,000,000	12,000,000	30,000,000
Management	100,000	2,000,000	8,000,000	10,000,000
Total	1,000,000	$ 80,000,000	$ 20,000,000	$ 100,000,000

CONCLUSION

The total consideration transferred for the business combination is $100 million, including $80 million in cash and $20 million in rollover equity.

ANALYSIS

Company A paid the same price for each share of Company B stock, regardless of whether it was settled with cash or rollover equity. Further, Company B's shareholders held fully vested shares as of the acquisition date, and no postcombination vesting is required for the rollover shares. Therefore, the entire $20 million of rollover equity is attributed to consideration transferred.

5.4.5 Contingent Consideration

FASB REFERENCES

ASC 805-30-25-5, ASC 805-30-30-7

ASC 805-10-20

Contingent Consideration

> *Usually an obligation of the acquirer to transfer additional assets or equity interests to the former owners of an acquiree as part of the exchange for control of the acquiree if specified future events occur or conditions are met. However, contingent consideration also may give the acquirer the right to the return of previously transferred consideration if specified conditions are met.*

Contingent consideration payable to the sellers is part of the consideration transferred. Contingent consideration usually involves the acquirer making future payments, or transferring additional equity interests, to the sellers, if a future event occurs or a specified condition is met. Such arrangements are often referred to as “earn-out” provisions. However, in some cases, contingent consideration involves the sellers returning a portion of the consideration previously paid. Regardless of the direction of the payments, contingent consideration is recognized at its acquisition-date fair value. The subsequent accounting for contingent consideration depends on whether it is classified as a liability (or asset) or as equity.

Contingent consideration is commonly included in business combinations to help buyers and sellers resolve differences in their views regarding the value of the business. For example, a buyer might estimate that the future business is worth an amount less than the seller believes is appropriate, based on differences in expectations regarding future revenue or cash flow projections for the business. As such, the buyer may make an offer based on its lower projections but agree to increase the price if the seller’s projections turn out to be accurate. Contingent consideration often includes additional payments to be transferred if the business can achieve specified results (such as, targeted revenues, earnings, or EBITDA) or specific milestones (such as, FDA approval of a drug candidate) or stock price targets.

Not all contingent amounts payable to (or receivable from) the former owners are accounted for as contingent consideration. Each contingent payment arrangement must be evaluated to determine whether it must be accounted for as contingent consideration or as a transaction separate from the business combination. Contingent payment arrangements that are determined to be separate from the business combination must be accounted for in accordance with other U.S. GAAP (for example, ASC 710 or ASC 718). Chapter 6 provides guidance for identifying elements that are not part of the business combination, including evaluating whether payments to selling shareholders represent contingent consideration or compensation for services (see Section 6.4.2).

5.4.5.1 Unit of Account

Some business combinations include more than one contingent payment arrangement, or a contingent payment arrangement may have multiple triggers (or underlyings). As such, an assessment of the relevant facts and circumstances is necessary to determine whether the arrangement represents a single contingent payment arrangement with multiple triggers or whether there are multiple contingent payment arrangements.

The acquirer must evaluate the substance of the contingent payment arrangements. To be treated as separate units of account, the arrangements must operate independently and relate to different risk exposures. Questions to consider may include:

- Do the contingent payment arrangements share the same risk (or the same underlying)? Or are they subject to different risks?
- Do the payout conditions, triggers, and targets operate independently of one another? For example, could a payout for the achievement of one target be realized even if another target is not achieved? Or are the multiple payout conditions, triggers, and targets cumulative or otherwise interrelated?

THE FORM OF A CONTINGENT CONSIDERATION ARRANGMENT IS NOT DETERMINATIVE

When analyzing the unit of account for contingent payment arrangements, the form of the arrangement is not determinative. In other words, it does not matter whether the contingent payment arrangements are included together in the same agreement, in separate parts of the same agreement, or in different legal agreements.

For each unit of account, the acquirer evaluates whether the contingent payment arrangement must be accounted for as part of the consideration transferred or as a transaction separate from the acquisition. Chapter 6 provides guidance for identifying elements that are not part of the business combination, including evaluating whether payments to selling shareholders represent contingent consideration or compensation for services (see Section 6.2).

Each unit of account determined to be contingent consideration is evaluated further to determine whether it must be classified as a liability (or asset) or as equity. The subsequent accounting differs depending on the classification of the contingent consideration.

Examples 5-5 and 5-6 illustrate contingent payment arrangement with multiple performance targets.

EXAMPLE 5-5: UNIT OF ACCOUNT — CONTINGENT PAYMENT ARRANGEMENT WITH MULTIPLE PERFORMANCE TARGETS - SCENARIO 1

FACTS

Company A acquires 100% of Company B in a business combination and agrees to the make contingent payments based on the acquiree's revenues in the year following the acquisition as follows:

- $2 million if revenues are at least $10 million but less than $12 million
- $6 million if revenues are at least $12 million

CONCLUSION

The contingent payment arrangement is accounted for as a single unit of account.

ANALYSIS

The contingent payments share the same risks (that is, they both relate to the acquiree's revenues for the same period) and do not operate independently from each other. The acquirer should evaluate this contingent payment arrangement to determine whether it is part of the consideration transferred or a transaction separate from the business combination.

If the arrangement is determined to represent contingent consideration, it will be classified as a liability as it is cash settled (see Section 5.4.5.2).

THE UNIT OF ACCOUNT IS IMPORTANT WHEN CLASSIFYING CONTINGENT CONSIDERATION

The unit of account determination is particularly important when assessing whether contingent consideration should be classified as a liability (or asset) or as equity. For example, contingent consideration payable in shares that is deemed a single unit of account with multiple settlement amounts (based on multiple performance targets) would likely fail step two of the indexation guidance in ASC 815-40-15 and would be accounted for as a liability. Conversely, contingent consideration that has multiple units of account (each with a single settlement amount), would be evaluated as exercise contingencies under step one of the indexation guidance and thus might not fail the indexation guidance.

EXAMPLE 5-6: UNIT OF ACCOUNT - CONTINGENT PAYMENT ARRANGEMENT WITH MULTIPLE PERFORMANCE TARGETS - SCENARIO 2

FACTS

Company A acquires 100% of Company B in a business combination and agrees to the transfer up to 200,000 additional shares to the sellers based on the acquiree's revenues in the two years after the acquisition as follows:

- 100,000 shares if revenues in year 1 are at least $10 million
- 100,000 shares if revenues in year 2 are at least $12 million

CONCLUSION

The contingent payment arrangement is accounted for as two separate units of account.

ANALYSIS

The contingent payments do not share the same risks (they relate to separate periods) and operate independently from each other. The acquirer must evaluate each unit of account to determine whether it is part of the consideration transferred or a transaction separate from the business combination.

For each unit of account that is determined to be contingent consideration, the acquirer must evaluate whether it is classified as a liability or equity. The acquirer first assesses whether each unit of account of contingent consideration is within the scope of ASC 480-10.

The arrangement is not in the scope of ASC 480-10 because each unit of account will not result in the issuance of a variable number of shares and the arrangement does not obligate the acquirer to transfer cash or other assets to settle the arrangement. As such, the acquirer must evaluate each unit of account under the indexation guidance in ASC 815-40-15.

Each unit of account is subject to an exercise contingency in step one of the indexation guidance in ASC 815-40-15. Because the exercise contingencies are not based on an observable market or observable index other than those for the company's stock or operations, they would not preclude an instrument from being considered indexed to the acquirer's own stock in step one. Further, because the settlement amount of each unit of account is fixed, no further evaluation under step two of the indexation guidance is necessary (see Section 5.4.5.2.2.1). As such, this instrument would meet the criteria to be considered indexed to the company's own stock under ASC 815-40-15 and must be further evaluated under the equity classification guidance in ASC 815-40-25 (see Section 5.4.5.2.2.2).

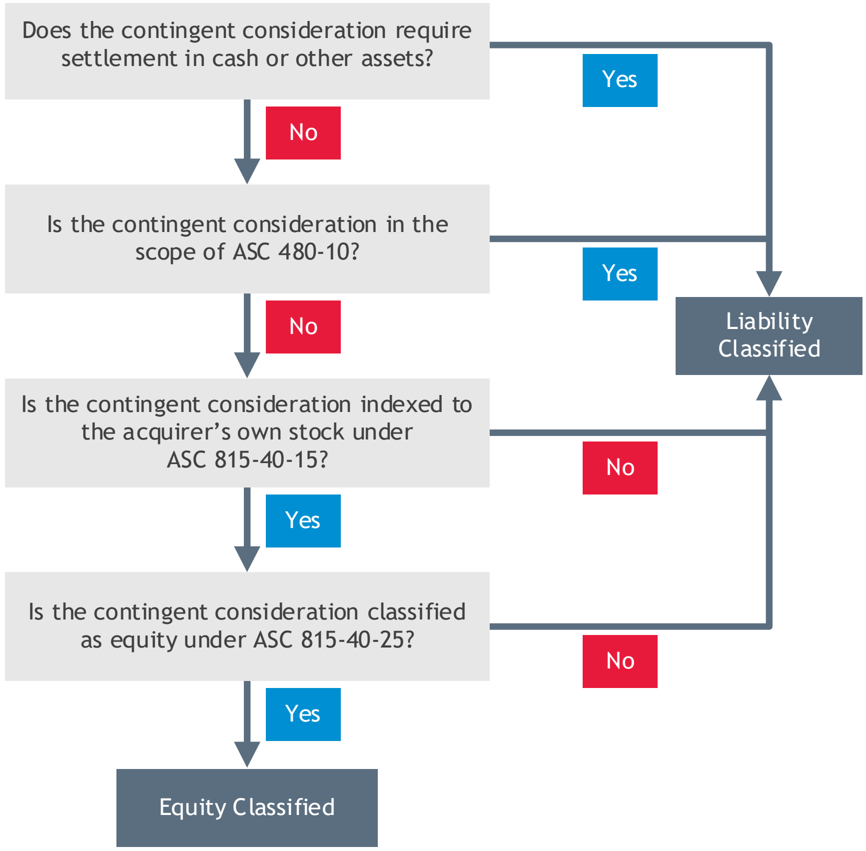
5.4.5.2 Classification of Contingent Consideration

FASB REFERENCES

ASC 805-30-25-6 through 25-7

An acquirer must apply the guidance in ASC 480-10 and ASC 815-40 or other applicable U.S. GAAP (for example, ASC 815-10) to determine the appropriate classification of contingent consideration. Contingent consideration is generally classified as a liability (or as an asset when it involves contingently returnable consideration) if the additional consideration transferred will be in the form of cash or other assets (that is, anything other than the acquirer's own equity securities).

If the additional consideration to be transferred will be the acquirer's own equity securities, the contingent consideration represents an equity-linked instrument. As such, the acquirer must analyze each unit of account of contingent consideration under the guidance in ASC 480-10 and ASC 815-40 to determine if it must be classified as a liability or equity.



The subsequent discussion within this section provides summary guidance for evaluating the classification of contingent consideration. For a more fulsome discussion for evaluating the classification of financial instruments, see BDO's publication, Understanding Complex Financial Instruments.

5.4.5.2.1 Assessing Whether Contingent Consideration is a Liability Under ASC 480

FASB REFERENCES

ASC 805-30-25-6 through 25-7, ASC 480-10-25-4, ASC 480-10-25-8, ASC 480-10-25-14, and ASC 480-10-55-33

ASC 805-30 requires that the acquirer separately evaluate the classification of contingent consideration under ASC 480-10 and ASC 815-40 or other applicable U.S. GAAP. As such, for contingent consideration that is payable in the acquirer's own equity securities, an acquirer must first assess whether the instrument is within the scope of ASC 480-10.

There are three categories of freestanding financial instruments that must be accounted for as liabilities under ASC 480-10:

- Mandatorily redeemable shares
- Instruments (other than an outstanding share) that do or may obligate the issuer to buy back some of its shares (or are indexed to such an obligation) in exchange for cash or other assets — for example, written puts (puts written by the issuer on its own shares and held by others)
- Obligations that must or may be settled with a variable number of shares, the monetary value of which is based solely or predominantly on either:
  - A fixed monetary amount known at inception

- A variable other than the fair value of the issuer's shares such as a market index
- A variable inversely related to the fair value of the issuer's shares

The first category applies only to instruments in the form of shares. Because share-settleable contingent consideration is an equity-linked contract and not shares, the first category is not applicable. However, the acquirer must evaluate the other two categories.

The second category applies to any financial instrument other than an outstanding share. Instruments that typically fall into this category include redeemable instruments and instruments that convert into mandatorily or contingently redeemable shares. For example, if contingent consideration is settleable with redeemable preferred stock, it would be within the scope of ASC 480-10 and would be classified as a liability.

Example 5-7 illustrates this concept.

EXAMPLE 5-7: EVALUATING CONTINGENT CONSIDERATION UNDER ASC 480-10 – CONTINGENTLY REDEEMABLE SHARES

FACTS

- Company A acquires 100% of Company B in a business combination.
- Company A agrees to transfer additional shares of preferred stock to the sellers if the acquiree's revenues exceed $100 million in the year following the acquisition.
- Company A's preferred stock is contingently redeemable (and would require presentation as mezzanine equity in Company A's financial statements if the Company follows the guidance in ASC 480-10-S99-3).
- Company A evaluated the contingent payment arrangement and concluded that it is contingent consideration rather than a transaction separate from the business combination.

CONCLUSION

The contingent consideration is classified as a liability under ASC 480-10.

ANALYSIS

The contingent consideration has a single performance target and represents a single unit of account.

The contingent consideration is a liability under ASC 480-10-25-8 because it will be settled in redeemable preferred stock. As such, it embodies a conditional obligation to repurchase Company A's equity instruments and may require the issuer to settle the obligation by transferring assets, similar to the guidance for warrants to purchase redeemable shares in ASC 480-10-55-33.

The third category requires an instrument that embodies an unconditional obligation, or an instrument other than shares that embodies a conditional obligation, to be classified as liabilities if the instrument includes an obligation to settle the instrument with a variable number of shares and the monetary value of the instrument is based solely or predominantly upon (a) a fixed monetary amount known at inception, (b) a variable other than the fair value of the issuer's shares, or (c) a variable inversely related to the fair value of the issuer's shares.

Contingent consideration that is settled in shares would trigger liability accounting if the settlement amount is predominantly fixed but the number of shares to settle the obligation varies.

Example 5-8 illustrates this concept.

EXAMPLE 5-8: EVALUATING CONTINGENT CONSIDERATION UNDER ASC 480-10 – FIXED MONETARY AMOUNT

FACTS

- Company A acquires 100% of Company B in a business combination.
- Company A agrees to transfer additional shares of common stock with a value of $5 million to the sellers if the acquiree's revenues exceed $100 million in the year following the acquisition.

- Company A evaluated the contingent payment arrangement and concluded that it is contingent consideration rather than a transaction separate from the business combination.

CONCLUSION

The contingent consideration is classified as a liability under ASC 480-10.

ANALYSIS

The contingent consideration has a single performance target and represents a single unit of account.

The contingent consideration is a liability under ASC 480-10-25-14(a) because it is an obligation that may be settled with a variable number of shares for which the monetary value is predominantly fixed at inception.

If the monetary value of the share-settled contingent consideration varies predominantly based on a variable (for example, revenues or EBITDA levels) other than the fair value of the issuer's shares, the contingent consideration would be a liability under ASC 480-10-25-14(b). Contingent consideration that would be a liability under ASC 480-10-25-14(b) would also fail step two of the indexation guidance and be recognized as a liability under ASC 815-40-15.

Example 5-9 illustrates this concept.

EXAMPLE 5-9: EVALUATING CONTINGENT CONSIDERATION UNDER ASC 480-10 - MULTIPLE PERFORMANCE TARGETS

FACTS

Company A acquires 100% of Company B in a business combination and agrees to transfer additional shares to the sellers based on the acquirer's EBITDA in the year following the acquisition as follows:

- 100,000 shares if EBITDA is at least $5 million but less than $10 million
- 200,000 shares if EBITDA is at least $10 million

CONCLUSION

The contingent consideration is classified as a liability under ASC 480-10 or ASC 815-40.

ANALYSIS

The contingent payments share the same risks (that is, they both relate to the acquiree's revenues for the same period) and do not operate independently from each other. As such, the contingent payment arrangement is accounted for as a single unit of account. The acquirer must evaluate the contingent payment arrangement to determine whether it is part of the consideration transferred or a transaction separate from the business combination.

If the arrangement is determined to represent contingent consideration, the acquirer must evaluate whether it must be classified as a liability or equity. The acquirer would first assess whether the contingent consideration is within the scope of ASC 480-10. This arrangement includes an obligation to deliver a variable number of shares for which the monetary value changes based on something other than the issuer's shares (EBITDA). Thus, this arrangement would be a liability under ASC 480-10-25-14(b) if the monetary value is based predominantly on the achievement of the performance target rather than predominantly on the share price. However, even if the acquirer concludes that the arrangement was not in the scope of ASC 480-10, the contingent consideration would fail step two of the indexation guidance in ASC 815-40-15 as changes to the settlement amount based on EBITDA are not an input to the fair value of a fixed-for-fixed forward or option on equity shares (see Section 5.4.5.2.2.1). As a result, the contingent consideration would be liability classified.

Contingent consideration that is settled in shares would trigger liability accounting under ASC 480-10-25-14(c) if the settlement amount (the number of shares) varies predominantly based on a variable inversely related to the fair value of the issuer's shares.

Example 5-10 illustrates this concept.

EXAMPLE 5-10: EVALUATING CONTINGENT CONSIDERATION UNDER ASC 480-10 – VARIABLE NUMBER OF SHARES ISSUED AS A SECURITY PRICE GUARANTEE

FACTS

- Company A acquires 100% of Company B in a business combination by issuing 2 million shares of common stock when the share price is $50 per share.
- Company A agrees to transfer additional shares of common stock to the sellers if the market price of its stock is below $50 one year after the acquisition date.
- The number of shares (if any) that Company A will be required to transfer will be the amount necessary to guarantee the $50 price per share.
- Company A evaluated the contingent payment arrangement and concluded that it is contingent consideration rather than a transaction separate from the business combination.

CONCLUSION

The contingent consideration is classified as a liability under ASC 480-10.

ANALYSIS

The contingent consideration has a single performance target and represents a single unit of account.

The contingent consideration is a liability under ASC 480-10-25-14(c) as it is an obligation that may be settled with a variable number of shares for which the monetary value varies predominantly based on a variable inversely related to the fair value of the issuer’s shares.

Because ASC 805 provides subsequent measurement guidance for contingent consideration in a business combination, the subsequent measurement guidance in ASC 480 does not apply. Section 5.4.5.3 discusses the subsequent measurement guidance for liability-classified contingent consideration for a business combination.

Share-settled contingent consideration that is not within the scope of ASC 480-10 must be evaluated further to determine whether it must be classified as equity or as a liability under ASC 815-40.

5.4.5.2.2 Assessing Whether Contingent Consideration Is a Liability Under ASC 815-40

FASB REFERENCES

ASC 815-10-15-74(a) and ASC 815-40-15-5

Share-settled contingent consideration is an equity-linked contract. ASC 815-40 indicates that an equity-linked instrument must be evaluated under the derivative scope exception in ASC 815-10-15-74(a), regardless of whether the instrument has all the characteristics of a derivative. As such, for share-settled contingent consideration that is not accounted for as a liability under ASC 480-10, the acquirer must assess whether the instrument is both (1) indexed to a company’s own stock and (2) classified in stockholders’ equity. This means that if the contingent consideration meets the scope exception, it can be accounted for within stockholders’ equity.

To qualify for the scope exception, the instrument must satisfy the requirements of both the indexation guidance in ASC 815-40-15 and the equity classification guidance in ASC 815-40-25. If the contingent consideration does not satisfy either of these requirements, the instrument is accounted for as a liability.

5.4.5.2.2.1 Assessing Whether Contingent Consideration is Indexed to the Entity's Own Stock

FASB REFERENCES

ASC 815-40-15-5C, ASC 815-40-15-7 through 15-7A, ASC 815-40-15-7C through 15-7G, and ASC 815-40-20: Standard Antidilution Provisions

ASC 815-40-15 provides a two-step test to determine whether contingent consideration is indexed to a company's own stock:

Step 1: Evaluate the instrument's contingent exercise provisions → Step 2: Evaluate the instrument's settlement provisions

Assessment Under Step 1

By its very nature, contingent consideration includes one or more exercise contingencies that must be evaluated under Step 1, which focuses on contingencies that affect whether or when an instrument can be exercised. In other words, an exercise contingency that is binary (that is, it acts as an "on/off switch" for determining whether the contingent consideration will be paid) should be evaluated under Step 1.

FASB REFERENCES

ASC 815-40-15-7A

An exercise contingency shall not preclude an instrument (or embedded feature) from being considered indexed to an entity's own stock provided that it is not based on either of the following:

a. An observable market, other than the market for the issuer's stock (if applicable)

b. *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).*

An instrument passes Step 1 (and would be analyzed under Step 2) if (1) the instrument's contingent exercise provisions are not based on an observable market or observable index, other than those for the company's stock or operations, and (2) once any contingent events occur, the instrument's settlement is based solely on the company's stock.

Contingency provisions based upon the company's results (such as, sales, EBITDA, or net income) generally would not preclude the instrument from being considered indexed to the company's own stock. On the other hand, contingency provisions that are based on external markets or indices (such as the S&P 500, an index of peer company stocks, or the price of a commodity) would not be considered indexed to a company's own stock.

If the evaluation of Step 1 does not preclude an instrument from being considered indexed to the entity's own stock, the analysis proceeds to Step 2.

BDO INSIGHTS — CONTINGENT CONSIDERATION INDEXED TO THE ACQUIREE'S PERFORMANCE DOES NOT FAIL STEP 1 OF INDEXATION GUIDANCE

Contingent consideration is often based on the acquired entity's postcombination performance rather than the performance of the combined entity as a whole. ASC 815-40-15-5C indicates that an instrument is not precluded from being considered indexed to the entity's own stock in the parent's consolidated financial statements if the subsidiary is a substantive entity. We believe that an acquired entity that qualifies as a business would be substantive. Therefore, contingent consideration that is indexed to the performance of the acquiree would not preclude the instrument from being considered indexed to the company's own stock in Step 1.

EXERCISE CONTINGENCIES THAT ADJUST CONSIDERATION TRANSFERRED MAY PRECLUDE EQUITY CLASSIFICATION

Exercise contingencies that adjust the amount of consideration transferred (for example, the settlement amount varies based on the level of revenues or earnings achieved) must also be evaluated under Step 2. Unless the exercise contingencies are inputs to the fair value of a fixed-for-fixed forward or an option on equity shares (which generally would not be the case for contingent consideration performance targets), the application of Step 2 would preclude equity classification for contingencies that adjust the amount of consideration to be paid. As such, the unit of account assessment is important. See Section 5.4.5.1 for more guidance on unit of account for contingent consideration.

Assessment Under Step 2

Step 2 focuses on the settlement of the instrument upon exercise or conversion. The instrument passes Step 2 when **either** of the following is met:

- If the instrument's settlement amount equals the difference between the fair value of a fixed number of the entity's shares and a fixed monetary amount or fixed amount of debt issued by the entity
- If the strike price or settlement amount is variable, the only variables that would affect the instrument's settlement amount would be inputs to the fair value of a "fixed-for-fixed" forward or option on equity shares. These inputs are generally the same as the inputs to the Black-Scholes model and include:
  - Strike price of the instrument
  - Term of the instrument
  - Expected dividends or other dilutive activities, such as the purchase of stock at above-market prices
  - Stock borrow cost
  - Interest rates
  - Stock price volatility
  - Ability to maintain a standard hedge position in the underlying shares
  - Company's credit spread

Further, standard antidilution provisions do not preclude a conclusion that an instrument is convertible into a fixed number of shares. ASC 815-40-20 defines standard antidilution provisions as *"those that result in adjustments to the conversion ratio in the event of an equity restructuring transaction that are designed to maintain the value of the conversion option."* Standard antidilution provisions include equity restructurings such as a stock dividend, stock split, spinoff, rights offering, or recapitalization through a large, nonrecurring cash dividend.

For potential adjustments other than standard antidilution adjustments, the instrument would generally not be considered indexed to the company's own stock if **either**:

- The instrument's settlement calculation incorporates variables other than those that would be inputs to the fair value of a fixed-for-fixed forward or option on equity shares, or
- There are features, such as a leverage factor, that increase exposure to the variables listed above in a manner that is inconsistent with the fixed-for-fixed model.

Example 5-11 illustrates the evaluation of a security price guarantee.

EXAMPLE 5-11: EVALUATING CONTINGENT CONSIDERATION UNDER ASC 815-40-15 - FIXED NUMBER OF SHARES ISSUED AS A SECURITY PRICE GUARANTEE

FACTS

- Company A acquires 100% of Company B in a business combination by issuing 2 million shares of common stock when the share price was $50 per share.
- Company A agrees to transfer 100,000 additional shares of common stock to the sellers if the market price of its stock is below $50 one year after the acquisition date.
- Company A evaluated the contingent payment arrangement and concluded that it is contingent consideration rather than a transaction separate from the business combination.

CONCLUSION

The contingent consideration is indexed to Company A's own stock.

ANALYSIS

The contingent consideration has a single performance target and represents a single unit of account.

The contingent consideration is not within the scope of ASC 480-10 because it does not include any obligation to repurchase Company A's equity instruments and is settleable in a fixed number of shares. Therefore, Company A assesses the contingent consideration under the indexation guidance in ASC 815-40-15.

- **Step 1: Evaluate the instrument's contingent exercise provisions** – The exercise contingency is based on the market price of the Company's stock. As such, it does not preclude the contingent consideration from being considered indexed to Company A's own stock.
- **Step 2: Evaluate the instrument's settlement provisions -** The settlement amount is fixed-for-fixed because it equals the difference between the fair value of a fixed number of shares (100,000 additional shares) and a fixed exercise price (zero).

As a result, the contingent consideration is indexed to Company A's own stock. Company A must perform further analysis under ASC 815-40-25 to determine whether the contingent consideration meets the requirements for equity classification.

Share-settled contingent consideration that does not satisfy the indexation criteria in either Step 1 or Step 2 would be liability classified. Section 5.4.5.3 discusses the subsequent measurement guidance for liability-classified contingent consideration.

For share-settled contingent consideration that satisfies the indexation criteria in Step 1 and Step 2, further analysis under the classification guidance of ASC 815-40-25 is necessary (see Section 5.4.5.2.2.2).

5.4.5.2.2.2 Assessing Whether Contingent Consideration Is Classified in Equity Under ASC 815-40-25

FASB REFERENCES

ASC 815-40-25-1 and ASC 815-40-25-7 through 25-30

The basic model in ASC 815-40-25 regarding whether the contingent consideration requires, or may require, net cash settlement must be considered to determine whether equity classification is appropriate.

ASC 815-40-25 defines the following three settlement methods:

Physical Settlement	The buyer delivers the full contractually stated amount in cash to the seller, and the seller delivers the full stated number of shares to the buyer.
Net-Share Settlement	The party with the loss on the contract delivers to the party with the gain the number of shares with a current fair value equal to the gain.
Net Cash Settlement	The party with the loss on the contract delivers to the party with the gain a cash payment equal to the gain, and no shares are exchanged.

Contracts that require, or may require, the issuer to settle the contract for cash are liabilities, and contracts that require settlement in shares are generally equity instruments. If the contract offers a choice of settlement to the issuer, settlement in shares is assumed. If the contract offers a choice of settlement to the holder, settlement in cash is assumed.

If net cash settlement is not required, the contingent consideration must also meet **all** the following criteria to qualify for equity classification:

- The contract must not explicitly require a cash settlement if registered shares are unavailable.
- The entity must have sufficient authorized and unissued shares available to settle the contract after considering all other commitments that may require the issuance of stock during the maximum period the instrument could remain outstanding.
- The contract must explicitly limit the number of shares to be delivered in a share settlement.
- There is no requirement to net cash settle the contract if the entity fails to make timely filings with the SEC.
- There are no cash settled top-off or make-whole provisions.

Share-settled contingent consideration that fails any of the criteria in ASC 815-40-25 must be classified as a liability. Section 5.4.5.3 discusses the subsequent measurement guidance for liability-classified contingent consideration.

Share-settled contingent consideration that satisfies all the criteria in ASC 815-40-25 and the criteria in ASC 815-40-15 is classified as equity. Section 5.4.5.4 discusses the subsequent measurement guidance for equity-classified contingent consideration.

5.4.5.3 Contingent Consideration Classified as a Liability (or Asset)

FASB REFERENCES

ASC 805-30-30-7 and ASC 805-30-35-1

As previously noted, contingent consideration is classified as a liability (or as an asset if it involves contingently returnable consideration) if the additional consideration transferred will be in the form of cash or other assets (anything other than the acquiring entity's own equity securities).

If the additional consideration to be transferred will be the acquirer's own equity securities, the acquirer must analyze the contingent consideration under the guidance in ASC 480-10 and ASC 815-40 to determine if it is classified as a liability or equity. Section 5.4.5.2 provides guidance for assessing the classification of share-settled contingent consideration.

For contingent consideration classified as a liability (or asset), the acquirer must initially recognize the contingent consideration payable (or receivable) at its acquisition-date fair value. Subsequently, contingent consideration classified as a liability (or asset) must be remeasured at fair value at each reporting date until the contingency is resolved. Changes in fair value are recognized in earnings.

DETERMINING WHEN A CONTINGENCY IS RESOLVED MAY REQUIRE JUDGMENT

Liability-classified contingent consideration must be remeasured at fair value at each reporting date until the contingency is resolved. In some cases, it may be clear when the contingency is resolved, but in other cases, determining when a contingency is resolved may require judgment. For example, an acquirer may agree to pay contingent consideration if the acquiree achieves a specific adjusted EBITDA target for the year-ending December 31, 20X5, as certified by the acquirer's board of directors. If, as of December 31, 20X5, the acquiree appears to have achieved the specified adjusted EBITDA target, but the results are not certified by the board of directors until after year-end (for example, after the entity's annual audit is completed), some may believe the contingency to be resolved as of December 31, 20X5.Others may conclude that the contingency has not been resolved until the board of directors certifies the acquiree's adjusted EBITDA. Determining when a contingency has been resolved requires the application of professional judgment based on the facts and circumstances.

Some changes in the fair value of contingent consideration may result from additional information about facts and circumstances that existed at the acquisition date. If such information becomes available during the measurement period, the change in fair value must be recognized as a measurement period adjustment with a corresponding adjustment to goodwill (or bargain purchase gain). However, changes to contingent consideration classified as a liability (or asset) resulting from events that occur after the acquisition date are not measurement period adjustments and must be recognized in earnings. Section 4.6 provides guidance regarding measurement period adjustments.

The graphic below summarizes the accounting for changes in in the fair value of contingent consideration.

Changes during the measurement period resulting from additional information about facts and circumstances that existed at the acquisition date	Measurement period adjustment
Changes during the measurement period resulting from events that occur after the acquisition date	Recognized in earnings
Changes after the measurement period	Recognized in earnings

5.4.5.3.1 Reassessment of Contingent Consideration Classified as a Liability (or Asset)

FASB REFERENCES

ASC 815-40-35-8

The acquirer must continuously reassess the classification of contingent consideration through the settlement date. For liability-classified contingent consideration, if the classification changes as a result of events that occurred during the reporting period, the acquirer recognizes a final mark-to-market adjustment in earnings to recognize the fair value of the liability at the date of the event that caused the reclassification and then, reclassifies the contingent consideration from a liability to equity. Any gains or losses previously recognized are not reversed. As discussed in Section 5.4.5.4, contingent consideration classified as equity is not remeasured (except for measurement period adjustments) and its subsequent settlement is accounted for in equity.

5.4.5.4 Contingent Consideration Classified as Equity

FASB REFERENCES

ASC 805-30-30-7 and ASC 805-30-35-1

Contingent consideration is classified as a liability (or as an asset if it involves contingently returnable consideration) if the additional consideration transferred will be in the form of cash or other assets (anything other than the acquiring entity's own equity securities).

If the additional consideration to be transferred will be the acquirer's own equity securities, the acquirer must analyze the contingent consideration under the guidance in ASC 480-10 and ASC 815-40 to determine if it is classified as a liability or equity. Section 5.4.5.2 provides guidance for assessing the classification of contingent consideration.

For contingent consideration classified as equity, the acquirer must initially recognize the contingent consideration at its acquisition-date fair value. Subsequently, contingent consideration classified as equity is not remeasured (except for measurement period adjustments) and its subsequent settlement is accounted for in equity.

Some changes in the fair value of contingent consideration may result from additional information about facts and circumstances that existed at the acquisition date. If such information becomes available during the measurement period, the change in fair value is recognized as a measurement period adjustment with a corresponding adjustment to goodwill (or bargain purchase gain). Section 4.6 provides guidance regarding measurement period adjustments.

5.4.5.4.1 Reassessment of Contingent Consideration Classified as Equity

FASB REFERENCES

ASC 815-40-35-8

The acquirer must continuously reassess the classification of contingent consideration through the settlement date. For equity-classified contingent consideration, if the classification changes as a result of events that occurred during the reporting period, the acquirer reclassifies the fair value of the contingent consideration from equity to a liability at the date of the event that caused the reclassification. Any amounts needed to adjust the carrying value to fair value are recognized in equity. Subsequently, changes in the fair value of the contingent consideration liability are recognized in earnings as discussed in Section 5.4.5.3.

Example 5-12 illustrates this concept.

EXAMPLE 5-12: RECLASSIFICATION OF CONTINGENT CONSIDERATION FROM EQUITY TO A LIABILITY

FACTS

- Company A entered a share-settled contingent consideration arrangement for the acquisition of Company B.
- Company A evaluated the arrangement and concluded that it was equity-classified contingent consideration. However, as a result of subsequent issuances of shares, six months after the acquisition date, the entity no longer has sufficient authorized shares available to settle its obligations under the contingent consideration arrangement.

CONCLUSION

Company A reclassifies the contingent consideration from equity to a liability.

ANALYSIS

Because there are insufficient shares to settle the contingent consideration, it no longer meets the conditions for equity classification. As such, Company A reclassifies the contingent consideration from equity to a liability. The liability is recorded at its fair value on the date the requirements for equity classification were no longer met with an offsetting adjustment to equity. Subsequently, the liability is measured at fair value with changes in fair value recognized in earnings.

5.4.5.5 Changes to Contingent Consideration to Resolve Disputes

Disputes may arise between the acquirer and sellers due to disagreements over the consideration to be transferred. If contingent consideration is adjusted to resolve such disputes, the acquirer must determine whether to reflect any amounts paid or received as an adjustment to the consideration transferred for the business combination or as a postcombination expense or income. Any adjustments made as a result of the dispute would generally be reflected in the income statement unless there is a clear and direct link to the consideration transferred (see Section 4.4.1.1.3.1).

5.4.5.6 Acquiree Contingent Consideration Assumed by the Acquirer

If an acquired entity is party to a contingent consideration as a result of a previous business combination or asset acquisition, the acquirer must account for the assumption of the liability (or asset) in connection with the current business combination. The accounting for such assumed contingent consideration depends on whether the acquiree was the acquirer or the acquiree in the previous business combination or asset acquisition.

5.4.5.6.1 Acquiree Was the Acquirer in a Previous Business Combination or Asset Acquisition

FASB REFERENCES

ASC 805-20-25-15A, ASC 805-20-30-9A, ASC 805-30-25-5, ASC 805-20-35-4C, ASC 805-30-35-1A, and ASC 805-30-35-1

If an acquired entity was the acquirer in a previous business combination or asset acquisition that included contingent consideration, it may have obligations or rights related to the previous contingent consideration that are assumed by the acquirer. Because the nature of the contingent consideration does not change as a result of the subsequent business combination, it is accounted for in the same manner as any other contingent consideration issued in a business combination.

Contingent consideration assumed by the acquirer in a business combination is initially recognized at fair value. The assumed contingent consideration must be evaluated under the guidance in ASC 480-10 and ASC 815-40 to determine if it is classified as a liability or equity. Section 5.4.5.2 provides guidance for assessing the classification of contingent consideration.

Subsequently, the assumed contingent consideration is accounted for based on its classification. Section 5.4.5.3 provides guidance for accounting for liability (or asset) classified contingent consideration, and Section 5.4.5.4 provides guidance for equity-classified contingent consideration.

BDO INSIGHTS — ACCOUNTING FOR CONTINGENT CONSIDERATION FROM PRIOR ACQUISITION

If contingent consideration assumed by the acquirer is equity classified, we believe it would be recognized as part of the consideration transferred for the business combination because it represents the issuance of an equity instrument. However, we believe that liability (or asset) classified contingent consideration is recognized as an assumed liability (or asset) rather than as part of the consideration transferred because it is not payable to (or receivable from) the sellers in the current business combination. However, there may be diversity in practice.

5.4.5.6.2 Acquiree Was the Seller in a Previous Business Combination or Asset Acquisition

FASB REFERENCES

ASC 805-20-25-18A through 25-20A

If an acquired entity was the seller in a previous business combination or asset acquisition that included contingent consideration, it may still have rights or obligations related to the previous contingent consideration that is assumed by the acquirer. In such cases, the acquirer accounts for the acquired right to receive (or obligation to pay) contingent consideration as an asset (or liability) arising from a contingency. Section 4.4.1.1 provides guidance for recognizing assets and liabilities arising from preacquisition contingencies.

5.4.5.7 Seller Accounting for Contingent Consideration

FASB REFERENCES

ASC 810-10-40-3A through 40-5, ASC 815-10-15-59(d), and ASC 450-20-25-2, ASC 450-30

Although ASC 805 includes guidance for the acquirer's accounting for contingent consideration in a business combination, that guidance does not apply to the seller. As such, the seller must determine whether the transaction is within the scope of ASC 810 or other U.S. GAAP. Generally, the loss of control of a business must be accounted for under ASC 810; however, ASC 810-10-40-3A indicates that a sale of a business that is in substance the transfer of a good or service in a contract with a customer would be accounted for in accordance with ASC 606. Thus, if the sale of a business is within the scope of ASC 606, that guidance would apply, and the contingent consideration would be accounted for as variable consideration by the seller.

BDO INSIGHTS — LOSS OF CONTROL OF A BUSINESS IS RARELY IN THE SCOPE OF ASC 606

Although ASC 810-10-40-3A indicates that a sale of a business that is in substance the transfer of a good or service in a contract with a customer would be accounted for in accordance with ASC 606, we believe that the loss of control of a business will rarely be in the scope of ASC 606. That is because it would be unusual for a sale of a business to meet the definition of revenue in ASC 606-10-20:

> *Revenue: Inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations.*

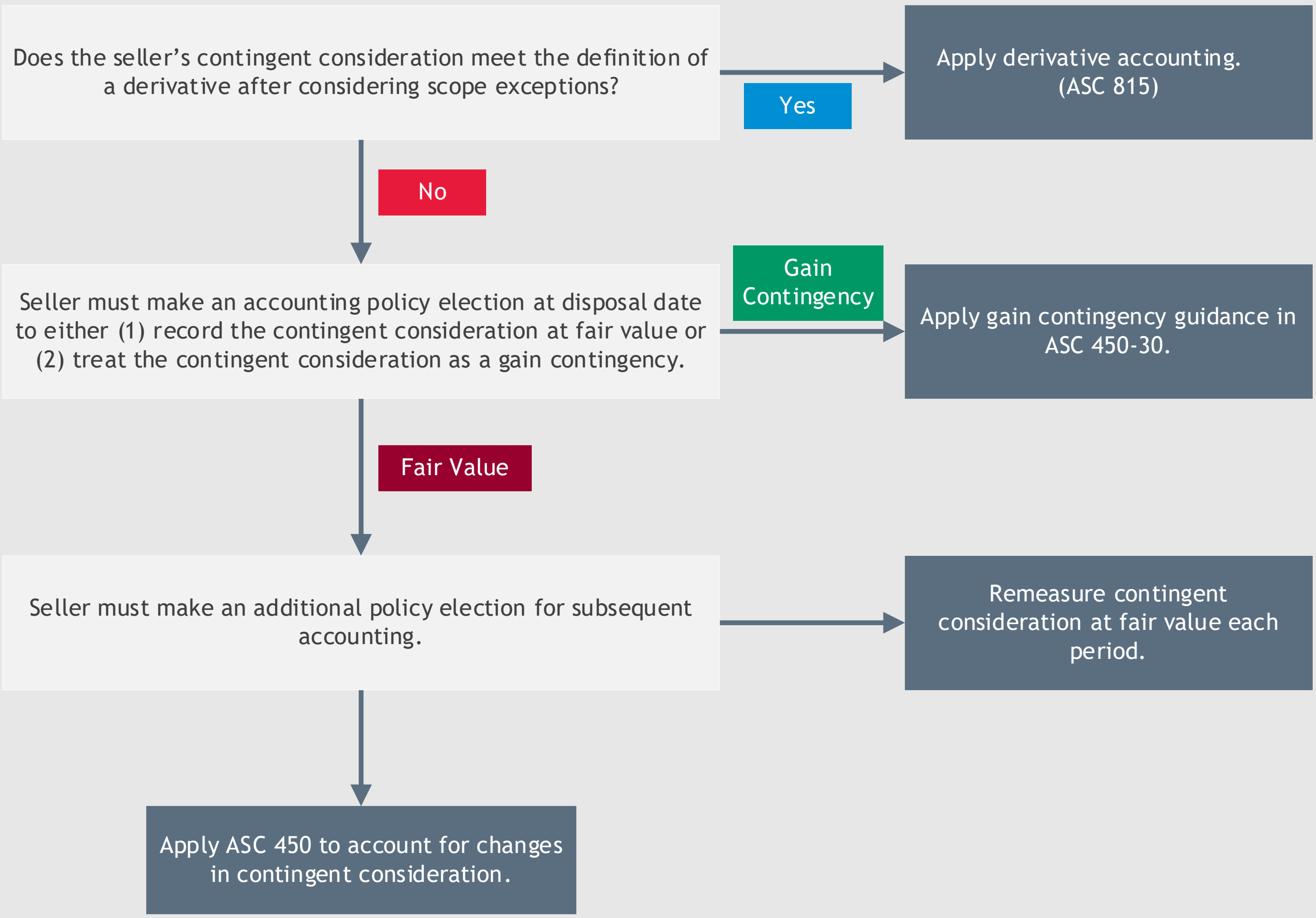
As such, we believe the loss of control of a business would usually be within the scope of ASC 810. Determining whether a sale of a business is within the scope of ASC 606 requires the application of professional judgment based on the facts and circumstances.

ASC 810 does not provide specific guidance for recognizing and measuring contingent consideration by an entity that loses control of a business. As such, the seller must apply judgment to determine the appropriate accounting.

If the contingent consideration meets the definition of a derivative, it is accounted for under ASC 815. That guidance requires the seller to measure the derivative asset (or liability) at fair value at each reporting period and recognize changes in fair value in earnings. However, contingent consideration often qualifies for a derivative scope exception. For example, ASC 815-10-15-59(d) states that contracts that are not exchange-traded are not required to be accounted for as derivatives if the underlying is based on specified volumes of revenue of one of the parties to the contract. Therefore, contingent consideration for which the underlying is revenue, net income, EBITDA, or a similar income-based measure often qualifies for that scope exception. For contingent consideration not accounted for as a derivative, there is diversity in practice, as noted in the following BDO Insights.

BDO INSIGHTS — ACCOUNTING FOR CONTINGENT CONSIDERATION UPON LOSS OF CONTROL OF A BUSINESS IN A TRANSACTION IN THE SCOPE OF ASC 810

We believe a seller could use this decision tree to determine the appropriate accounting for the loss of control of a business in a transaction that is within the scope of ASC 810.



For contingent consideration that is not accounted for as a derivative, there is diversity in practice:

- Some sellers recognize the contingent consideration at fair value upon loss of control.
- Other sellers recognize the contingent consideration as a gain contingency under ASC 450-30 only when the contingency is resolved and the consideration is realized.
- Other approaches may also be acceptable.

We believe that the chosen approach represents a policy election that must be consistently applied.

Fair Value Approach

ASC 810-10-40-5 includes guidance for determining the gain or loss recognized by the seller upon loss of control of a business. That guidance requires a seller to recognize a gain or loss based in part on the fair value of any consideration received, which could be interpreted to include contingent consideration. As such, we believe that it is acceptable for the seller to make a policy election to recognize the fair value of contingent consideration upon loss of control. If the seller elects to recognize the contingent consideration at fair value, it must make an additional accounting policy election for the subsequent accounting. We believe that **either** of the following approaches is acceptable:

- Remeasure the contingent consideration at fair value each period.
- Apply the contingency guidance in ASC 450 to account for any changes in the contingent consideration. Recognize increases in the carrying amount of the asset using the gain contingency guidance under ASC 450-30 and recognize impairments based on the guidance in ASC 450-20-25-2.

Gain Contingency Approach

ASC 450-30 includes guidance for recognizing gain contingencies, which indicates that an entity cannot reflect a gain contingency in the financial statements before it is realized. Thus, we believe that it is acceptable for the seller that has lost control of a business to elect a policy to treat the contingent consideration as a gain contingency. Under this approach, the seller does not include the contingent consideration in the calculation of the gain or loss on deconsolidation.

5.4.6 Consideration Transferred in a Reverse Acquisition

Section 7.3.1 provides guidance for determining the consideration transferred in a reverse acquisition.

5.4.7 Business Combination in Which No Consideration is Transferred

FASB REFERENCES

ASC 805-30-30-3

As noted in Section 1.1.4, a business combination can occur even without the transfer of consideration if an entity gains control of a business. Examples of transactions or events that may result in a change in control without transferring consideration include a share repurchase by an investee, lapse of participating rights held by other investors, or combinations achieved by contract alone.

For a business combination in which no consideration is transferred, the acquirer uses the acquisition-date fair value of the acquirer's interest in the acquiree in place of the acquisition-date fair value of consideration transferred to determine the amount of goodwill to recognize. It would be unusual for a business combination in which no consideration is transferred to result in a bargain purchase gain.

When accounting for a business combination in which no consideration is transferred, consistent with other business combinations, the acquirer must also:

- Revalue its previously held equity interest in the acquiree and recognize a gain or loss equal to the difference between the carrying amount of its previously held equity interest in the acquiree before the business combination and the fair value of its controlling interest that results from the transaction (see Section 5.5.1).
- Recognize any noncontrolling interests at their acquisition-date fair values (see Section 4.5).
- Recognize the identifiable assets acquired and liabilities assumed measured in accordance with the business combination guidance under ASC 805 (see Chapter 4).

Sections 5.1 and 5.2 provide guidance for determining goodwill (or bargain purchase gain) in a business combination.

5.4.8 Acquisition Costs

FASB REFERENCES

ASC 805-10-25-23

Acquisition-related costs that the acquirer incurs to effect a business combination are not part of the consideration transferred for a business combination because they are not part of the fair value exchange between the buyer and seller for the business.[15] As a result, acquisition-related costs incurred for a business combination must be expensed as incurred. The only exception is for costs to issue debt or equity securities, which are recognized in accordance with other applicable U.S. GAAP. Section 6.3 provides additional guidance on accounting for acquisition-related costs, including acquisition-related costs incurred by the acquiree.

ACCOUNTING FOR TRANSACTION COSTS FOR AN ASSET ACQUISITION

The accounting for acquisition-related costs in a business combination is different than the accounting for transaction costs for an asset acquisition. Direct acquisition costs in an asset acquisition are generally capitalized as part of the cost of the acquired assets. Refer to Appendix C for more guidance on asset acquisitions.

5.5 BUSINESS COMBINATIONS ACHIEVED IN STAGES

FASB REFERENCES

ASC 805-10-25-9 through 25-10 and ASC 805-10-50-2(g)

A business combination achieved in stages (also referred to as a step acquisition) occurs when an acquirer gains control of an acquiree in which it held an equity interest immediately before the acquisition date.

Before an investor gains control of an investee, it accounts for its investment in accordance with other U.S. GAAP. For example, if the investor can exert significant influence over the investee, it may be required to account for its investment using the equity method in accordance with ASC 323. Alternatively, if the equity method is not required, the investor may be required to account for its investment in accordance with ASC 321.

At the date the acquirer gains control (the acquisition date), it must apply the acquisition method to account for the step acquisition in accordance with ASC 805. The core principle when accounting for a business combination is the recognition of the acquired business at its full fair value at the acquisition date. As a result, the acquirer must measure the consideration transferred and any noncontrolling interests at fair value. Further, for a business combination achieved in stages, the acquirer must remeasure its previously held equity interests in the acquiree at fair value. The excess of these amounts over the amounts recognized for the identifiable assets acquired and liabilities assumed is recognized as goodwill, as discussed in Section 5.2.

Because previously held equity interests are often not accounted for at fair value, their remeasurement typically results in a gain or loss which must be recognized in earnings. Any amounts previously recognized in other comprehensive income related to the investee must be reclassified and included in the calculation of the gain or loss at the acquisition date. The acquirer is required to disclose the gain or loss recognized upon remeasuring the previously held NCI (see Section 8.6.4).

BDO INSIGHTS — POTENTIAL LOSS ON REMEASUREMENT OF PREVIOUSLY HELD EQUITY INTERESTS

Although the guidance in ASC 805-10-25-10 indicates that the remeasurement of previously held equity interests may result in a gain or loss, we observe that the remeasurement typically does not result in a loss because investors are required to periodically evaluate their investments for impairment.

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[15] FAS 141(R), paragraph B366

5.5.1 Measuring the Fair Value of Previously Held Equity Interests

FASB REFERENCES

ASC 805-10-25-10

Although ASC 805 is clear that the acquirer's previously held equity interests in the acquiree must be remeasured at fair value, it is unclear whether the fair value measurement should incorporate a control premium. The question that arises is whether the acquirer's previously held equity interest and the newly acquired controlling interest in the acquiree are accounted for as a single (combined) unit of account or as separate units of account.

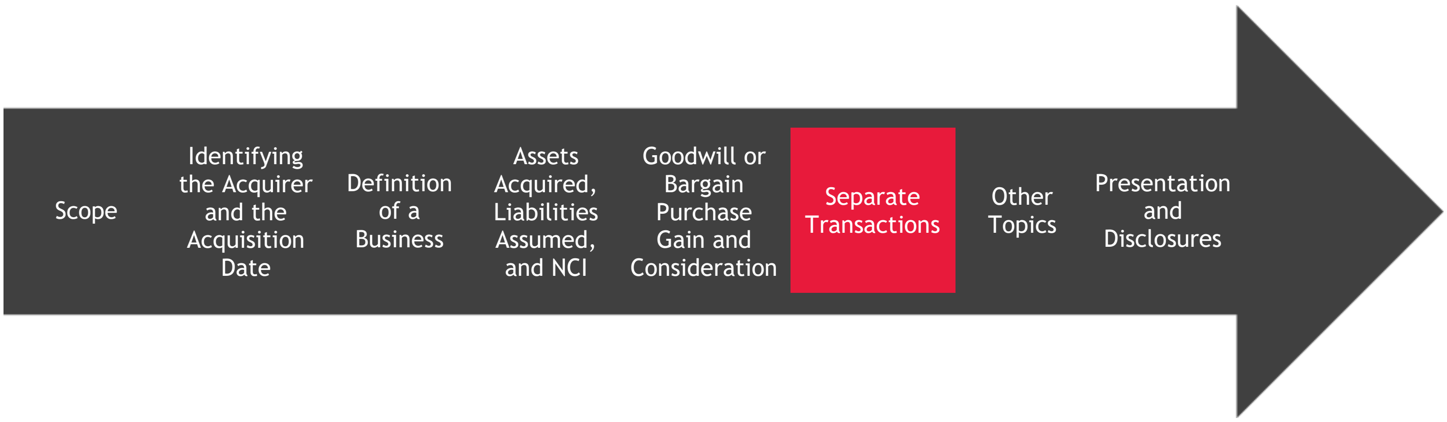
BDO INSIGHTS — REMEASUREMENT OF PREVIOUSLY HELD EQUITY INTERESTS AND CONTROL PREMIUM

If the acquirer accounts for its previously held equity interests and newly acquired controlling interest as a single unit of account, the valuation of the acquirer's previously held equity interest would be the same as the newly acquired controlling interests, which would include a control premium.

Conversely, if the previously held equity interests are accounted for as a separate unit of account, the entire control premium would be ascribed to the newly acquired controlling interests. As a result, the remeasurement of the acquirer's previously held equity interest would exclude a control premium.

The FASB Valuation Resource Group discussed whether a control premium should be included at its September 23, 2008, meeting. At that meeting, members of the FASB staff expressed their belief that measuring a previously held equity interest without a control premium is consistent with the FASB's intent in developing the business combination guidance. However, there has been no standard setting in response to these staff discussions, so there is diversity in practice in this area. Measuring a previously held equity interest requires the use of professional judgment and that different approaches may be reasonable depending on the facts and circumstances.

Chapter 6 - Transactions Separate From the Business Combination



6.1 OVERVIEW

An acquirer may enter various arrangements with the sellers or the acquiree in connection with a business combination. Such arrangements require analysis to determine whether they must be accounted for as part of, or separate from, the business combination. This is particularly important for transactions entered in close proximity to the business combination.

Determining whether an arrangement between the acquirer and a seller is separate from the business combination is important because business combination accounting does not apply to transactions that are separate from the acquisition. Instead, the acquirer accounts for a transaction that is separate from the business combination in accordance with other relevant U.S. GAAP. It may also be necessary to allocate a portion of the consideration transferred to the separate transaction (see Section 5.4.1).

ASC 805 provides a framework to assist the acquirer in identifying transactions that are separate from the business combination. Generally, arrangements that primarily benefit the acquirer or the combined entity are accounted for as separate transactions. Conversely, transactions that primarily benefit the acquiree or its former owners are typically part of the business combination.

6.2 DETERMINING WHAT IS PART OF THE BUSINESS COMBINATION

FASB REFERENCES

ASC 805-10-25-20 through 25-21 and ASC 805-10-55-18

An acquirer may enter various arrangements with the sellers or the acquiree in connection with a business combination. Such arrangements require analysis to determine whether they must be accounted for as part of, or separate from, the business combination. ASC 805 provides a core principle for identifying a transaction that is separate from the business combination, as noted in the following graphic:

Arrangement	Likely treatment
Arrangement primarily benefits the acquirer (or the combined entity)	Arrangement is likely to be separate from the business combination and accounted for under other U.S. GAAP.
Arrangement primarily benefits the acquiree (or its former owners) before the business combination	Arrangement is likely to be part of the business combination and accounted for under ASC 805.

ASC 805 provides the following additional factors to consider when analyzing whether a transaction is part of the business combination:

FACTOR	GUIDANCE
Reasons for the transaction	Understanding the reasons for the transaction may provide insight into whether the transaction is separate from the business combination. 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, that portion of the transaction price is less likely to be part of the exchange for the business.
Who initiated the transaction	Understanding who initiated the transaction may provide insight into whether the transaction is part of the exchange for the acquiree. A transaction or other event that is initiated by the acquirer may be entered into to provide future economic benefits to the acquirer or combined entity with little or no benefit received by the acquiree 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.
Timing of the transaction	The timing of the transaction may also provide insight into whether the transaction is part of the exchange for the acquiree. A transaction between the acquirer and acquiree that takes place during the negotiations for a business combination may have been entered into in contemplation of the business combination to provide future economic benefits to the acquirer or 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.

These factors are neither mutually exclusive, nor individually conclusive; rather, an acquirer must holistically evaluate them to reach a conclusion. Evaluating whether a transaction is separate from the business combination requires the application of professional judgment, based on facts and circumstances.

In addition to the general principle and factors above, ASC 805 lists the following specific transactions that must be accounted for separately:

- Reimbursing the acquiree for paying the acquirer's acquisition-related costs (see Section 6.3.2)
- Compensation for future services (see Section 6.4)
- Settlement of preexisting relationships (see Section 6.5)

These transactions and other arrangements are discussed in more detail in the sections that follow.

6.3 ACQUISITION-RELATED COSTS

FASB REFERENCES

ASC 805-10-25-23

Acquisition-related costs the acquirer incurs to effect a business combination include direct costs (such as, accounting, legal, and advisory fees), indirect costs (such as, maintaining a mergers and acquisitions department), and financing costs (such as, for debt and equity issuance).

Acquisition-related costs are not part of the consideration transferred for a business combination because they are not part of the fair value exchange between the buyer and seller for the business.[16] As a result, acquisition-related costs incurred for a business combination must be expensed as incurred. The only exception is for costs to issue debt and equity securities, which are be recognized in accordance with other applicable U.S. GAAP (see Section 6.3.1).

ACCOUNTING FOR TRANSACTION COSTS FOR AN ASSET ACQUISITION

The accounting for acquisition-related costs in a business combination is different than the accounting for transaction costs for an asset acquisition. Direct acquisition costs in an asset acquisition are generally capitalized as part of the cost of the acquired assets. See Appendix C for more guidance on asset acquisitions.

6.3.1 Allocating Acquisition-Related Costs Between Business Combination and Financing Transactions

FASB REFERENCES

ASC 805-10-25-23

ASC 805 indicates that costs to issue debt or equity securities are not expensed as acquisition-related costs; rather, they are recognized in accordance with other applicable U.S. GAAP. Debt issuance costs are generally recognized as a discount against the face amount of debt and amortized as interest expense over the term of the debt in accordance with ASC 835. Similarly, direct and incremental costs of issuing equity securities are generally recognized as a reduction of the gross proceeds from the offering in accordance with SEC Staff Accounting Bulletin (SAB) Topic 5.A.

In some cases, debt or equity issuance costs can be specifically identified; for example, if the counterparty only provides services related to a financing transaction but not to the business combination. In other cases, however, a counterparty may provide services that relate to both a financing transaction and the business combination. In such cases, it is necessary to allocate the costs between the separate transactions. The FASB has not provided specific guidance for allocating transaction costs between the separate transactions; however, in SAB Topic 2.A.6, the SEC staff has discussed a scenario in which an investment banker provided both advisory and underwriting services in connection with a business combination:

[16] FAS 141(R), paragraph B366

SEC STAFF GUIDANCE

Excerpt from SAB Topic 2.A.6, *Debt Issue Costs*

> *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.* [Footnotes omitted]

Based on this guidance, the acquirer must allocate the transaction costs between the acquisition-related costs of the business combination and the financing costs based on their relative fair values. The objective of the allocation is to ascribe the total fees incurred to the actual services provided by the counterparty.

6.3.2 Reimbursing the Acquiree or its Former Owners for the Acquirer's Acquisition-Related Costs

FASB REFERENCES

ASC 805-10-25-21

A transaction that reimburses the acquiree or its former owners for the acquirer's transaction costs is separate from the business combination. An acquirer accounts for any costs incurred by the acquiree on its behalf as such costs are incurred, based on their nature (for example, acquisition-related costs, debt issuance costs, or equity issuance costs) as discussed in Section 6.3.1.

Example 6-1 illustrates this concept.

EXAMPLE 6-1: COSTS RELATED TO REPRESENTATIONS AND WARRANTIES INSURANCE

FACTS

- Company A acquires 100% of Company B in a business combination.
- At the request of Company A, Company B purchases representations and warranties insurance for $10,000 with Company A named as the insured.
- The insurance is effective as of the acquisition date and covers losses resulting from Company B's breach of representations and warranties made in the purchase agreement.
- Coverage includes events occurring before or at the acquisition date.
- On the acquisition date, Company A reimburses Company B for the insurance costs.

CONCLUSION

The transaction to reimburse the acquiree or its former owners for paying the acquirer's acquisition-related costs is accounted for as a transaction separate from the business combination. As such, Company A must recognize an expense for the $10,000 insurance premium paid by Company B.

ANALYSIS

If Company A had purchased the insurance policy directly, the policy would be accounted for as an acquisition-related cost paid to a third-party, which must be expensed as incurred. Company A cannot circumvent the requirement to expense its acquisition-related costs by requiring Company B to purchase the insurance on Company A's behalf. Thus, because the insurance policy is for the benefit of Company A or the combined entity, the reimbursement of insurance costs is a transaction separate from the business combination. In this case, because the insurance is effective on the acquisition date and covers losses from events occurring before or at the acquisition date, Company A must expense the $10,000 insurance premium at the acquisition date.

6.3.3 Acquiree's Acquisition-Related Costs

An acquiree may incur transaction costs in connection with a business combination. Consistent with the accounting for acquisition-related costs incurred by the acquirer, the acquiree must expense its acquisition-related costs as incurred.

BDO INSIGHTS — ACQUIRER'S ACCOUNTING FOR ACQUIREE TRANSACTION COSTS PAID BY THE ACQUIRER

It is not uncommon for an acquirer to agree to pay for the acquiree's acquisition-related costs. In some instances, the acquirer pays the transaction costs at (or within a day or two of) the acquisition date. If this is the case, we believe the amounts paid to settle the transaction costs should generally be included as part of the consideration transferred, because the settlement represents a payment for the benefit of the sellers. In other instances, the acquirer may assume the liabilities incurred by the acquiree for its acquisition-related costs and settle them at a future date. If this is the case, the acquirer recognizes the assumed liabilities as part of the business combination, as with other assumed liabilities. Regardless of whether the acquiree's transaction costs are recognized as part of the consideration transferred or as an assumed liability, the effect on goodwill (or bargain purchase gain) is the same.

Examples 6-2 through 6-3A illustrate these concepts.

EXAMPLE 6-2: ACQUIREE'S ACQUISITION-RELATED COSTS

FACTS

- Company A acquires 100% of Company B in a business combination for $10 million in cash plus reimbursement of the acquiree's acquisition-related costs.
- Company B incurred $500,000 of sell-side due diligence expenses and $300,000 of legal and accounting expenses in connection with the business combination.
- Company B paid its sell-side due diligence expenses before the acquisition. However, Company A agreed to reimburse Company B for these expenses and remitted $500,000 to Company B's former owners on the acquisition date.
- Company B had accrued the legal and accounting fees at the acquisition date. Company A assumed the liability as part of the business combination and paid the $300,000 to the vendors two weeks after the acquisition.

CONCLUSION

Company A includes the $500,000 reimbursement for sell-side due diligence expenses as part of the consideration transferred and recognizes $300,000 in accrued legal and accounting fees as an assumed liability as part of the business combination.

ANALYSIS

The $500,000 payment to reimburse the sellers for sell-side due diligence expenses is part of the consideration transferred to the sellers. The total consideration transferred by Company A is $10.5 million.

The $300,000 for Company B's legal and accounting fees is recognized as an assumed liability as part of the business combination because it was not settled at (or within a day or two of) the acquisition date.

EXAMPLE 6-3: COSTS INCURRED FOR DIRECTORS' AND OFFICERS' (D&O) LIABILITY INSURANCE

FACTS

- Company A acquires 100% of Company B in a business combination for $10 million in cash.
- Before closing of the business combination, the sellers purchased and paid for a D&O insurance policy that provides coverage for matters related to the directors' and officers' service at the acquiree before the closing date of the acquisition. The decision to purchase of the insurance policy was made by the sellers, for their benefit, to make Company B more marketable to potential buyers.
- Claims under the D&O insurance policy can be made for up to three years following the closing date.

CONCLUSION

Company B recognizes the expense in its precombination financial statements. Company A does not recognize a prepaid expense as part of the business combination.

ANALYSIS

The D&O policy insures matters that occur in periods before the business combination. Even though the policy allows claims to be made for up to three years after the closing date, it does not provide any insurance coverage for matters that occur after the date of the business combination. Therefore, the cost of the insurance policy does not represent an asset as of the acquisition date and must be expensed as incurred in the acquiree's preacquisition financial statements.

EXAMPLE 6-3A: COSTS INCURRED FOR D&O LIABILITY INSURANCE

FACTS

Assume the same facts as in Example 6-3, except that the insurance policy is not purchased until after the acquisition date, when the acquirer decides to terminate some of the acquiree's officers. As such, the purchase of the insurance policy was for the benefit of the acquirer or the combined entity after the acquisition date.

CONCLUSION

Company A recognizes the expense as incurred in its postacquisition financial statements.

ANALYSIS

The D&O policy insures matters that occur in periods before the business combination. Even though the policy allows claims to be made for up to three years after the closing date, it does not provide any insurance coverage for matters that occur after the date of the business combination. Therefore, the cost of the insurance policy does not represent a prepaid expense. Because the costs were incurred for the acquirer's benefit, such costs must be expensed as incurred (immediately) in the acquirer's postacquisition financial statements.

6.3.4 Success Fees

An acquirer may agree to pay fees to third parties, such as advisors and investment bankers, that are contingent upon a successful closing of a business combination. Because such "success fees" are contingent upon the closing of the transaction, there is no obligation until the acquisition date, and an acquirer does not recognize a liability or an expense for them until the business combination has closed and the fees are earned. In other words, the success fees are recognized in the acquirer's financial statements in the period that includes the acquisition date.

An acquiree may also enter an arrangement that requires the payment of a success fee. If an acquiree prepares stand-alone financial statements and does not apply pushdown accounting after the business combination, the success fee incurred by the acquiree is similarly recognized in the acquiree's financial statements in the period that includes the acquisition date. However, if an acquiree elects pushdown accounting for its separate financial statements, there is diversity in practice for accounting for an acquiree's success fee. See Section A.9.1 in Appendix A for guidance on accounting for a success fee in the acquiree's separate financial statements when pushdown accounting is applied.

6.4 COMPENSATION ARRANGEMENTS

FASB REFERENCES

ASC 805-10-25-21(b)

Arrangements that compensate the acquiree's employees or former owners for future services are transactions separate from the business combination. ASC 805 does not provide accounting guidance for compensation arrangements, but it does require them to be accounted for separate from the acquisition. Therefore, an acquirer recognizes compensation in its postcombination financial statements in accordance with other U.S. GAAP. As such, the acquirer must evaluate each arrangement with the acquiree's employees or the sellers determine whether the arrangement is part of the business combination or if it should be accounted for separate from the business combination.

Arrangements that may compensate the acquiree's employees or the sellers for future services include (but are not limited to) the following:

- Employment agreements
- Consulting agreements
- Contingent payment arrangements
- Transition services agreements
- Share-based compensation arrangements

The following sections provide guidance for some common arrangements that an acquirer must analyze to determine whether the acquiree's employees or former owners will receive compensation for future services.

Acquiree's existing compensation arrangements (see Section 6.4.1)

Contingent payment arrangements with employees or selling shareholders (see Section 6.4.2)

Exchange of share-based payment awards in a business combination (see Section 6.4.3)

6.4.1 Acquiree's Existing Compensation Arrangements

An acquiree may have existing compensation arrangements with its employees that are contingent upon a business combination occurring or that accelerate payment in the event of a business combination. An acquirer must evaluate such arrangements to determine whether to recognize the related compensation in the postacquisition period or as part of the consideration transferred (or a liability assumed) in the business combination.

6.4.1.1 Change-in-Control Payments

FASB REFERENCES

ASC 805-10-55-34 through 55-36

An acquiree might have compensation arrangements that incentivize executives and key employees to remain employed through the date of a business combination or for a defined period after the business combination. For example, employees may receive payments contingent upon the closing of a business combination. Such arrangements may be referred to as “change-in-control payments,” “stay bonuses,” or “golden parachutes.” Change-in-control events may also trigger accelerated vesting for compensation arrangements, including share-based compensation arrangements.

An acquirer must account for these arrangements based on their substance. The acquirer must consider the factors in Section 6.2 to determine whether change-in-control payments must be recognized as compensation in the acquirer’s postcombination financial statements or as part of the consideration transferred (or liabilities assumed) in the business combination.

Examples 6-4 and 6-4A illustrate how to evaluate change-in-control payments.

EXAMPLE 6-4 (ADAPTED FROM ASC 805-10-55-34 THROUGH 55-35): ARRANGEMENT FOR CONTINGENT PAYMENT TO AN EMPLOYEE EXECUTED BEFORE NEGOTIATIONS FOR BUSINESS COMBINATION

FACTS

- Acquiree hired a chief executive officer (CEO) under a 10-year contract.
- The contract required Acquiree to pay the CEO $5 million if Acquiree is acquired before the contract expires.
- Acquirer acquires Acquiree eight years later.
- Acquiree’s CEO was still employed and thus receives the $5 million payment from the Acquirer at the closing of the business combination.

CONCLUSION

Acquirer recognizes the $5 million payment as part of the consideration transferred for the business combination.

ANALYSIS

Acquirer analyzes the change-in-control payment arrangement between Acquiree and its CEO, noting the following:

- **The reasons for the transaction***:* The purpose of the agreement was to obtain the CEO’s services.
- **Who initiated the transaction***:* Acquiree and CEO mutually negotiated the terms of the employment agreement, including the change-in-control payment.
- **The timing of the transaction***:* Acquiree entered into the employment agreement before the negotiations of the combination began.

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. Because the payment to the CEO was made at closing, Acquirer recognizes the $5 million payment as part of the consideration transferred for the acquisition. If the payment was not made at (or within a day or two of) the closing, it would have been recognized as an assumed liability.

EXAMPLE 6-4A (ADAPTED FROM ASC 805-10-55-34 THROUGH 55-36): ARRANGEMENT FOR CONTINGENT PAYMENT TO AN EMPLOYEE EXECUTED DURING NEGOTIATIONS FOR BUSINESS COMBINATION

FACTS

Assume the same facts as Example 6-4, except that Acquiree's compensation arrangement with the CEO did not include the $5 million change-in-control payment. Rather, the provision was added to the contract during the negotiations for the business combination at the suggestion of Acquirer.

CONCLUSION

Acquirer recognizes the $5 million payment in its postcombination financial statements separately from the application of the acquisition method.

ANALYSIS

Acquirer analyzes the change-in-control payment arrangement between Acquiree and its CEO, noting the following:

- **The reasons for the transaction:** The purpose of the transaction is to provide severance pay to the CEO.
- **Who initiated the transaction:** Acquirer suggested that Acquiree amend the compensation arrangement to provide for the $5 million payment.
- **The timing of the transaction:** The agreement was executed during negotiations for the business combination.

Acquirer determines the change-in-control payment arrangement is primarily for the benefit of Acquirer or the combined entity rather than Acquiree or its former owners. Therefore, Acquirer accounts for the $5 million liability to pay the CEO in its postcombination financial statements separately from application of the acquisition method (as an expense).

6.4.1.2 Dual Trigger Payments

An acquiree's compensation arrangements may include clauses requiring payment or accelerated vesting if there is a change in control and a second defined triggering event (typically if employment is terminated within a defined period following the acquisition date). These arrangements are known as "dual trigger" arrangements, and acquirers must analyze these arrangements following the guidance in Section 6.2.

Because the decision to terminate employment (and therefore to incur the payment) is within the acquirer's control, the arrangement is primarily for the benefit of the acquirer or the combined entity (it reduces future costs). As a result, the acquirer recognizes the dual trigger payment (or accelerated vesting) in its postcombination financial statements as a transaction separate from the business combination.

Example 6-5 illustrates this concept.

EXAMPLE 6-5: DUAL TRIGGER AWARDS – TERMINATION OF EMPLOYMENT ON THE ACQUISITION DATE

FACTS

- Acquirer acquires Acquiree in a business combination transaction.
- Acquiree's chief people officer has an employment agreement that provides that her awards will vest upon a change in control if her employment is terminated (or she has a reduction in responsibilities or compensation) as a result of the transaction.
- Acquirer decides not to offer employment to the chief people officer.

CONCLUSION

Acquirer recognizes the acceleration of compensation cost in its postcombination financial statements.

ANALYSIS

Acquirer analyzes the dual trigger payment, noting the following:

- **The reasons for the transaction:** The purpose of the transaction is to provide severance pay to the chief people officer. Acquirer controls the decision to terminate the chief people officer’s employment and chooses not to offer employment to the executive to reduce future compensation costs.
- **Who initiated the transaction:** Acquirer controls the decision to terminate the employment of (or not offer employment to) the employee, so it initiates the transaction that triggers the acceleration of vesting.
- **The timing of the transaction:** Acquirer decides to terminate the employment of (or not offer employment to) the employee contemporaneously with the business combination.

Acquirer concludes that the accelerated vesting of the awards is primarily for the benefit of Acquirer or the combined company. As such, it recognizes the acceleration of compensation cost in its postcombination financial statements.

6.4.2 Contingent Payment Arrangements With Employees or Selling Shareholders

FASB REFERENCES

ASC 805-10-55-24 through 55-25

A business combination may include one or more contingent payment arrangements in which the acquirer agrees to pay additional amounts to the selling shareholders, contingent upon achieving specific targets or milestones (for example, revenue or EBITDA) after the acquisition date. Often, such arrangements require the selling shareholders to continue to provide services to the acquirer or combined entity, either as employees or through other arrangements (such as consulting arrangements and transition service agreements. The acquirer must evaluate each arrangement to determine whether it is contingent consideration for the business combination or a separate transaction, such as compensation for future services.

To determine whether a contingent payment arrangement is part of the consideration transferred or compensation, gaining an understanding of the factors discussed in Section 6.2 may be helpful, including:

- The reasons for the transaction
- Who initiated the transaction
- The timing of the transaction

Further, if it is unclear whether the contingent payment is part of the consideration transferred or compensation, ASC 805 provides the following additional factors to consider:

TOPIC	SECTION
Continuing Employment	Section 6.4.2.1
Duration of Continuing Employment	Section 6.4.2.2
Level of Compensation	Section 6.4.2.3
Incremental Payments to Employees	Section 6.4.2.4
Number of Shares Owned	Section 6.4.2.5
Linkage to the Valuation	Section 6.4.2.6
Formula for Determining Consideration	Section 6.4.2.7
Other Agreements and Issues	Section 6.4.2.8

6.4.2.1 Continuing Employment

FASB REFERENCES

ASC 805-10-55-25(a)

The terms of employment arrangements with the selling shareholders may indicate whether the substance of a contingent payment arrangement is consideration for the business combination or compensation for services. A contingent payment that is automatically forfeited if employment is terminated is compensation for postcombination services. On the other hand, an arrangement that is not affected by the termination of employment may indicate that the contingent payments are additional consideration rather than compensation.

AUTOMATIC FORFEITURE UPON TERMINATION OF EMPLOYMENT IS CONCLUSIVE

ASC 805-10-55-25(a) states "*A contingent consideration arrangement in which the payments are automatically forfeited if employment terminates is compensation for postcombination services.*" As such, if this is the case, no analysis of the other factors in ASC 805-10-55-25 is necessary, because the arrangement must be recognized as compensation in the postcombination period.

If payments are not automatically forfeited upon the termination of employment, the acquirer must evaluate the other factors to determine whether the contingent payment arrangement is consideration for the business combination or postcombination compensation.

Examples 6-6 through 6-8 illustrate these concepts.

EXAMPLE 6-6: PAYMENT CONTINGENT ON CONTINUING EMPLOYMENT WITH A “GOOD-LEAVER” CLAUSE

FACTS

- Acquirer acquires Acquiree in a business combination.
- Acquiree’s selling shareholders (founders) become employees of Acquirer after the acquisition.
- The founders will receive contingent payments based on meeting specified revenue and EBITDA targets if the founders are employed by Acquirer for 12 months after the acquisition date.
- If the founders resign without good reason or if their employment is terminated for cause, they will forfeit the contingent payments.
- If the founders leave for good reason or their employment is terminated without cause, the founders will still be entitled to receive the contingent payments if Acquiree achieves the specified revenue and EBITDA targets. This kind of clause is often referred to as a “good leaver” clause.

CONCLUSION

Because the founders would automatically forfeit the contingent payments upon one or more termination events, Acquirer must recognize the contingent payment arrangement as compensation in its postcombination financial statements.

ANALYSIS

Even though the founders will not automatically forfeit the contingent payments for some types of termination events (if they leave for good reason or their employment is terminated without cause), because they would automatically forfeit the contingent payments upon some termination events (if they resign without good reason or if their employment is terminated for cause), Acquirer must account for the contingent payments as postcombination compensation. In substance, Acquirer is compensating the founders for their future services, so it must recognize compensation expense over the 12-month service period. The fact that the founders could retain the contingent payments if they are “good leavers” does not change that conclusion.

BDO INSIGHTS — PORTION OF CONTINGENT PAYMENT ARRANGMENT TIED TO CONTINUING EMPLOYMENT

Sometimes, only a portion of a contingent payment arrangement is dependent upon the continuing employment of a selling shareholder. In other words, there may be a floor amount that will be paid regardless of whether the selling shareholder’s employment is terminated. In such instances, it may be appropriate to separate the arrangement into multiple units of account, recognizing the portion that is not subject to automatic forfeiture as contingent consideration (if the other factors in ASC 805-10-55-25 indicate that the contingent payment arrangement is not compensation) and recognizing the amount that is subject to automatic forfeiture upon termination as compensation.

Example 6-7 illustrates this concept.

EXAMPLE 6-7: PORTION OF CONTINGENT PAYMENT ARRANGEMENT TIED TO CONTINUING EMPLOYMENT

FACTS

- Acquirer acquires Acquiree in a business combination.
- Acquiree’s founder will continue as an employee of the combined company after the acquisition.
- None of the other selling shareholders will continue as employees.
- Acquirer pays the selling shareholders $15 per share of stock at the acquisition date and will pay an additional $1.50 per share if Acquiree’s revenues exceed a specified target within one year of the acquisition date.
- If the specified revenue target is met, the founder will receive an extra $1 per share if he is still employed one year after the acquisition date.

CONCLUSION

Only a portion of the contingent payment arrangement is subject to automatic forfeiture upon termination of employment, so we believe it is appropriate to evaluate the arrangement as multiple units of account.

ANALYSIS

The initial payment of $15 per share is noncontingent and is accounted for as consideration for the business combination. Because only a portion of the contingent payment arrangement is subject to automatic forfeiture upon termination of employment, we believe it is appropriate to evaluate the arrangement as multiple units of account.

- The contingent payment of $1.50 per share to all shareholders (including the founder) upon achievement of revenue target is not automatically forfeited upon the termination of employment; therefore, Acquirer must analyze the other factors in ASC 805-10-55-25 to determine whether to account for the payment as contingent consideration for the business combination or as compensation in the postcombination period.
- The extra contingent payment of $1 that will be paid to the founder if the revenue target is met and the founder is employed for one year is automatically forfeited if the founder's employment is terminated. As such, this portion of the contingent payment arrangement is accounted for as postcombination compensation of Acquirer.

BDO INSIGHTS — PAYMENT CONTINGENT ON CONTINUING EMPLOYMENT OF A SPECIFIC EMPLOYEE

Sometimes, a selling shareholder's contingent payment arrangement depends upon the continuing employment of another party. ASC 805 indicates that an arrangement in which payments are automatically forfeited if employment terminates is compensation for postcombination services. As such, even if the selling shareholders are not required to perform future service, if their payments are contingent upon another party's future service, the acquirer generally recognizes the entire contingent payment arrangement (including contingent payments to nonemployee selling shareholders) as compensation in its postcombination financial statements.

Example 6-7 illustrates this concept.

EXAMPLE 6-8: PAYMENT CONTINGENT ON CONTINUING EMPLOYMENT OF A SPECIFIC EMPLOYEE

FACTS

- Acquirer acquires Acquiree in a business combination from five selling shareholders.
- The five selling shareholders will each receive a $2 million payment contingent on achieving specified operational results within two years of the acquisition if Acquiree's CEO (one of the selling shareholders) remains employed for the two-year period.
- If the CEO resigns before the second anniversary, none of the five selling shareholders will receive the contingent payments.

CONCLUSION

Because the payments are contingent on continued employment (albeit one shareholder's employment), Acquirer recognizes the entire contingent payment arrangement (including contingent payments to nonemployee selling shareholders) as compensation in its postcombination financial statements.

ANALYSIS

ASC 805 indicates that a contingent consideration in which payments are automatically forfeited if employment terminates is compensation for postcombination services. Because all selling shareholders will forfeit their contingent payments if the CEO resigns within two years, the payments are contingent on continued employment (albeit one shareholder's employment). Therefore, we believe Acquirer should recognize the entire contingent payment arrangement (including contingent payments to nonemployee selling shareholders) as compensation in its postcombination financial statements.

We are aware of an alternative view under which only the CEO's contingent payment arrangement is accounted for as compensation because the other selling shareholders are not required to perform future services to retain their contingent payments. Under this view, Acquirer would evaluate the contingent payment arrangements for the remaining four shareholders considering all the factors in ASC 805-10-55-25 to determine whether the contingent payment arrangements are contingent consideration transferred for the business combination or postcombination compensation. If Acquirer determines that such contingent payment arrangements do not represent postcombination compensation, the fair value recognized for the contingent consideration must consider the probability of the CEO remaining employed by the combined company for two years.

Determining whether a contingent payment arrangement represents contingent consideration or postcombination compensation requires professional judgment based on the facts and circumstances.

6.4.2.1.1 Considering Whether There Is an In-Substance Service Period

FASB REFERENCES

ASC 718-20-55-87 through 55-92

BDO INSIGHTS — CONSIDERING WHETHER THERE IS AN IN-SUBSTANCE SERVICE PERIOD

When a selling shareholder who becomes an employee of the acquirer does not automatically forfeit the contingent payment upon termination of employment, we believe the acquirer should assess whether there is an in-substance service period indicating that the employee must provide services to earn the contingent payment.

An analysis of the following factors may indicate that a contingent payment arrangement contains an in-substance service period.

The acquiree's industry	The acquired business is in a very specialized industry, such that the employee is essential to the success of the acquired business. For example, the employee possesses expertise that is difficult to replace.
Earnings target	Earnings target is likely not achievable without the employee's continued employment of the employee.
Noncompete agreements	The employee has executed a legally enforceable noncompete agreement for a period that coincides with or is longer than the contingent payment period.
Size of contingent payment	The value of the contingent payment is significant compared to the upfront payment received by the selling shareholders.

No single factor is determinative, so all relevant factors must be considered. Determining whether a contingent payment arrangement includes an in-substance service period requires the application of professional judgment based on the facts and circumstances.

6.4.2.1.2 Last-Person-Standing Arrangements

An acquirer might grant share-based payment awards to a group of selling shareholders who become employees of the combined entity in which the awards for individual employees vest if they remain employed for a period of time. However, if an individual employee does not vest in the award (because he terminates employment), the forfeited shares are redistributed among the remaining selling shareholder employees in the group. Such an arrangement is typically referred to as a "last-person-standing" arrangement. For such arrangements, even though there may be no circumstances in which the acquirer can retain the contingent payments or share-based awards, because the vesting of the awards depends on continued employment, the arrangements are compensatory in nature and therefore, accounted for separately from the business combination as compensation.

When an award is forfeited by one employee and is redistributed to the remaining employees in the group, the acquirer accounts for the transaction as a forfeited award followed by the grant of a new award. In other words, the acquirer reverses previously recognized compensation expense for the forfeited award and follows the principles in ASC 718 to measure and recognize compensation expense for the newly granted awards over the requisite service period.

The payment form (for example cash or share-based payments) does not affect the accounting. Because the contingent payment arrangement is forfeited by an individual shareholder if employment is terminated, the arrangement is compensatory in nature.

Examples 6-9 and 6-10 illustrate this concept.

EXAMPLE 6-9: LAST-PERSON-STANDING ARRANGEMENT INVOLVING SHARE-BASED AWARDS

FACTS

- Company A acquires Company B in a business combination.
- Company B's five selling shareholders become employees of Company A.
- On the acquisition date, each of Company B's selling shareholders receives 200 equity-classified share-based payment awards. The grant date fair value of each award is $15.
- The awards cliff-vest upon the selling shareholders completing two years of service with Company A.
- Any selling shareholder employee whose employment is terminated before the vesting date forfeits the share-based awards, which are then evenly redistributed among the remaining employees in the group.
- Eighteen months after the acquisition date one of the employees in the group resigns. The fair value of the redistributed share-based awards is $20 at that date.
- The Acquirer's accounting policy is to account for forfeitures as they occur.

CONCLUSION

Company A accounts for the arrangement as compensation, separate from the business combination.

ANALYSIS

Because the share-based awards are forfeited by an individual shareholder if employment is terminated, the arrangement is compensatory in nature and must be accounted for separate from the business combination.

Compensation expense for the 18-month service period following the acquisition: Company A recognizes compensation expense of $11,250 in the 18 months following the acquisition date (five employees x 200 awards x $15 x 75% completed service).

Compensation expense reversed on the employee's resignation date: Upon the employee's resignation, Company A reverses $2,250 in compensation expense (one employee x 200 awards x $15 x 75% completed service).

Compensation expense recognized after the employee's resignation date: Each of the four remaining employees in the group receives 50 additional awards (200 forfeited awards evenly redistributed among the four remaining employees). Company A recognizes $3,000 of compensation over the remaining six months related to the original awards (four employees x 200 awards x $15 x 25% remaining service) and additional compensation of $4,000 over the six-month service period for the awards redistributed to the remaining employees in the group (four employees x 50 awards x $20 grant date fair value).

EXAMPLE 6-10: LAST-PERSON-STANDING ARRANGEMENT INVOLVING CONTINGENT CASH PAYMENT

FACTS

- Company A acquires Company B in a business combination.
- Company B's five selling shareholders become employees of Company A.
- The selling shareholders will each receive an additional $200,000 in cash if revenue and EBITDA targets are met.
- The selling shareholders must remain employed with Company A for two years to receive the payment.
- Any selling shareholder employee whose employment is terminated during the two-year period forfeits the contingent payment, which is then redistributed among the remaining employees in the group based on their preacquisition ownership percentages.
- One year after the acquisition date one of the employees in the group resigns.

CONCLUSION

Company A accounts for the arrangement as compensation, separate from the business combination.

ANALYSIS

Because each contingent payment is forfeited by an individual shareholder if employment is terminated, the arrangement is compensatory in nature and must be accounted for separate from the business combination.

6.4.2.2 Duration of Continuing Employment

FASB REFERENCES

ASC 805-10-55-25(b)

If the employment period for the selling shareholders coincides with or is longer than the contingent payment period, this may indicate that the contingent payment is in substance compensation for services. When evaluating duration of employment, we believe an acquirer should also consider whether noncompete agreements could create an in-substance service period (see Section 6.4.2.1.1).

6.4.2.3 Level of Compensation

FASB REFERENCES

ASC 805-10-55-25(c)

If the compensation of the selling shareholder employee is reasonable compared to the acquirer's other employees, this may indicate that the contingent payment is part of the consideration transferred. However, in evaluating this factor, an entity must take into account the responsibilities of the selling shareholders who became employees of the acquirer, which may differ due to factors such as experience, qualifications, and geographical area.

6.4.2.4 Incremental Payments to Employees

FASB REFERENCES

ASC 805-10-55-25(d)

If the selling shareholders who become employees of the combined entity will receive contingent payments that are greater than the contingent payments to be received by the selling shareholders that do not become employees, this may indicate that the payment is compensation for future services.

Example 6-11 illustrates this concept.

EXAMPLE 6-11: INCREMENTAL PAYMENTS TO EMPLOYEES

FACTS

- Company A acquires Company B in a business combination for $25 million in cash.
- Company B's CEO and COO (two of five selling shareholders) become employees of Company A. The remaining three selling shareholders do not become employees of Company A or provide any ongoing services.
- Before the transaction, each selling shareholder owned 20% of Company B.
- Each of the five selling shareholders will receive $500,000 in additional consideration if specified financial metrics are achieved within two years of the acquisition date.
- the CEO and COO will also each receive $1 million in incremental consideration if the financial metrics are achieved.
- The CEO and COO do not automatically forfeit any of their contingent payments if their employment is terminated during the two-year period.

CONCLUSION

Company A accounts for the $2 million of incremental payments that the CEO and COO can earn as compensation. The remaining contingent payments are part of the consideration transferred.

ANALYSIS

The CEO and COO each have the potential to receive an incremental $1 million during the earnout period. Therefore, Company A concludes that the $2 million ($1 million incremental payment x 2 selling shareholders) of incremental payments is compensation for services. The remaining $2.5 million in contingent payments ($500,000 x 5 selling shareholders) is part of the consideration transferred and must be recognized at fair value on the acquisition date.

6.4.2.5 Number of Shares Owned

FASB REFERENCES

ASC 805-10-55-25(e)

The relative number of shares owned by the selling shareholders who remain as employees may help indicate the substance of the arrangement. For example, if the selling shareholders who owned substantially all the acquiree's shares become employees of the combined entity, the contingent payment arrangement might be akin to a profit-sharing arrangement intended to compensate the employees for future services. On the other hand, if the selling shareholders who continue as employees owned only a small percentage of the acquiree's shares and all selling shareholders receive the same amount of contingent consideration on a per-share basis, that may indicate that the contingent payments are additional consideration for the business combination.

When determining preacquisition ownership percentages, the preacquisition ownership interests held by parties related to the selling shareholders (for example, family members) must also be considered. Determining whether parties are related to selling shareholders requires the use of professional judgment based on the facts and circumstances.

6.4.2.6 Linkage to the Valuation

FASB REFERENCES

ASC 805-10-55-25(f)

Understanding how a contingent payment arrangement is linked to the acquirer's valuation of the acquiree may be helpful in evaluating whether the contingent payment is consideration or compensation. For example, it is not uncommon for the acquirer and selling shareholders to have differences in opinions regarding the acquiree's value, but they may agree that the value is within a specified range (with the acquirer believing the value is at the low end of the range and the selling shareholders believing that the value is at the high end). In such cases, the acquirer may agree to pay initial consideration based on the low end of the range with additional consideration to be paid contingent upon the performance of the acquiree. If the contingent payment formula is designed to bridge the gap between the values at the low and high ends of the range, it may indicate that the contingent payment arrangement is consideration for the business combination.

On the other hand, if the contingent payment arrangement could potentially pay consideration greater than the high end of the range or is consistent with prior profit-sharing arrangements, that may indicate that the substance of the arrangement is to provide compensation.

6.4.2.7 Formula for Determining Contingent Consideration

FASB REFERENCES

ASC 805-10-55-25(g)

The formula used to determine the contingent payment may be helpful in assessing the substance of the arrangement. For example, if the contingent payment is calculated as a percentage of earnings, the contingent consideration could be akin to a profit-sharing arrangement to compensate employees for future services. Conversely, if the contingent payment is determined based on a multiple of earnings (or a similar target such as revenues or EBITDA), that may suggest that the formula is designed to verify the acquiree's fair value and that the contingent payment arrangement is additional consideration for the business combination.

6.4.2.8 Other Agreements and Issues

FASB REFERENCES

ASC 805-10-55-25(h)

An acquirer may enter separate arrangements (such as noncompete agreements, transition services agreements, and leases) with the selling shareholders at or near the acquisition date. The terms of such agreements may indicate that the contingent payments are for something other than consideration for the business combination. For example, if the payments required for those agreements are less than fair value, it may indicate that the contingent payment arrangement (or some portion thereof) is attributable to those arrangements. On the other hand, if the contractual payments for those arrangements are at fair value, it may indicate that the contingent payment arrangement is consideration for the business combination.

The income tax treatment of contingent payments might indicate whether the contingent payment is part of the consideration transferred or compensation. For example, an acquirer might characterize contingent payments as compensation so the payments can be deducted on the tax return. If the deduction is supportable, this would likely indicate that the contingent payments are also compensation for accounting purposes.

6.4.2.8.1 Noncompete Agreements

In connection with a business combination, an acquirer may enter noncompete agreements with the sellers. Because noncompete agreements with the sellers are generally entered for the benefit of the acquirer and do not represent the assumption of an existing contract, they are often accounted for as transactions separate from the business combination (see Section 4.4.2.7.5.1.3). However, in paragraph BC 19 of ASU 2014-18, the FASB acknowledged that there may be diversity in views regarding whether noncompete agreements should be accounted for as part of the business combination or as a separate transaction, but that such diversity has not resulted in significantly different outcomes.

See Section 7.2.4.2 for additional guidance for entities that elect the private company alternative to not recognize specified intangible assets separately from goodwill.

6.4.2.8.2 Transition Service Agreements

An acquirer and seller sometimes enter a TSA in connection with a business combination in which the seller agrees to provide services for a defined period following the acquisition date to assist with the transition of the acquired business to the acquirer. Because such agreements compensate the former owners for future services, they are typically accounted for separate from the business combination. See Example 3-15 for an example of a contract with a seller that is accounted for separate from the acquisition transaction.

Because a TSA is typically accounted for separate from the business combination, the acquirer must assess whether the contractual amounts for the TSA are commensurate with the services provided. If the TSA is not priced at market rates, it would typically be appropriate to allocate a portion of the consideration for the business combination to the TSA as noted in the following graphic:

Services priced at market rates →	Acquirer generally accounts for the TSA based on the contractual amount.
Services priced below market rates →	Acquirer typically allocates a portion of the consideration transferred to the TSA (see Example 5-2).

6.4.2.9 Modifications of Contingent Payment Arrangements During the Measurement Period

FASB REFERENCES

ASC 805-10-55-18

Sometimes, an acquirer modifies a contingent payment arrangement during the measurement period. For example, the parties may modify the metrics that need to be met to increase the likelihood of the target being met. However, modifications do not affect the original conclusion of whether the contingent payment arrangement is separate from the business combination (unless there was an error in the original conclusion). As such, even if the original conclusion was that the contingent payment arrangement was part of consideration transferred for the business combination, the acquirer must evaluate whether the modification is a transaction separate from the business combination (see Section 6.2).

6.4.2.10 Selling Shareholders Share Proceeds With Acquiree's Employees

FASB REFERENCES

ASC 718-10-15-4

In some business combination transactions, the selling shareholders might direct the acquirer to distribute some of the initial or contingent consideration they are entitled to receive to non-shareholder employees. Unless the amounts shared with non-selling shareholders are clearly for a purpose other than compensation, acquirers must evaluate them using the guidance in Section 6.2 to determine whether such amounts are compensation that must be recognized by the acquirer.

6.4.3 Exchange of Share-Based Payment Awards in a Business Combination

FASB REFERENCES

ASC 805-30-30-9 through 30-10

In some business combinations, an acquirer may exchange its share-based payment awards for awards held by grantees of the acquiree. Such replacement awards are modifications in the scope of ASC 718. The replacement awards can be part of the consideration for the business combination, postcombination compensation, or a combination of both.

If the acquirer is obligated to replace the acquiree awards, either all or a part of the awards is included in the consideration for the business combination.

The acquirer has an obligation to replace the awards when replacement is required by **any** of the following:

- Terms of the acquisition agreement
- Terms of the acquiree's awards
- Applicable laws or regulations

If an acquirer has an obligation to replace the awards, it must determine what portion of the replacement awards is accounted for as consideration and what portion is recognized as postcombination compensation (see Sections 6.4.3.2 and 6.4.3.3).

Conversely, if the acquirer does not have an obligation to replace the awards, the full amount of the replacement awards must be recognized as compensation in the postcombination period.

An acquirer may also issue share-based payment awards concurrent with a business combination that are not replacement awards. Any such awards are accounted for as transactions separate from the business combination in accordance with ASC 718.

6.4.3.1 Measurement of Share-Based Payment Awards in a Business Combination

FASB REFERENCES

ASC 805-20-30-21, ASC 805-30-30-11 through 30-12, ASC 805-30-55-7, and ASC 805-30-55-10

As discussed in Section 5.4, entities generally measure the consideration for an acquiree at fair value; however, the portion of share-based replacement awards that are included in the consideration is measured in accordance with ASC 718.

When an acquirer is obligated to issue replacement awards, it must determine at the acquisition date the values of both the original acquiree awards and the replacement awards in accordance with ASC 718. The amount included in the consideration cannot exceed the ASC 718 fair value of the acquiree awards that were replaced. Any excess fair value is included in postcombination compensation.

Examples 6-12 and 6-13 illustrate this concept.

EXAMPLE 6-12 (ADAPTED FROM ASC 805-30-55-17 THROUGH 55-19): EMPLOYEE REPLACEMENT AWARDS – NO POSTCOMBINATION VESTING REQUIRED

FACTS

- Acquirer issues replacement awards with an ASC 718 value of $100 that it was obligated to issue to Acquiree’s employees at the acquisition date.
- Acquiree’s original employee awards have an ASC 718 value of $100 at the acquisition date.
- No postcombination vesting is required for the replacement awards.
- Acquiree's employees have rendered all the required service to vest in Acquiree’s original awards as of the acquisition date.

CONCLUSION

Acquirer includes $100 in the consideration for the business combination and recognizes compensation of $10 immediately in the postcombination financial statements.

ANALYSIS

As Acquiree’s employees have rendered the required service as of the acquisition date and no postcombination vesting is required, the portion attributable to precombination vesting is the entire ASC 718 value of the original awards ($100). Therefore, Acquirer includes $100 in the consideration.

Because the ASC 718 value of the replacement awards exceeds the ASC 718 value of the original awards by $10, Acquirer recognizes the excess as postcombination compensation. Because no postcombination vesting is required, Acquirer immediately recognizes the $10 compensation cost in its postcombination financial statements.

EXAMPLE 6-13 (ADAPTED FROM ASC 805-30-55-25 THROUGH 55-29): NONEMPLOYEE REPLACEMENT AWARDS – NO POSTCOMBINATION VESTING REQUIRED

FACTS

- Acquirer issues replacement awards with an ASC 718 value of $110 that it was obligated to issue to nonemployees of Acquiree at the acquisition date.
- Acquiree’s original nonemployee awards have an ASC 718 value of $100 at the acquisition date.
- No postcombination vesting is required for the replacement awards.
- The only vesting condition of the original awards was the delivery of engines to Acquiree. Acquiree’s grantees have delivered all engines necessary to vest in Acquiree’s original awards as of the acquisition date.

CONCLUSION

Acquirer includes $100 in the consideration and recognizes compensation of $10 immediately in the financial statements.

ANALYSIS

Because Acquiree’s grantees have delivered all engines necessary as of the acquisition date and no postcombination vesting is required, the portion attributable to precombination vesting is the entire ASC 718 value of the original awards ($100). Therefore, Acquirer includes $100 in the consideration.

Because the ASC 718 value of the replacement awards exceeds the ASC 718 value of the original awards by $10, Acquirer recognizes the excess as postcombination compensation. Because no postcombination vesting is required, Acquirer immediately recognizes the $10 compensation cost in its postcombination financial statements.

6.4.3.2 Allocation of Replacement Awards Between Consideration and Postcombination Compensation - Employee Awards

FASB REFERENCES

ASC 805-30-30-12, ASC 805-30-55-6 through 55-9, ASC 805-30-55-10, and ASC 805-30-55-13

As discussed in Section 6.4.3, when the acquirer is obligated to replace share-based payment awards, all or a part of the replacement awards may represent consideration for the business combination. As such, the acquirer must determine the appropriate amounts to allocate between consideration and postcombination compensation as shown in the following graphic:

Consideration →	The compensation attributable to precombination service is allocated to consideration for the business combination.
Postcombination compensation →	All compensation not attributable to precombination vesting (including any increases in fair value of the replacement awards compared to the original acquiree awards) is allocated to postcombination compensation.

The method of allocating the ASC 718 value of the replacement awards is the same for equity- and liability-classified awards.

ALLOCATION GUIDANCE IS DIFFERENT FOR NONEMPLOYEE AWARDS

The method for determining the portion attributable to consideration for the business combination and postcombination compensation for awards issued to nonemployees is different from the method involved in determining the allocation for employee awards. See Section 6.4.3.3 for guidance on determining the allocation for nonemployee awards.

6.4.3.2.1 Allocation to Precombination Vesting – Employee Awards

FASB REFERENCES

ASC 805-30-55-8 through 55-9

As noted in Section 6.4.3.2, the acquirer must first determine the amount of compensation attributable to precombination service, with all remaining compensation amounts of the replacement awards are attributable to postcombination compensation. The acquirer determines the amounts attributable to precombination service for employee awards as follows:

Precombination vesting percentage = Precombination service period ÷ Greater of total service period or service period of the original acquiree award

Amount attributable to precombination service (consideration)	=	ASC 718 value of the acquiree awards at the acquisition date	×	Precombination vesting percentage

This approach for allocating the ASC 718 value of the replacement awards between consideration and postcombination compensation cost is designed to limit the consideration to the amounts the employees had earned as of the acquisition date. If the replacement awards shorten the requisite service period, the calculation results in the acquirer recognizing the acceleration of vesting in the postcombination period because it is primarily for the benefit the acquirer or combined company. Similarly, if the acquirer increases the requisite service period, the calculation results in the acquirer recognizing a greater portion of the compensation in the postcombination period because the longer vesting period is also for the benefit of the acquirer or combined company.

The acquirer calculates the total service period as follows:

Total service period	=	Requisite service period for the original acquiree awards completed before the acquisition date	+	Postcombination requisite service period for the replacement award

6.4.3.2.2 Allocation to Postcombination Vesting – Employee Awards

FASB REFERENCES

ASC 805-30-55-10, ASC 805-30-55-17, and ASC 805-30-55-20 through 55-22

An acquirer calculates the amount attributable to postcombination compensation as follows:

Postcombination compensation	=	ASC 718 value of the replacement awards at the acquisition date	−	Amount attributable to precombination service (consideration)

Examples 6-14 and 6-15 illustrate the calculation of amounts attributable to precombination service (consideration) and to postcombination compensation for employee replacement awards.

EXAMPLE 6-14 (ADAPTED FROM ASC 805-30-55-17 AND ASC 805-30-55-20): EMPLOYEE REPLACEMENT AWARDS - POSTCOMBINATION VESTING REQUIRED, ALL REQUISITE SERVICE RENDERED AT ACQUISITION DATE

FACTS

- Acquirer issues replacement awards with an ASC 718 value of $100 that it was obligated to issue to Acquiree's employees at the acquisition date.
- Acquiree's original employee awards also have an ASC 718 value of $100 at the acquisition date.
- The replacement awards require one year of postcombination vesting.
- At the original grant date, Acquiree's awards had a requisite service period of four years.
- Acquiree's employees had completed the requisite service period for the original awards before the acquisition date.
- Assume awards are equity classified and there is only an explicit service period.

CONCLUSION

Acquirer attributes $80 to consideration for the business combination and $20 to postcombination compensation.

ANALYSIS

Although Acquiree's employees had already rendered all the requisite service before the acquisition date under the terms of the original awards, because the replacement awards require one year of postcombination vesting, Acquirer must attribute a portion of them to postcombination compensation. Acquirer calculates the amounts attributable to consideration for the business combination and postcombination compensation as follows:

Total service period = 4 years (the portion of the requisite service period for the original acquiree awards completed prior to the acquisition date) + 1 year (the postcombination requisite service period for the replacement awards) = 5 years

Greater of the total service period or original service period of the acquiree's award = 5 years (total service period) > 4 years (service period of the original acquiree award)

Precombination vesting percentage = 4 years (precombination service period) / 5 years (total service period) = 80%

Amount attributable to precombination service (consideration) = 80% (precombination vesting) x $100 (ASC 718 value of the acquiree awards at the acquisition date) = $80

Amount attributable to postcombination compensation = $100 (ASC 718 value of replacement awards at the acquisition date) - $80 (amount attributable to precombination service (consideration)) = $20

Acquirer recognizes $20 as compensation in its postcombination financial statements over the postcombination requisite service period of one year in accordance with ASC 718.

EXAMPLE 6-15 (ADAPTED FROM ASC 805-30-55-17 AND ASC 805-30-55-21 THROUGH 55-22): EMPLOYEE REPLACEMENT AWARDS – POSTCOMBINATION VESTING REQUIRED, ALL REQUISITE SERVICE NOT RENDERED AT ACQUISITION DATE

FACTS

- Acquirer issues replacement awards with an ASC 718 value of $100 that it was obligated to issue to Acquiree's employees at the acquisition date.
- Acquiree's original employee awards also have an ASC 718 value of $100 at the acquisition date.
- The replacement awards require one year of postcombination vesting.
- At the original grant date, Acquiree's awards had a requisite service period of four years.
- As of the acquisition date, Acquiree's employees had rendered a total of two years of service since the grant date and would have had to render two additional years of service after the acquisition date for their awards to vest.
- Assume awards are equity classified and there is only an explicit service period.

CONCLUSION

Acquirer attributes $50 to consideration for the business combination and $50 to postcombination compensation.

ANALYSIS

Acquirer calculates the amounts attributable to consideration for the business combination and postcombination compensation as follows:

Total service period = 2 years (the portion of the requisite service period for the original acquiree awards completed before the acquisition date) + 1 year (the postcombination requisite service period for the replacement awards) = 3 years

Greater of the total service period or original service period of the acquiree's award = 3 years (total service period) < 4 years (service period of the original acquiree award)

Precombination vesting percentage = 2 years (precombination service period) / 4 years (service period of the original acquiree award) = 50%

Amount attributable to precombination service (consideration) = 50% (precombination vesting) x $100 (ASC 718 value of the acquiree awards at the acquisition date) = $50

Amount attributable to postcombination compensation = $100 (ASC 718 value of replacement awards at the acquisition date) - $50 (amount attributable to precombination service (consideration)) = $50

Acquirer recognizes $50 as compensation in its postcombination financial statements over the postcombination requisite service period of one year in accordance with ASC 718.

6.4.3.2.3 Forfeitures

FASB REFERENCES

ASC 805-30-55-11

ASC 718 allows entities to make an accounting policy election to estimate forfeitures for share-based awards or record the forfeitures as they occur. However, regardless of which policy has been elected, ASC 805 requires that the amount of the share-based awards attributable to consideration must reflect the acquirer's forfeiture estimate at the acquisition date. That means that even if an acquirer has elected a policy to account for forfeitures as they occur, it must still estimate forfeitures at the acquisition date. The amounts excluded from the consideration based on estimated forfeitures must be included in postcombination compensation. Also, any changes in forfeiture estimates are reflected as an adjustment to postcombination compensation as they occur (see Section 6.4.3.2.3.1).

FORFEITURE ESTIMATE AT ACQUISITION DATE IS REQUIRED - REGARDLESS OF ACCOUNTING POLICY

Regardless of whether an entity has elected a policy to estimate forfeitures or to recognize them as they occur, ASC 805 requires that the amount of the share-based awards attributable to consideration must reflect the acquirer's forfeiture estimate at the acquisition date. In other words, an acquirer is only allowed to include amounts as consideration for awards that are expected to vest. For example, if $100 represents the share-based awards attributable to precombination service and estimated forfeitures are 10%, the acquirer would include only $90 in the consideration — even if it has elected an accounting policy to recognize forfeitures as they occur. Entities may need to use the acquiree's historical employee data and consider the acquisition's impact when estimating forfeitures.

Examples 6-16 and 6-16Aillustrate how the acquirer's policy for accounting for forfeitures impacts the accounting for replacement awards.

EXAMPLE 6-16: EMPLOYEE REPLACEMENT AWARDS - ACQUIRER'S POLICY IS TO ESTIMATE FORFEITURES

FACTS

- Acquirer issues replacement awards with an ASC 718 value of $500 that it was obligated to issue to Acquiree's employees at the acquisition date.
- Acquiree's original employee awards have an ASC 718 value of $500 at the acquisition date.
- The replacement awards require one year of postcombination service.
- At the original grant date, Acquiree's awards had a requisite service period of five years.
- As of the acquisition date, Acquiree's employees had rendered a total of four years of service since the grant date and would have had to render one additional year of service after the acquisition date for their awards to vest.

- Acquirer estimates that 80% of Acquiree's employees will render the remaining service and 20% will forfeit the awards before the end of the service period.
- Acquirer has an accounting policy to estimate expected forfeitures.

CONCLUSION

Acquirer estimates total share-based compensation of $400 (ASC 718 value of the replacement awards at the acquisition date of $500 less 20% estimated forfeitures) and attributes $320 to consideration for the business combination and $80 to postcombination compensation.

ANALYSIS

Acquirer calculates the amounts attributable to consideration for the business combination and postcombination compensation as follows:

Total service period = 4 years (the portion of the requisite service period for the original acquiree awards completed before the acquisition date) + 1 year (the postcombination requisite service period for the replacement awards) = 5 years

Greater of the total service period or original service period of the acquiree's award = 5 years (total service period) = 5 years (service period of the original acquiree award)

Precombination vesting percentage = 4 years (precombination service period) / 5 years (total service period) = 80%

Amount attributable to precombination service (that is, consideration) = 80% (precombination vesting) x $500 (ASC 718 value of the acquiree awards at the acquisition date) x 80% (awards expected to vest after estimated forfeitures) = $320

Amount attributable to postcombination compensation = $400 (ASC 718 value of replacement awards at the acquisition date of $500 less 20% estimated forfeitures) - $320 (amount attributable to precombination service) = $80

Acquirer recognizes $80 as compensation in its postcombination financial statements over the postcombination requisite service period of one year in accordance with ASC 718. Any changes in forfeiture estimates are reflected as an adjustment to compensation as they occur.

EXAMPLE 6-16A: EMPLOYEE REPLACEMENT AWARDS – ACQUIRER'S POLICY IS TO RECOGNIZE FORFEITURES AS THEY OCCUR

FACTS

Assume the same facts as Example 6-16, except that Acquirer has an accounting policy to recognize forfeitures as they occur.

CONCLUSION

Acquirer attributes $320 to consideration for the business combination and $180 to postcombination compensation. It accounts for forfeitures in the period in which they occur.

ANALYSIS

Acquirer calculates the amounts attributable to consideration for the business combination and postcombination compensation as follows:

Total service period = 4 years (the portion of the requisite service period for the original acquiree awards completed before the acquisition date) + 1 year (the postcombination requisite service period for the replacement awards) = 5 years

Greater of the total service period or original service period of the acquiree's award = 5 years (total service period) = 5 years (service period of the original acquiree award)

Precombination vesting percentage = 4 years (precombination service period) / 5 years (total service period) = 80%

Amount attributable to precombination service (consideration) = 80% (precombination vesting) x $500 (ASC 718 value of the acquiree awards at the acquisition date) x 80% (awards expected to vest after estimated forfeitures) = $320

Amount attributable to postcombination compensation = $500 (ASC 718 value of replacement awards) - $320 (amount attributable to precombination service) = $180

Acquirer recognizes $180 as compensation in its postcombination financial statements over the postcombination requisite service period of one year in accordance with ASC 718. It accounts for forfeitures in the period in which they occur.

6.4.3.2.3.1 Changes in Forfeiture Estimates or Actual Forfeitures in the Postcombination Period

FASB REFERENCES

ASC 805-30-55-11

An acquirer must recognize actual forfeitures (if it has elected a policy to recognize forfeitures as they occur) or changes in forfeiture assumptions (if it has elected a policy to estimate forfeitures) after the acquisition date as compensation in the postcombination period rather than as adjustments to consideration for the business combination (unless they represent valid measurement period adjustments). However, there is diversity in practice on how an acquirer reflects those changes if there is an increase in actual or estimated forfeitures compared to the expected forfeitures that were estimated at the acquisition date.

BDO INSIGHTS — ACCOUNTING POLICY ELECTION FOR ACCOUNTING FOR INCREASE IN FORFEITURES

ASC 805 requires that actual forfeitures (if the acquirer has elected a policy to recognize forfeitures as they occur) or changes in forfeiture assumptions (if the acquirer has elected a policy to estimate forfeitures) after the acquisition date be recognized as adjustments to compensation in the postcombination period. However, neither ASC 805 nor ASC 718 specifically addresses how an acquirer reflects an increase in actual forfeitures (or forfeiture estimates above the expected forfeitures that were estimated at the acquisition date). An increase in actual forfeitures (or forfeiture estimates) results in the reversal of previously recognized compensation, which raises a question about whether the acquirer can reverse compensation that was not recognized in the postcombination financial statements (because the compensation was attributed to precombination service). In this regard, we believe an acquirer can make **one** of the following accounting policy elections (which should be consistently applied):

- Reverse only compensation that was attributed to postcombination compensation and recognized in the postcombination period.
- Reverse compensation regardless of whether it was attributed to precombination service or postcombination compensation, which can result in a reversal of amounts that exceed the compensation previously recognized in the postcombination financial statements.

6.4.3.2.4 Graded Vesting

FASB REFERENCES

ASC 805-30-55-12

For share-based awards that vest solely based on service conditions, ASC 718 allows an entity to make an accounting policy election to recognize compensation expense for awards with graded vesting provisions, either using a graded vesting method (treating each tranche of the award as a separate unit of account) or on a straight-line basis over the requisite service period of the award (treating the entire award as a single unit of account). ASC 805 requires that an acquirer recognize compensation for its replacement awards based on the acquirer's existing accounting policy election. The acquiree's accounting policy election is irrelevant. If the acquirer did not previously have any graded vesting awards, it may make an accounting policy election on the acquisition date; it is not required to adopt the acquiree's policy.

The acquirer's accounting policy election affects the determination of the compensation attributable to precombination service (consideration) and postcombination compensation (see Sections 6.4.3.2.1 and 6.4.3.2.2).

Example 6-17 illustrates the calculation when the acquirer's accounts for compensation using the graded-vesting method.

EXAMPLE 6-17: REPLACEMENT AWARDS WITH GRADED VESTING - DETERMINING ATTRIBUTION BETWEEN PRECOMBINATION SERVICE AND POSTCOMBINATION COMPENSATION - ACQUIRER'S POLICY IS TO RECOGNIZE COMPENSATION USING GRADED-VESTING METHOD

FACTS

- Acquirer issues replacement awards with an ASC 718 value of $1,000 that it was obligated to issue to Acquiree's employees at the acquisition date.
- Acquiree's original employee awards also have an ASC 718 value of $1,000 at the acquisition date.
- The replacement awards require one year of postcombination vesting.
- At the original grant date, Acquiree's awards would vest 20% each year for five years.
- As of the acquisition date, Acquiree employees had rendered a total of four years of service since the grant date and would have had to render one additional year of service after the acquisition date for their awards to vest.
- Assume awards are equity classified and there is only an explicit service condition.
- Acquiree had elected to record compensation for awards with graded vesting provisions on a straight-line basis before the acquisition.
- Acquirer elects to recognize compensation for awards with graded vesting provisions based on the accelerated graded-vesting approach.
- Acquirer expects 100% of the awards to vest.

CONCLUSION

Acquirer attributes $960 to consideration for the business combination (based on its election to use the graded-vesting approach) and $40 to postcombination compensation.

ANALYSIS

Acquirer calculates the amounts attributable to consideration for the business combination and postcombination compensation as follows:

Amount attributable to precombination service (consideration) = $960 (precombination vesting of ASC 718 value of the original acquiree awards as of the acquisition date, as calculated in the table):

	COMPENSATION FOR EACH TRANCHE	YEAR 1	YEAR 2	YEAR 3	YEAR 4	CUMULATIVE COMPENSATION BEFORE TRANSACTION
Tranche 1	$ 200	$ 200	$ —	$ —	$ —	$ 200
Tranche 2	200	100	100	—	—	200
Tranche 3	200	67	67	66	—	200
Tranche 4	200	50	50	50	50	200
Tranche 5	200	40	40	40	40	160
Total	**$ 1,000**	**$ 457**	**$ 257**	**$ 156**	**$ 90**	**$ 960**

Amount attributable to postcombination compensation = $1,000 (ASC 718 value of replacement awards at the acquisition date) - $960 (amount attributable to precombination service (consideration)) = $40

Acquirer recognizes $40 as compensation in its postcombination financial statements over the postcombination requisite service period of one year in accordance with ASC 718.

6.4.3.2.5 Exchange of Awards With Performance Conditions

FASB REFERENCES

ASC 805-30-55-12

For the exchange of share-based awards with performance conditions, the same model applies for attributing the awards to precombination service (consideration) or postcombination compensation that was discussed in Sections 6.4.3.2.1 and 6.4.3.2.2. However, when determining the service periods to use in the calculation, the acquirer must consider the implicit or derived service period of the original acquiree awards and the replacement awards. The acquirer must also consider the probability for achieving the performance condition at the acquisition date; no amounts are allocated to consideration for awards that are not probable of vesting at the acquisition date. Any changes in the probabilities of achieving the performance condition after the acquisition date are reflected as adjustments to postcombination compensation, and not as adjustments to the consideration for the business combination.

NO AMOUNTS ALLOCATED TO CONSIDERATION IF ACHIEVEMENT OF PERFORMANCE CONDITION IS NOT PROBABLE

If, at the acquisition date, an acquirer determines that it is not probable that the performance condition in a share-based award will be achieved, it does not allocate any amounts to precombination service (consideration). If it becomes probable that the performance condition will be achieved, the acquirer recognizes the full ASC 718 acquisition-date value of the replacement award as postcombination compensation in accordance with ASC 718. In other words, the acquirer does not adjust the consideration for the business combination.

Examples 6-18 and 6-18A illustrate the accounting for replacement awards with a performance condition.

EXAMPLE 6-18: REPLACEMENT AWARDS WITH A PERFORMANCE CONDITION

FACTS

- Acquirer issues replacement awards with an ASC 718 value of $500 that it was obligated to issue to Acquiree's employees at the acquisition date.
- Acquiree's original employee awards have an ASC 718 value of $400 at the acquisition date and cliff-vest if Acquiree achieves specified cumulative sales.
- The replacement awards contain the same performance condition as Acquiree's original awards.
- Before the acquisition, Acquiree considered it probable that the cumulative sales target will be achieved four years after the award's grant date.
- At the acquisition date (which was two years after the grant date) Acquirer determined that it is probable the cumulative sales target will be achieved one year after the acquisition date (three years after the grant date).

CONCLUSION

Acquirer attributes $200 to consideration for the business combination and $300 to postcombination compensation.

ANALYSIS

Acquirer calculates the amounts attributable to consideration for the business combination and postcombination compensation as follows:

Total service period = 2 years (the portion of the requisite service period for the original acquiree awards completed before the acquisition date) + 1 years (the postcombination requisite service period for the replacement awards) = 3 years

Greater of the total service period or original service period of the acquiree's award = 3 years (total service period) < 4 years (service period of the original acquiree's award)

Precombination vesting percentage = 2 years (precombination service period) / 4 years (service period of the original acquiree award) = 50%

Amount attributable to precombination service (consideration) = 50% (precombination vesting) x $400 (ASC 718 value of the acquiree awards at the acquisition date) = $200

Amount attributable to postcombination compensation = $500 (ASC 718 value of replacement awards at the acquisition date) - $200 (amount attributable to precombination service) = $300

Acquirer recognizes $300 as compensation in its postcombination financial statements over the postcombination requisite service period of one year in accordance with ASC 718.

EXAMPLE 6-18A: REPLACEMENT AWARDS WITH A PERFORMANCE CONDITION

FACTS

Assume the same facts as Example 6-18, except that at the acquisition date, Acquirer determined that it is not probable that the sales targets will be met. Therefore, it is not probable that the award will vest.

CONCLUSION

Acquirer attributes $500 to postcombination compensation and recognizes it in accordance with ASC 718 once the award becomes probable of vesting.

ANALYSIS

Because it is not probable that the award will vest, no amounts are allocated to precombination vesting. Acquirer must allocate the entire acquisition-date fair value of the replacement award to postcombination compensation and recognize it in accordance with ASC 718 once the award becomes probable of vesting.

6.4.3.2.5.1 Changes in Probability of Achieving a Performance Condition in the Postcombination Period

FASB REFERENCES

ASC 805-30-55-12

An acquirer must recognize changes to the probability of achieving a performance condition in the postcombination period rather than as adjustments to consideration for the business combination (unless they represent valid measurement period adjustments). However, there is diversity in practice on how an acquirer reflects such changes if there is a decrease in the number of awards that vest (or are expected to vest).

BDO INSIGHTS — ACCOUNTING POLICY ELECTION FOR CHANGE IN PROBABILITY THAT REDUCES THE NUMBER OF AWARDS PROBABLE OF VESTING

ASC 805 requires that changes in the probability of achieving a performance condition after the acquisition date be recognized as an adjustment to compensation in the postcombination period. However, it does not specifically address how an acquirer reflects c reductions in the number of awards that are probable of vesting (for example, because a performance condition that was probable of being achieved at the acquisition date is no longer probable). A decrease in the number of awards that are probable of vesting results in the reversal of previously recognized compensation, which raises a question about whether the acquirer can reverse compensation that was not recognized in the postcombination financial statements (because the compensation was attributed to precombination service). We believe an acquirer can make **one** of the following accounting policy elections (which should be consistently applied):

- Reverse only compensation that was attributed to postcombination vesting and recognized as compensation in the postcombination period.
- Reverse compensation regardless of whether it was attributed to precombination or postcombination vesting, which can result in a reversal amount that exceeds the compensation previously recognized in the postcombination financial statements.

6.4.3.2.6 Exchange of Awards With Market Conditions

FASB REFERENCES

ASC 805-30-55-12

For the exchange of share-based replacement awards with market conditions, the same model applies for attributing the awards to precombination service (consideration) or postcombination compensation that was discussed in Sections 6.4.3.2.1 and 6.4.3.2.2. However, when determining the service periods to use in the calculation, the acquirer must consider the explicit or derived service period of the original acquiree awards and the replacement awards. Market conditions also affect the fair value of the acquiree awards and replacement awards.

AWARDS WITH MARKET CONDITIONS - COMPENSATION COST IS NOT REVERSED WHEN REQUIRED SERVICE HAS BEEN RENDERED

Unlike for awards with performance conditions, an entity does not reverse compensation for an award with market conditions when all required services have been rendered. If grantees have rendered the required service, an entity must recognize postcombination compensation even if the market condition is not achieved.

6.4.3.2.7 Acquirer Does Not Replace Acquiree's Share-Based Payment Awards

FASB REFERENCES

ASC 805-30-30-1

In some acquisitions, an acquirer may not replace the acquiree's awards, which remain outstanding after the acquisition date. For example, this could occur if the acquirer does not have an obligation to issue replacement awards and the acquiree becomes a separate subsidiary of the acquirer. When such awards are equity classified, they represent noncontrolling interests in the subsidiary in the acquirer's financial statements.

BDO INSIGHTS — ACCOUNTING FOR ACQUIREE AWARDS THAT REMAIN OUTSTANDING AFTER THE COMBINATION

Although ASC 805-30-30-1 generally requires noncontrolling interests to be recognized at fair value (in accordance with ASC 820) at the acquisition date, we believe that unvested share-based awards should be measured consistent with replacement awards (in accordance with ASC 718). Additionally, we believe that if there are vesting requirements after the acquisition date, the acquirer should apply the guidance for replacement awards by analogy. In other words, the acquirer determines the amount attributable to precombination vesting following the guidance in Section 6.4.3.2.1 and records it as noncontrolling interest. The acquirer determines the amount attributable to postcombination compensation following the guidance in Section 6.4.3.2.2.

6.4.3.3 Allocation of Replacement Awards Between Consideration and Postcombination Compensation - Nonemployee Awards

FASB REFERENCES

ASC 805-30-55-9A through 55-10, ASC 805-30-55-25 through 55-27, and ASC 805-30-55-30 through 30-35

As with employee awards (see Section 6.4.3.2), an acquirer must determine the portion of nonemployee awards that relate to precombination service (consideration) and postcombination compensation. The acquirer must first determine the amount of compensation attributable to precombination service; all remaining compensation amounts of the replacement awards are attributable to postcombination compensation. The acquirer determines the amounts attributable to precombination service for nonemployee awards as follows:

Amount attributable to precombination vesting = ASC 718 value of the acquiree awards at the acquisition date × Precombination vesting percentage

The precombination vesting percentage is the portion of compensation the acquiree would have recognized had it paid for the goods and services in cash instead of paying with a nonemployee award. The precombination vesting percentage is the lower of either:

- Percentage that would have been recognized calculated based on the original vesting requirements of the nonemployee award
- Percentage that would have been recognized calculated based on the effective vesting requirements, which are equal to the services or goods provided before the acquisition date plus any additional postcombination services or goods required by the replacement award

An acquirer calculates the amount attributable to postcombination compensation as follows:

Postcombination compensation = ASC 718 value of the replacement awards at the acquisition date − Amount attributable to precombination vesting (consideration)

The acquirer recognizes the amount attributable to postcombination compensation in the same periods and the same manner as if it had paid cash for the goods and services instead of using the share-based award.

Examples 6-19 through 6-20A illustrate the calculation of amounts attributable to precombination service (consideration) and to postcombination compensation for nonemployee replacement awards.

EXAMPLE 6-19 (ADAPTED FROM ASC 805-30-55-25 THROUGH 55-26 AND ASC 805-30-55-30 THROUGH 31): NONEMPLOYEE REPLACEMENT AWARDS - POSTCOMBINATION VESTING REQUIRED, ORIGINAL VESTING CONDITIONS MET AT THE ACQUISITION DATE

FACTS

- Acquirer issues replacement awards with an ASC 718 value of $100 that it was obligated to issue to replace Acquiree's nonemployee awards at the acquisition date.
- Acquiree's original nonemployee awards also have an ASC 718 value of $100 at the acquisition date.
- The replacement awards require the grantee to deliver 10 additional engines after the acquisition date.
- At the original grant date, Acquiree's awards required the grantee to deliver a total of 40 engines to vest in the award.
- The grantee had met the vesting requirements for the Acquiree's original awards before the acquisition date because it had delivered all 40 required engines before that date.
- Assume the awards are equity classified and the only vesting requirements are to deliver engines.

CONCLUSION

Acquirer attributes $80 to consideration to the business combination and $20 to postcombination compensation.

ANALYSIS

The nonemployee grantee had delivered all the requisite goods prior to the acquisition date under the terms of the original awards. However, because the replacement awards require the delivery of another 10 engines postacquisition, Acquirer must attribute a portion of the awards to postcombination compensation. Acquirer calculates the amounts attributable to consideration for the business combination and postcombination compensation as follows:

Percentage that would have been recognized based on the original vesting requirements = 40 engines delivered / 40 total engines required = 100%

Percentage that would have been recognized based on the effective vesting requirements = 40 engines delivered preacquisition / 50 total engines required (40 engines delivered preacquisition plus 10 engines required postacquisition) = 80%

Precombination vesting percentage = 80% (lower of the two percentages)

Amount attributable to precombination service (consideration) = 80% (precombination vesting) x $100 (ASC 718 value of original awards) = $80

Amount attributable to postcombination compensation = $100 (ASC 718 value of replacement awards) - $80 (amount attributable to precombination service (consideration)) = $20

Acquirer recognizes $20 as compensation in its postcombination financial statements in accordance with ASC 718 as the remaining 10 engines are delivered.

EXAMPLE 6-20 (ADAPTED FROM ASC 805-30-55-25 THROUGH 55-26 AND ASC 805-30-55-32 THROUGH 33): NONEMPLOYEE REPLACEMENT AWARDS – POSTCOMBINATION VESTING REQUIRED, ORIGINAL VESTING CONDITIONS NOT MET AT THE ACQUISITION DATE

FACTS

- Acquirer issues replacement awards with an ASC 718 value of $100 that it was obligated to issue to replace Acquiree's nonemployee awards at the acquisition date.
- Acquiree's original nonemployee awards also have an ASC 718 value of $100 at the acquisition date.
- The replacement awards require the grantee to deliver 10 additional engines after the acquisition date.
- At the original grant date, Acquiree's awards required the grantee to deliver a total of 40 engines to vest in the award.
- The grantee had not met the vesting requirements for the Acquiree's original awards prior to the acquisition date because it had delivered only 20 of the 40 total engines required. Grantee would have been required to deliver an additional 20 engines after the acquisition date for the awards to vest.
- Assume the awards are equity classified and the only vesting requirements are to deliver engines.

CONCLUSION

Acquirer attributes $50 to consideration to the business combination and $50 to postcombination compensation. Acquirer recognizes $50 as compensation in its postcombination financial statements in accordance with ASC 718 as the remaining 10 engines are delivered.

ANALYSIS

Acquirer calculates the amounts attributable to consideration for the business combination and postcombination compensation as follows:

Percentage that would have been recognized based on the original vesting requirements = 20 engines delivered / 40 total engines required = 50%

Percentage that would have been recognized based on the effective vesting requirements = 20 engines delivered preacquisition / 30 total engines total required (20 engines delivered preacquisition plus 10 engines required postacquisition) = 66.67%

Precombination vesting percentage = 50% (lower of the two percentages)

Amount attributable to precombination service (consideration) = 50% (precombination vesting) x $100 (ASC 718 value of original awards) = $50

Amount attributable to postcombination vesting = $100 (ASC 718 value of replacement awards) - $50 (amount attributable to precombination service (consideration)) = $50

Acquirer recognizes $50 as compensation in its postcombination financial statements in accordance with ASC 718 as the remaining 10 engines are delivered.

EXAMPLE 6-20A (ADAPTED FROM ASC 805-30-55-25 THROUGH 55-26 AND ASC 805-30-55-34 THROUGH 35): NONEMPLOYEE REPLACEMENT AWARDS – NO POSTCOMBINATION VESTING REQUIRED, ORIGINAL VESTING CONDITIONS NOT MET AT ACQUISITION DATE

FACTS

Assume the same facts as Example 6-20, except that Acquirer exchanges replacement awards that require no postcombination vesting (no additional engines must be delivered to vest in the awards) for Acquiree's share-based awards.

CONCLUSION

Acquirer attributes $50 to consideration to the business combination and $50 to postcombination compensation and immediately recognizes $50 as compensation in its postcombination financial statements in accordance with ASC 718 because there is no postcombination vesting required.

ANALYSIS

Acquirer calculates the amounts attributable to consideration for the business combination and postcombination compensation as follows:

Percentage that would have been recognized based on the original vesting requirements = 20 engines delivered / 40 total engines required = 50%

Percentage that would have been recognized based on the effective vesting requirements = 20 engines delivered preacquisition / 20 engines total required (20 engines delivered preacquisition plus zero engines required postacquisition) = 100%

Precombination vesting percentage = 50% (lower of the two percentages)

Amount attributable to precombination service (consideration) = 50% (precombination vesting) x $100 (ASC 718 value of original awards) = $50

Amount attributable to postcombination compensation = $100 (ASC 718 value of replacement awards) - $50 (amount attributable to precombination service (consideration)) = $50

Acquirer immediately recognizes $50 as compensation in its postcombination financial statements in accordance with ASC 718 because there is no postcombination vesting required.

6.4.3.4 Acceleration of Vesting Upon Change in Control

The acquiree's awards may include provisions that accelerate vesting of the awards upon a change in control. In some cases, these change-in-control provisions are included in the original acquiree awards before negotiations of a business combination begins. In other cases, the awards are modified to include a change-in-control provision in contemplation of a business combination, sometimes at the request of the acquirer.

The acquirer's allocation to precombination service or postcombination compensation depends on the facts and circumstances regarding the change-in-control provisions. An acquirer must assess the timing of when such provisions were added to the awards and determine whether they are primarily for the benefit of the sellers or for the acquirer or combined company.

6.4.3.4.1 Automatic Vesting Upon Change in Control – Preexisting Provision

If an acquiree's awards contain preexisting provisions that require the awards to vest upon a change in control, the full ASC 718 value of the acquiree awards at the acquisition date is attributable to precombination service. If the ASC 718 value of the replacement awards exceeds the ASC 718 value of the acquiree awards, the excess value must be attributed to postcombination expense, as discussed in Section 6.4.3.1. The graphic below summarizes the accounting treatment when no postcombination vesting is required and the acquiree's awards contain preexisting automatic change-in-control provisions:

ASC 718 value of the replacement awards equals the ASC 718 value of acquiree awards at the acquisition date	The acquirer attributes the entire ASC 718 value of the acquiree awards to precombination service.
ASC 718 value of the replacement awards exceeds the ASC 718 value of acquiree awards at the acquisition date	The acquirer attributes the ASC 718 value of the acquiree awards to precombination service and the excess value as compensation in its postcombination financial statements.

6.4.3.4.2 Change-in-Control Provision Added in Contemplation of a Business Combination

If a change-in-control provision is added to an acquiree's awards in contemplation of a business combination, the acquirer must analyze facts and circumstances to determine whether the amendment is primarily for the benefit of the acquiree (or its former owners) or the acquirer (or the combined entity) (see Section 6.2). Generally, if a change-in-control provision is added to the original awards after the negotiations for a business combination have begun, there is a presumption that the modification is primarily for the benefit of the acquirer (or the combined entity); however, all facts and circumstances must be considered. If the modification is primarily for the benefit of the acquirer (or the combined entity), it is accounted for as a transaction separate from the business combination in accordance with ASC 718. In such case, if the awards vest upon close of the acquisition, the acquirer must immediately recognize the accelerated vesting as compensation in its postcombination financial statements.

Conversely, if the acquiree modified its awards to include a change-in-control provision before initiating discussions with the acquirer, that would likely indicate that the modification was for the acquiree's benefit. In such case, the guidance in Section 6.4.3.4.1 regarding a preexisting provision for automatic vesting upon change in control applies.

Example 6-21 illustrates this concept.

EXAMPLE 6-21: ORIGINAL AWARDS MODIFIED TO INCLUDE CHANGE-IN-CONTROL PROVISION

FACTS

- Acquirer issues replacement awards with an ASC 718 value of $100 that it was obligated to issue to Acquiree's employees at the acquisition date.
- Acquiree's original employee awards also have an ASC 718 value of $100 at the acquisition date.
- The replacement awards do not require postcombination vesting.
- After discussions with Acquirer had begun for the business combination, Acquiree added a provision to its awards that accelerates vesting upon a change in control.
- Acquiree's original awards cliff-vested upon completion of five years of service. The business combination occurred three years after the grant date.
- Anticipated forfeitures are ignored in this example.

CONCLUSION

Acquirer attributes $60 to consideration for the business combination and $40 to postcombination compensation.

ANALYSIS

Because the change-in-control provision was added to Acquiree's awards after discussions for the business combination had begun, Acquirer concluded that the acceleration of vesting is a transaction separate from the business combination. Acquirer calculates the amounts attributable to consideration for the business combination and postcombination compensation as follows:

Total service period = 3 years (the portion of the requisite service period for the original acquiree awards completed before the acquisition date) + 0 years (the postcombination requisite service period for the replacement awards) = 3 years.

Greater of the total service period or original service period of the acquiree's award = 3 years (total service period) < 5 years (service period of the original acquiree award)

Precombination vesting percentage = 3 years (precombination service period) / 5 years (service period of the original acquiree award) = 60%

Amount attributable to precombination service (that is, consideration) = 60% (precombination vesting) x $100 (ASC 718 value of the acquiree awards at the acquisition date) = $60

Amount attributable to postcombination compensation = $100 (ASC 718 value of replacement awards at the acquisition date) - $60 (amount attributable to precombination service (consideration)) = $40

Because no postcombination vesting is required, Acquirer immediately recognizes $40 as compensation in its postcombination financial statements in accordance with ASC 718.

6.4.3.4.3 Discretionary Change-in-Control Provisions

If vesting is accelerated for an acquiree's awards based on the discretion of either the acquirer or acquiree, the acceleration of vesting must be evaluated to determine whether it is primarily for the benefit of the acquiree (or its former owners) or the acquirer (or the combined company), as discussed in Section 6.2. When the decision to accelerate vesting is made by the acquirer (or if the acquirer must approve of the transaction), that indicates the acceleration is primarily for the benefit of the acquirer (or the combined entity) and is accounted for as a transaction separate from the business combination. In such case, the ASC 718 value of the acquiree awards related to the acceleration of vesting would be recognized as compensation in the acquirer's postcombination financial statements.

For example, if the acceleration of vesting is contingent on a change-in-control event and an additional event that is within the acquirer's control (a dual trigger payment), the expense related to the acceleration of vesting is recognized as compensation in the acquirer's postcombination financial statements. See Section 6.4.1.2 for guidance on dual trigger payments.

6.4.3.4.4 Acquirer Accelerates Vesting

FASB REFERENCES

ASC 805-30-55-17 and ASC 805-30-55-23 through 55-24

If an acquirer issues replacement awards that accelerate vesting or reduce the required postcombination service that would have otherwise been required for the acquiree awards to vest, the formula in Section 6.4.3.2.1 results in the acquirer recognizing the acceleration of vesting in the postcombination period because it is primarily for the benefit of the acquirer (or the combined company).

Example 6-22 illustrates this concept.

EXAMPLE 6-22 (ADAPTED FROM ASC 805-30-55-17 AND ASC 805-30-55-23 THROUGH 55-24): EMPLOYEE REPLACEMENT AWARDS -NO POSTCOMBINATION VESTING REQUIRED, ORIGINAL REQUISITE SERVICE NOT RENDERED AT ACQUISITION DATE

FACTS

- Acquirer issues replacement awards with an ASC 718 value of $100 that it was obligated to issue to Acquiree's employees at the acquisition date.
- Acquiree's original employee awards also have a fair value of $100 at the acquisition date.
- The replacement awards do not require any postcombination vesting.
- Acquiree's employees had not rendered all the requisite service as of the acquisition date.
- At the original grant date, Acquiree's awards had a requisite service period of four years. The terms of the Acquiree's awards did not include a provision that would accelerate vesting upon a change in control.
- As of the acquisition date, Acquiree employees had rendered a total of two years of service since the grant date and would have had to render two additional years of service after the acquisition date for their awards to vest.
- Assume the awards are equity classified and there is only an explicit service period.

CONCLUSION

Acquirer attributes $50 to consideration for the business combination and $50 to postcombination compensation.

ANALYSIS

Acquirer calculates the amounts attributable to consideration for the business combination and postcombination compensation as follows:

Total service period = 2 years (the requisite service period for the original acquiree awards completed before the acquisition date) + 0 years (the postcombination requisite service period for the replacement awards) = 2 years

Greater of the total service period or original service period of the acquiree's award = 2 years (total service period) < 4 years (service period of the original acquiree award)

Precombination vesting percentage = 2 years (precombination service period) / 4 years (service period of the original acquiree award) = 50%

Amount attributable to precombination service (consideration) = 50% (precombination vesting) x $100 (ASC 718 value of the acquiree awards at the acquisition date) = $50

Amount attributable to postcombination compensation = $100 (ASC 718 value of replacement awards at the acquisition date) - $50 (amount attributable to precombination service (consideration)) = $50

Because no postcombination vesting is required, Acquirer immediately recognizes $50 as compensation in its postcombination financial statements in accordance with ASC 718.

6.4.3.5 Cash Settlement of Acquiree Share-Based Payment Awards

BDO INSIGHTS — ACCOUNTING FOR CASH SETTLEMENT OF ACQUIREE AWARDS

An acquirer may decide to settle the acquiree's awards in cash or acquirer-issued notes instead of issuing replacement awards. ASC 805 does not explicitly address the accounting for cash settlement of share-based payment awards in a business combination; however, we believe that the acquirer should apply the principles for the exchange of share-based awards in a business combination to such situations. In other words, the acquirer must determine the amount of compensation attributable to precombination service (consideration) and postcombination compensation consistent with the principles discussed in Sections 6.4.3.2 and 6.4.3.3.

Following those principles, the acquirer typically includes cash settlements of share-based payment awards in the consideration for the business combination if:

- The fair value of the cash settlements is not greater than the ASC 718 value of the settled acquiree awards, **and**
- The settled acquiree awards were fully vested at the acquisition date (based on preexisting terms of the awards).

Otherwise, those principles result in amounts attributable to precombination service and postcombination compensation as follows:

Fair value of the cash settlement > ASC 718 value of settled awards at the acquisition date	→	The acquirer attributes the excess value as compensation in its postcombination financial statements.
Settled awards not fully vested at the acquisition date	→	Acquirer attributes compensation to precombination service and postcombination compensation by following the guidance in Sections 6.4.3.2 (employee awards) and 6.4.3.3 (nonemployee awards).

Even if it is the acquiree that initiates the settlement of an award, the acquirer must evaluate all facts and circumstances to determine whether the settlement is primarily for the benefit of the acquiree (or its former owners) or the acquirer (or combined company) (see Section 6.2).

Example 6-23 illustrates the cash settlement of acquiree share-based payments in a business combination.

EXAMPLE 6-23: CASH SETTLEMENT OF ACQUIREE SHARE-BASED PAYMENT AWARDS

FACTS

- Acquirer acquires Acquiree in a business combination and settles Acquiree's existing awards to employees for $110 in cash.
- Acquiree's original employee awards have an ASC 718 value of $100 at the acquisition date.
- At the original grant date, Acquiree's awards had a requisite service period of five years.
- As of the acquisition date, Acquiree's employees had rendered a total of three years of service since the grant date and would have had to render two additional years of service after the acquisition date for their awards to vest.
- Assume the awards are equity classified and there is only an explicit service period.

CONCLUSION

Acquirer attributes $60 to consideration for the business combination and $50 to postcombination compensation.

ANALYSIS

The cash settlement effectively accelerated the vesting of the awards. Acquirer calculates the amounts attributable to consideration for the business combination and postcombination compensation as follows:

Total service period = 3 years (the portion of the requisite service period for the original acquiree awards completed before the acquisition date) + 0 years (the postcombination requisite service period for the replacement awards) = 3 years

Greater of the total service period or original service period of the acquiree's award = 3 years (total service period) < 5 years (service period of the original acquiree award)

Precombination vesting percentage = 3 years (precombination service period) / 5 years (service period of the original acquiree award) = 60%

Amount attributable to precombination service (consideration) = 60% (precombination vesting) x $100 (ASC 718 value of the acquiree awards at the acquisition date) = $60

Amount attributable to postcombination vesting = $110 (fair value of cash settlement) - $60 (amount attributable to precombination service (consideration)) = $50

Because no postcombination vesting is required, Acquirer immediately recognizes $50 as compensation in its postcombination financial statements in accordance with ASC 718.

6.4.3.6 Income Tax Effects of Replacement Awards

FASB REFERENCES

ASC 805-740-25-10 through 25-11 and ASC 805-740-45-5

If the acquirer is expected to benefit from future tax deductions for its equity-classified share-based awards, it recognizes as part of consideration for the business combination a deferred tax benefit for the share-based payment amounts attributable to the consideration. For the amounts attributable to postcombination compensation, the acquirer recognizes a deferred tax benefit as it recognizes compensation in the postcombination financial statements. Further, ASC 805 requires that any differences between the actual deduction taken on a tax return and the deferred tax asset established using an ASC 718 value is recognized as income tax expense or benefit in the income statement of the acquirer (it is not recognized as an adjustment to the consideration for the business combination).

6.4.3.7 Payroll Taxes for Replacement Awards

FASB REFERENCES

ASC 718-10-25-22 through 25-23

An employer may be required to pay payroll taxes on the intrinsic value of nonqualified options on the exercise date and on the fair value of share awards on the vesting date. At the date of a business combination, the acquirer should not recognize a payroll tax liability unless the event triggering the tax liability has occurred. In the United States, the triggering event for non-qualified stock options is generally the exercise date, and for share awards it is typically the vesting date. As such triggering events typically occur after the acquisition date, the acquirer generally does not record a payroll tax liability for share-based awards as part of purchase accounting. Subsequently, when the triggering event occurs, the acquirer does not adjust the consideration for the business combination; rather, the accrual of payroll taxes is recognized as a current-period expense.

6.4.3.8 Postcombination Accounting for Share-Based Awards

FASB REFERENCES

ASC 805-30-35-3

After the acquisition date, an acquirer accounts for share-based awards attributable to future services in accordance with ASC 718. In other words, the acquirer follows ASC 718 to determine whether the award is equity- or liability-classified and to determine the attribution of compensation cost.

Similarly, if, in connection with a business combination, the acquirer issues new awards to its employees (including the former employees of the acquiree) rather than replacement awards, it accounts for the entire amount of the awards as compensation in the postcombination period in accordance with ASC 718 (that is, no amounts are attributable to precombination service).

If share-based awards are modified after the acquisition date, the acquirer must account for that in accordance with ASC 718, even if such modifications occur during the measurement period. Therefore, modifications to share-based awards that occur after the acquisition date do not affect the consideration for the business combination. Further, as discussed in Section 6.4.3.2.3.1 changes in actual forfeitures or forfeiture assumptions are typically recognized as compensation in the postcombination period.

Example 6-24 illustrates this concept.

EXAMPLE 6-24: MODIFICATION TO A CONTINGENT SHARE-BASED PAYMENT AFTER THE ACQUISITION DATE

FACTS

- Acquirer acquires Acquiree in a business combination.
- Acquirer will make share-based payments to Acquiree's selling shareholders over a period of two years, which coincides with the duration of employment contracts with the selling shareholders.
- The selling shareholders will not receive the share-based payments if they terminate employment before the vesting date.
- On the acquisition date, the acquirer determined the payments represent compensation because they are automatically forfeited if the selling shareholders do not remain employed for a specified period.
- Nine months after the acquisition date, Acquirer terminates the employment of the selling shareholders because their services were no longer needed, but it agrees to pay the share-based compensation payments.

CONCLUSION

Acquirer accounts for the modification of the share-based payment arrangement in the postcombination financial statements in accordance with ASC 718.

ANALYSIS

Because Acquirer properly determined at the acquisition date that the contingent share-based payments represent compensation under ASC 718, it does not revisit that assessment when an arrangement is modified, even if the modification occurs within the measurement period. As such, the modification does not affect the consideration for the business combination and is accounted for in the postcombination financial statements in accordance with ASC 718.

6.5 EFFECTIVE SETTLEMENT OF PREEXISTING RELATIONSHIPS BETWEEN ACQUIRER AND ACQUIREE

FASB REFERENCES

ASC 805-10-55-20 through 55-23

There may be contractual (for example, receivables and payables, purchase and supply arrangements, or leases) or noncontractual relationships (for example, disputes or litigation) between the acquirer and the acquiree that existed prior to the acquisition date, which are effectively settled on the acquisition date. For example, even if a contract is not legally cancelled as part of the business combination, after the business combination, the relationship between the parties becomes an intercompany relationship and the balances and transactions between the parties will eliminate in consolidation. If the business combination effectually settles a preexisting relationship, the acquirer recognizes a gain or loss because the settlement of a preexisting relationship is a transaction separate from the business combination (see Section 6.2). The accounting treatment for the effective settlement of a preexisting relationship between the acquirer and acquiree depends on whether the relationship is contractual or noncontractual.

6.5.1 Effective Settlement of a Noncontractual Preexisting Relationship

FASB REFERENCES

ASC 805-10-55-21(a) and ASC 805-10-55-22

Examples of noncontractual preexisting relationships include disputes and actual or threatened litigation. ASC 805 requires that an acquirer measure the gain or loss on the effective settlement of a noncontractual preexisting relationship at fair value.

Examples 6-25 and 6-25A illustrate the accounting for the effective settlement of noncontractual preexisting relationships.

EXAMPLE 6-25: EFFECTIVE SETTLEMENT OF NONCONTRACTUAL PREEXISTING RELATIONSHIP; PREVIOUSLY RECOGNIZED LIABILITY

FACTS

- Acquirer acquires Acquiree in a business combination for $10 million in cash.
- Before the acquisition, Acquirer was a defendant in a lawsuit filed by Acquiree for copyright infringements.
- Acquirer had accrued a loss contingency of $1 million for the litigation matter with Acquiree.
- As a result of the business combination, Acquirer and Acquiree have effectively settled the litigation on the acquisition date.
- Acquirer determined the fair value of the lawsuit on the acquisition date was $2 million.

CONCLUSION

Acquirer recognizes $2 million of the consideration as a transaction separate from the business combination, resulting in the reversal of a previous accrual of $1 million and a loss on litigation settlement of $1 million. The remaining $8 million ($10 million - $2 million) is accounted for as consideration for the business combination.

ANALYSIS

Acquirer has effectively settled a noncontractual preexisting relationship with Acquiree. Therefore, Acquirer includes the fair value of the litigation settlement and the liability already recorded when determining the loss on settlement. Acquirer recognizes a loss of $1 million ($2 million fair value less the $1 million already accrued).

Because the settlement of the noncontractual preexisting relationship is a transaction separate from the business combination, the consideration for Acquiree excludes the fair value of the settled litigation. Therefore, the consideration that Acquirer allocates to the acquired assets and assumed liabilities is $8 million ($10 million cash payment less the $2 million fair value of litigation settlement).

EXAMPLE 6-25A: EFFECTIVE SETTLEMENT OF NONCONTRACTUAL PREEXISTING RELATIONSHIP, NO PREVIOUSLY RECOGNIZED LIABILITY

FACTS

Assume the same facts as Example 6-25, except that Acquirer had not recognized a loss contingency before the acquisition because a loss was not probable and estimable.

CONCLUSION

Acquirer recognizes $2 million of the consideration as a transaction separate from the business combination, resulting in a loss on litigation settlement of $2 million. The remaining $8 million ($10 million - $2 million) is accounted for as consideration for the business combination.

ANALYSIS

Acquirer has effectively settled a noncontractual preexisting relationship with Acquiree. Therefore, Acquirer includes the fair value of the litigation settlement and the liability amounts already recorded when determining the loss on settlement. Acquirer recognizes a loss of $2 million ($2 million fair value less the $0 already accrued).

As the settlement of the noncontractual preexisting relationship is a transaction separate from the business combination, the consideration for Acquiree excludes the fair value of the settled litigation. Therefore, the consideration that Acquirer allocates to the acquired assets and assumed liabilities is $8 million ($10 million cash payment less the $2 million fair value of litigation settlement).

6.5.2 Effective Settlement of a Contractual Preexisting Relationships

FASB REFERENCES

ASC 805-10-55-21(b) through 55-22 and ASC 805-10-55-30 through 55-33

An acquirer determines the gain or loss on effective settlement of a contractual preexisting relationship as the lesser of **either**:

- The amount by which the contract is favorable or unfavorable from the acquirer's perspective when compared with pricing for current market transactions for the same or similar items. An unfavorable contract 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 but instead is a contract that is unfavorable in terms of current market terms.
- 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 the option above, the difference is included as part of the business combination accounting.

If the preexisting contract is cancelable without penalty, the stated settlement provision is zero, and the acquirer recognizes no settlement gain or loss. Conversely, if the contract is not cancelable and there are no stated settlement terms, the acquirer must recognize a gain or loss on the settlement based on the amount by which the contract is favorable or unfavorable to the acquirer (based on the settled contract's acquisition date fair value).

Examples 6-26 through 6-27A illustrate the accounting for the effective settlement of contractual preexisting relationships.

EXAMPLE 6-26: EFFECTIVE SETTLEMENT OF ACCOUNTS RECEIVABLE

FACTS

- Acquirer acquires Acquiree in a business combination for $10 million in cash.
- Acquiree was a customer of Acquirer before the business combination.
- Acquirer recognized $0.5 million in accounts receivable from Acquiree before the business combination. Acquiree had recognized accounts payable of $0.5 million before the business combination.

CONCLUSION

Acquirer does not recognize a gain or loss on the effective settlement of the accounts receivable balance from Acquiree.

ANALYSIS

Acquirer has effectively settled a contractual preexisting relationship with Acquiree. There are no stated settlement provisions in the contract and the contract is not favorable or unfavorable from the Acquirer's perspective, so Acquirer does not recognize a gain or loss on the settlement.

The consideration for Acquiree is $10.5 million ($10 million in cash plus "forgiveness" of $0.5 million of accounts receivable). Acquirer also does not include Acquiree's accounts payable to Acquirer in the liabilities assumed as part of the business combination due to its settlement against the related receivable.

EXAMPLE 6-27 (ADAPTED FROM ASC 805-10-55-30 THROUGH 55-32): EFFECTIVE SETTLEMENT OF A SUPPLY CONTRACT; NO ASSETS OR LIABILITIES PREVIOUSLY RECOGNIZED

FACTS

- Acquirer purchases electronic components from Acquiree under a five-year supply contract at fixed rates that are currently higher than rates at which Acquirer could purchase similar electronic components from another supplier.
- Acquirer can terminate the supply contract with Acquiree by paying a $6 million penalty.
- With three years remaining in the supply contract, Acquirer acquires Acquiree in a business combination for $50 million, which represents the Acquiree's fair value.
- The fair value of the supply contract is $8 million and is included in Acquiree's fair value of $50 million. The supply contract includes a $3 million at-market component and a $5 million component with pricing that is unfavorable to Acquirer.
- Acquiree has no other identifiable assets or liabilities related to the supply contract.
- Acquirer has not recognized any assets or liabilities related to the supply contract before the business combination.

CONCLUSION

Acquirer recognizes a loss of $5 million for the effective settlement of the supply contract with Acquiree.

ANALYSIS

Acquirer has effectively settled a contractual preexisting relationship with Acquiree. It recognizes a gain or loss on the settlement based on the lesser of the stated settlement amount ($6 million) and the amount by which the contract is unfavorable to Acquirer ($5 million) less any amounts previously recognized. As such, Acquirer recognizes a loss of $5 million ($5 million, the amount by which the contract is unfavorable to Acquirer, less the zero liability previously recognized). The consideration for Acquiree is $45 million ($50 million less the $5 million settlement of the unfavorable supply contract).

EXAMPLE 6-27A (ADAPTED FROM ASC 805-10-55-30 THROUGH 55-33): EFFECTIVE SETTLEMENT OF A SUPPLY CONTRACT, LIABILITIES PREVIOUSLY RECOGNIZED

FACTS

Assume the same facts as Example 6-27, except that Acquirer had previously recognized a liability of $6 million for the supply contract before the business combination.

CONCLUSION

Acquirer recognizes a gain of $1 million for the effective settlement of the supply contract with Acquiree.

ANALYSIS

Acquirer has effectively settled a contractual preexisting relationship with Acquiree. It recognizes a gain or loss on the settlement based on the lesser of the stated settlement amount ($6 million) and the amount by which the contract is unfavorable to Acquirer ($5 million) less any amounts previously recognized. As such, Acquirer recognizes a gain of $1 million ($5 million, the amount by which the contract is unfavorable to Acquirer, less $6 million liability 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. The consideration for Acquiree is $45 million ($50 million less the $5 million settlement of the unfavorable supply contract).

6.5.2.1 Effective Settlement of Debt Between the Acquirer and Acquiree

FASB REFERENCES

ASC 805-10-55-21(b) through 55-22

A business combination may result in the effective settlement of debt issued to the acquiree by the acquirer. In these situations, the acquirer must apply the guidance on debt extinguishment in ASC 470. If the carrying value of the debt is different from the reacquisition price (as determined based on the lower of the stated settlement provision and the amount that is favorable or unfavorable from the acquirer's perspective), the acquirer should recognize a gain or loss on the extinguishment separate from the business combination.

If the acquiree issued debt to the acquirer, the acquirer effectively settled a receivable balance and must apply the guidance on contractual preexisting relationships (see Section 6.5.2).

Example 6-28 illustrates this concept.

EXAMPLE 6-28: SETTLEMENT OF DEBT ISSUED BY THE ACQUIREE TO THE ACQUIRER

FACTS

- Acquirer acquires Acquiree in a business combination for $100 million, which represents the fair value of Acquiree.
- Acquirer issued debt securities to Acquiree two years before the acquisition.
- On the acquisition date, the carrying value and fair value of the debt is $3 million and $4 million, respectively.
- There is no separate agreement to settle the debt between Acquirer and Acquiree.

CONCLUSION

Acquirer recognizes a loss on extinguishment of debt of $1 million.

ANALYSIS

Acquirer has effectively settled the debt issued to Acquiree. The loss on settlement is $1 million, the difference between the fair value and carrying value of the debt ($4 million - $3 million). The consideration for Acquiree is $96 million ($100 million less the fair value of the debt of $4 million).

6.5.2.2 Reacquired Rights

FASB REFERENCES

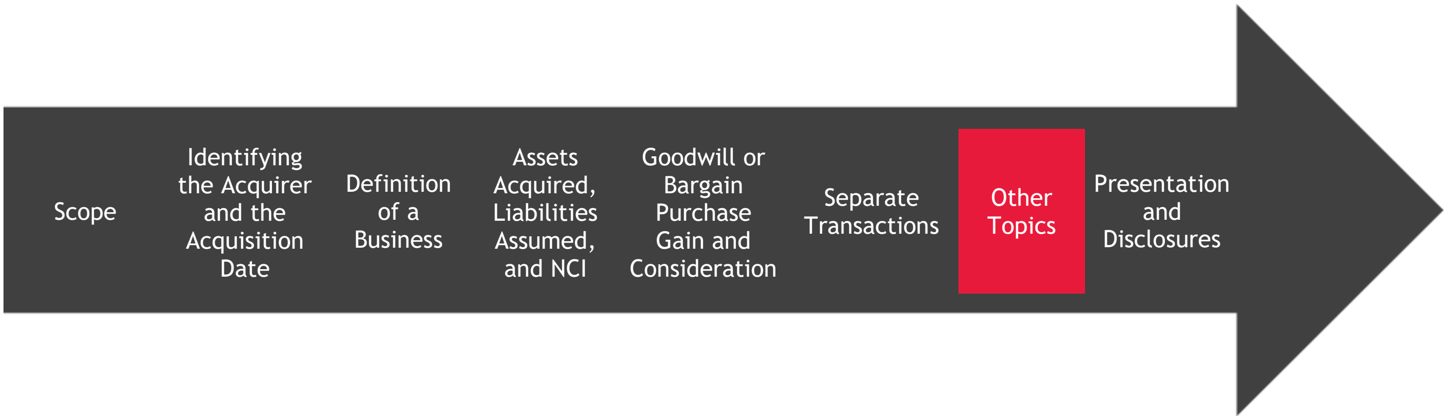
ASC 805-10-55-23

If, before the business combination, the acquirer had granted rights to use its assets (whether recognized or unrecognized), the reacquisition of those rights in a business combination results in the acquirer's recognition of an intangible asset (a reacquired right). Examples 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 licensing agreement. Further, because the reacquired right settles a preexisting relationship, the acquirer may need to recognize a settlement gain or loss separate from the business combination. See Section 4.4.1.7 for guidance on the recognition and measurement of reacquired rights and gains or losses on the settlement of preexisting relationships.

6.6 DISPUTES ARISING FROM THE BUSINESS COMBINATION

Circumstances may arise that result in litigation between the acquirer and the acquiree’s sellers or between the acquirer and its owners. Such disputes are typically accounted for as transactions separate from the business combination (see Section 4.4.1.1.3.1).

Chapter 7 — Other Topics



7.1 OVERVIEW

This chapter provides guidance on private company accounting alternatives for goodwill and intangible assets and the accounting for reverse acquisitions.

7.2 ACCOUNTING ALTERNATIVES FOR PRIVATE COMPANIES AND NOT-FOR-PROFIT ENTITIES

U.S. GAAP provides private companies and NFP entities several accounting alternatives related to goodwill and intangible assets acquired in a business combination. These accounting alternatives are meant to simplify the accounting for goodwill and intangible assets and may provide relief for entities that elect them. The following accounting alternatives are available:

Goodwill	▶ Amortization of goodwill on a straight-line basis over 10 years (or less than 10 years if the entity demonstrates that another useful life is more appropriate)	Section 7.2.2
	▶ Evaluation of goodwill impairment triggering events only as of the end of each reporting period, whether the reporting period is an interim or annual period	Section 7.2.3
Intangible assets	▶ Non-separation of specific customer-related intangible assets and noncompetition agreements from goodwill	Section 7.2.4

The goodwill accounting alternatives can be elected independently, meaning an entity that qualifies for these elections can apply either or both. Further, an entity that elects either or both goodwill accounting alternatives is not required to elect the intangible assets accounting alternative. However, an entity that elects the intangible assets accounting alternative must also adopt the accounting alternative for amortizing goodwill to prevent subsuming finite-lived intangible assets into indefinite-lived goodwill.

Entities that qualify for these accounting alternatives do not need to perform a preferability assessment the first time they elect the alternatives; however, any subsequent changes in accounting policy would need to be preferable under ASC 250.

7.2.1 Eligibility to Elect the Accounting Alternatives

FASB REFERENCES

ASC 805-20-20

Private Company

*An entity other than a **public business entity**, a **not-for-profit entity**, or an employee benefit plan within the scope of Topics 960 through 965 on plan accounting.*

Public Business Entity

*A public business entity is a business entity meeting any one of the criteria below. Neither a **not-for-profit entity** nor an employee benefit plan is a business entity.*

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.

Not-for-Profit Entity

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.

To be eligible to elect the accounting alternatives for goodwill and intangible assets, an entity must meet the definition of a private company or NFP entity. Entities that want to elect these alternatives must determine whether they meet the definitions.

If an entity meets the definition of a public business entity solely because its financial statements are included in another entity's SEC filing, it is a public business entity for purposes of filing or furnishing information with the SEC, and thus would not qualify for the accounting alternatives for any financial statements filed with the SEC. However, the entity could still elect the accounting alternatives in its standalone financial statements that are not filed or furnished with the SEC.

ENTITIES SHOULD BE CAUTIOUS WHEN ADOPTING PRIVATE COMPANY ALTERNATIVES

Before making an election to apply any of the accounting alternatives discussed in this chapter, an entity should consider whether it expects to meet the definition of a public business entity in the future. If so, it would be required to unwind its accounting under the private company accounting alternatives and retrospectively adjust its historical financial statements to comply with U.S. GAAP for public business entities. That exercise may be costly and difficult and become increasingly complex as time passes. For example, upon becoming a public business entity, a company that previously adopted the alternative to amortize goodwill would not only need to unwind the historical amortization, it would also need to perform goodwill impairment tests during each historical period without using hindsight. Similarly, a company that elected the accounting alternative to evaluate goodwill impairment triggering events only as of the end of each reporting period would need to assess whether any additional triggering events occurred during previous reporting periods.

7.2.2 Accounting Alternative: Amortizing Goodwill (Private Companies and NFP Entities)

FASB REFERENCES

ASC 350-20-35-62 through 35-64

An entity that elects the goodwill amortization accounting alternative can choose to amortize goodwill on a straight-line basis over 10 years without justifying whether 10 years is an appropriate life. In other words, an entity can simply default to an amortization period of 10 years. However, if an entity wants to amortize goodwill over a period less than 10 years, it must demonstrate that a shorter life is more appropriate. An entity may revise its estimates of the remaining useful life of goodwill if events and circumstances change, but the cumulative amortization period for any amortizable unit of goodwill cannot exceed 10 years.

Upon adoption of this accounting alternative, all existing and future goodwill must be amortized. Goodwill existing as of the beginning of the period of adoption shall be amortized prospectively on a straight-line basis over 10 years (or less if an entity demonstrates that another useful life is appropriate). Any subsequent additions to goodwill represent separate amortizable units of goodwill and must be assigned a useful life (10 years or less) at the acquisition date.

Key differences between the goodwill amortization accounting alternative and U.S. GAAP for entities not eligible for, or do not elect, the accounting alternative are summarized in the following table:

	U.S. GAAP	GOODWILL AMORTIZATION ACCOUNTING ALTERNATIVE	SECTION
Eligible Entities	All entities	▶ Private companies (entities that are not public business entities or employee benefit plans) ▶ NFP entities	7.2.1
Amortization	Not allowed	Amortized on a straight-line basis over a period of 10 years (or less than 10 years, if the entity demonstrates that another useful life is appropriate)	7.2.2
Level for Testing Goodwill Impairment	Reporting unit	Policy election to test impairment at entity-wide level or reporting unit level	7.2.2.1.1
Frequency of Impairment Test	Annually or upon the occurrence of a triggering event	Upon the occurrence of a triggering event	7.2.2.1.2
Measurement of Impairment	Single-step test that compares the fair value of the reporting unit to its carrying amount	Single-step test that compares the fair value of the entity (or reporting unit) to its carrying amount	7.2.2.1.3 7.2.2.1.4
Allocation of Impairment	No requirement to allocate impairment loss below reporting unit level	Impairment loss allocated to separate amortizable units of goodwill using either a pro rata allocation based on relative carrying amounts or another reasonable and rational basis	7.2.2.1.5
Disposal of a Portion of a Reporting Unit That Constitutes a Business	Goodwill allocated based on the relative fair values of the business disposed of and the portion of the reporting unit being retained	Goodwill allocated to the disposed business using a reasonable and rational approach	7.2.2.1.6

7.2.2.1 Goodwill Impairment Testing (Private Companies and Not-for-Profit Entities)

Entities that elect the goodwill accounting alternative to amortize goodwill are still required to test goodwill for impairment. However, electing this alternative changes several aspects of the goodwill impairment test; most notably, the level at which the impairment test may be performed and the required timing of the test. This accounting alternative also provides guidance for the measurement of impairment losses.

7.2.2.1.1 Level for Testing Goodwill Impairment (Private Companies and Not-for-Profit Entities)

FASB REFERENCES

ASC 350-20-35-65

Entities that elect to amortize goodwill are allowed to perform the goodwill impairment test at either the reporting unit level (which is consistent with the level at which entities that have not elected to amortize goodwill must perform the test) or at the entity level. This is an accounting policy election that is made at the date this accounting alternative is adopted. If an entity elects to test goodwill for impairment at the reporting unit level, it must follow existing guidance on determining reporting units and assigning assets (including goodwill) and liabilities to such reporting units. If an entity elects to test goodwill for impairment at the entity level, it is not required to determine the entity's reporting units.

7.2.2.1.2 Frequency of Goodwill Impairment Test (Private Companies and Not-for-Profit Entities)

FASB REFERENCES

ASC 350-20-35-3C and ASC 350-20-35-66

Entities that elect to amortize goodwill are not required to perform an annual goodwill impairment test. Instead, goodwill is tested for impairment only if a triggering event occurs that indicates the fair value of the entity (or the reporting unit) may be below its carrying amount. The triggering events assessment requires an entity to consider all relevant events and circumstances that affect the fair value or the carrying amount of the entity (or reporting unit), including the factors listed in ASC 350-20-35-3C. The triggering events assessment is consistent with the assessment required for entities that have not elected to amortize goodwill. If an entity determines that there are no triggering events, further testing is unnecessary.

An entity may also elect to test goodwill for impairment only at the end of its reporting period. If that election is made, a goodwill triggering event evaluation is performed only as of the end of each reporting period. Section 7.2.3 provides guidance on this accounting alternative.

7.2.2.1.3 Performing the Goodwill Impairment Test (Private Companies and Not-for-Profit Entities)

FASB REFERENCES

ASC 350-20-35-67 through 35-72, ASC 350-20-35-79, and ASC 350-20-35-3C

Triggering event(s) → Optional qualitative test → Quantitative impairment test

When a triggering event has been identified, the entity has the option of first performing a qualitative assessment to determine if it is more likely than not that the fair value of the entity (or reporting unit) is less than its carrying amount. However, if qualitative factors indicate that it is more likely than not that an impairment exists, a quantitative assessment must be performed.

The qualitative assessment requires an entity to consider all relevant events and circumstances that affect the fair value or carrying amount of the entity (or reporting unit). For example, the entity must consider:

- Macroeconomic conditions
- Industry and market conditions
- Cost factors
- Overall financial performance
- Other relevant entity-specific events
- Events affecting a reporting unit
- If applicable, a sustained decrease in share price

The qualitative assessment is consistent with the assessment required for entities that have not elected to amortize goodwill. If, after assessing the totality of events and circumstances, an entity determines that it is unlikely that the fair value of the entity (or reporting unit) is less than its carrying amount, further testing is unnecessary. Alternatively, if the likelihood that an impairment exists is greater than 50%, a quantitative assessment would be required.

If there has been a triggering event, it often may be difficult to qualitatively demonstrate that there has not been an impairment and it may be easier to perform the quantitative analysis. As such, the accounting guidance does not require entities to perform a qualitative assessment. Instead, an entity can elect to bypass the qualitative assessment and proceed directly to the quantitative calculation that compares the entity's (or reporting unit's) fair value with its carrying amount (including goodwill). An entity that bypasses the qualitative test may resume performing the qualitative test upon occurrence of any subsequent triggering events. A goodwill impairment loss is recognized if the carrying amount of the entity (or reporting unit) exceeds its fair value.

TESTING OTHER ASSETS FOR IMPAIRMENT IF A GOODWILL IMPAIRMENT TRIGERRING EVENT EXISTS

If there has been a goodwill impairment triggering event, it may also be necessary to test other assets for impairment. If goodwill and another asset (or asset group) are tested for impairment at the same time, the other asset (or asset group) must be tested for impairment before goodwill. This is consistent with the order of impairment testing for entities that have not elected to amortize goodwill.

7.2.2.1.4 Measurement of an Impairment Loss (Private Companies and Not-for-Profit Entities)

FASB REFERENCES

ASC 350-20-35-6 and ASC 350-20-35-73 through 35-76

A goodwill impairment is measured as the excess of the carrying amount of the entity (or reporting unit) over its fair value. The amount of loss is limited to the carrying amount of the goodwill within the entity (or reporting unit).

Carrying amount of the entity (or reporting unit), including goodwill	−	Fair value of the entity (or reporting unit)	=	Impairment loss (cannot exceed carrying amount of goodwill)

When calculating the potential impairment charge, deferred income taxes are included in the carrying amount of the entity (or reporting unit), regardless of whether the fair value of the entity (or reporting unit) will be determined by assuming it would be bought or sold in a taxable or nontaxable transaction.

7.2.2.1.4.1 Entity or Reporting Unit With a Zero or Negative Carrying Amount (Private Companies and NFP Entities)

For entities (or reporting units) with a zero or negative carrying amount, the single-step impairment test will generally not result in an impairment because the fair value of an entity (or reporting unit) is rarely negative. However, the entity must disclose the amount of goodwill attributed to entities (or reporting units) with a zero or negative carrying amount.

7.2.2.1.5 Allocation of Goodwill Impairment Loss (Private Companies and Not-for-Profit Entities)

FASB REFERENCES

ASC 350-20-35-77 through 35-78

Whether the impairment test is performed at the entity level or at the reporting unit level, any impairment loss must be allocated to the individual amortizable units of goodwill. This is because each amortizable unit of goodwill may have a different remaining amortizable life (for example, because the goodwill was acquired at different times).

If the impairment test is performed at the entity level, the impairment loss would be allocated to the individual amortizable units of goodwill in the entity. However, if the impairment test is performed at the reporting unit level, the impairment loss for a reporting unit would be allocated only to the individual amortizable units of goodwill within the reporting unit. It would not be appropriate to allocate the impairment loss to other reporting units. This is true even if the excess carrying value of the reporting unit over its fair value exceeds the goodwill in that reporting unit. The impairment loss recognized by an entity for each reporting unit is limited to the carrying amount of the goodwill in that reporting unit.

A goodwill impairment loss is allocated to the individual amortizable units of goodwill on a pro rata basis using their relative carrying amounts or using another reasonable and rational basis.

BDO INSIGHTS — PRO RATA ALLOCATION METHOD IS GENERALLY APPROPRIATE

We believe that entities should generally use the pro rata allocation method unless there is clear evidence supporting a specific identification of the impairment loss to one or more specific amortizable units of goodwill.

When a goodwill impairment charge is recognized, the remaining amount after impairment becomes the new basis for the goodwill and thus impairment charges cannot be subsequently reversed. The goodwill should be amortized over its remaining useful life. An entity may revise its estimates of the remaining useful life of goodwill in connection with a goodwill impairment, if appropriate; however, the cumulative amortization period for any amortizable unit of goodwill cannot exceed 10 years.

7.2.2.1.6 Allocation of Goodwill Upon Disposal of a Business (Private Companies and Not-for-Profit Entities)

FASB REFERENCES

ASC 350-20-40-8 through 40-9 and ASC 350-20-40-3

When a portion of an entity (or reporting unit) that constitutes a business or nonprofit activity is disposed of, the associated goodwill is included in its carrying amount when determining the gain or loss on disposal. The entity must use a reasonable and rational approach to allocate goodwill to the portion of the entity (or reporting unit) to be disposed of.

This is different from the guidance for a disposal of all or a portion of a reporting unit for entities that have not elected to amortize goodwill, which requires entities to allocate goodwill on a relative fair value basis.

BDO INSIGHTS — METHODS FOR ALLOCATING GOODWILL UPON DISPOSAL OF A BUSINESS

For entities that have elected to amortize goodwill, we believe that it would be acceptable to allocate goodwill using a relative fair value basis, but there may also be other reasonable and rational methods, such as an allocation based on relative carrying amounts or on specific identification. Choosing the appropriate allocation method requires professional judgment based on the facts and circumstances.

7.2.2.1.7 Goodwill Presentation and Disclosure Requirements (Private Companies and Not-for-Profit Entities)

Entities that elect to amortize goodwill must follow the presentation and disclosure guidance noted in the following sections.

7.2.2.1.7.1 Financial Statement Presentation (Private Companies and Not-for-Profit Entities)

FASB REFERENCES

ASC 350-20-45-4

The following guidance for goodwill applies to entities within the scope of paragraph 350-20-15-4 that elect the accounting alternative for amortizing goodwill.

ASC 350-20-45-5

The aggregate amount of goodwill net of accumulated amortization and impairment shall be presented as a separate line item in the statement of financial position.

ASC 350-20-45-6

The amortization and aggregate amount of impairment of goodwill shall be presented in income statement or statement of activities line items within continuing operations (or similar caption) unless the amortization or a goodwill impairment loss is associated with a discontinued operation.

ASC 350-20-45-7

The amortization and impairment of goodwill associated with a discontinued operation shall be included (on a net-of-tax basis) within the results of discontinued operations.

7.2.2.1.7.2 Disclosure Requirements (Private Companies and Not-for-Profit Entities)

FASB REFERENCES

ASC 350-20-50-3A

The information in paragraphs 350-20-50-4 through 50-7 shall be disclosed in the notes to financial statements for any entity within the scope of paragraph 350-20-15-4 that elects the accounting alternative for amortizing goodwill.

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.

ASC 350-20-50-5

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.*
>
> ASC 350-20-50-6
>
> *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.*
>
> ASC 350-20-50-7
>
> *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 not-for-profit entity.*

7.2.2.1.8 Income Tax Considerations Related to the Goodwill Amortization Accounting Alternative (Private Companies and NFP Entities)

The goodwill amortization accounting alternative does not provide any incremental or revised guidance for income tax accounting, so entities that elect this accounting alternative must continue to apply the complex income tax accounting requirements related to goodwill in ASC 805-740-25-1 through 25-9. Entities that elect to amortize goodwill must work through these complexities when accounting for goodwill amortization and impairments. Adopting the goodwill amortization accounting alternative may also affect preexisting valuation allowances on deferred tax assets, with any adjustments being considered an indirect effect of a change in accounting principle that is recognized in income tax expense in continuing operations.

7.2.3 Accounting Alternative: Evaluation of Triggering Events for Goodwill Impairment (Private Companies and Not-for-Profit Entities)

FASB REFERENCES

ASC 350-20-15-4A, ASC 350-20-35-83 through 35-85, and ASC 350-20-55-28 through 55-29

The FASB issued ASU 2021-03, *Intangibles - Goodwill and Other (Topic 350): Accounting Alternative for Evaluating Triggering Events,* to provide relief for private companies and NFPs. This accounting alternative allows entities to identify and assess goodwill triggering events only as of each reporting date (interim or annual) rather than assessing potential triggering events throughout the entire reporting period. Entities that qualify for this accounting alternative may apply it whether they have elected the accounting alternative to amortize goodwill or not.

The FASB provided the following example regarding the application of this accounting alternative:

EXAMPLE 7-1: ILLUSTRATION OF THE ACCOUNTING ALTERNATIVE FOR A GOODWILL IMPAIRMENT TRIGGERING EVENT EVALUATION

(Quoted from ASC 350-20-55-28 through 55-29**)**

ASC 350-20-55-28

Entity A adopted the accounting alternative for a goodwill impairment triggering event evaluation and performs a goodwill impairment triggering event evaluation only as of the end of each reporting period. Entity A also adopted the accounting alternative for amortizing goodwill in accordance with paragraph 350-20-05-5 and elected to perform an impairment test for goodwill at the entity level upon the occurrence of a triggering event only. During the second quarter, Entity A lost a significant customer. However, Entity A was able to replace that customer late in the third quarter of the same year, and the entity's operations returned to previously forecasted levels by the annual reporting date.

ASC 350-20-55-29

If Entity A reports only annually, then it would evaluate the facts and circumstances as of the annual reporting date and may conclude that no triggering event exists; therefore, no further goodwill impairment testing would be necessary. Alternatively, if Entity A reports on both a quarterly basis and an annual basis, then it would evaluate the facts and circumstances as of the end of each quarter and may conclude that the loss of the significant customer represents a goodwill impairment triggering event requiring additional impairment testing as of the end of the second quarter.

This accounting alternative may ease the compliance burden for entities that only report annually, but it may provide limited relief for entities that issue U.S. GAAP-compliant financial information quarterly (for example, to lenders to satisfy debt covenants). This accounting alternative requires the entity to assess triggering events at the end of each reporting period, including interim dates. As such, an entity that reports U.S. GAAP-compliant financial information for interim periods cannot delay its triggering events assessment to the annual reporting date.

BDO INSIGHTS — REPORTING U.S. GAAP COMPLIANT FINANCIAL INFORMATION ON AN INTERIM BASIS MAY PRECLUDE ELECTING THE ACCOUNTING ALTERNATIVE FOR THE EVALUATION OF TRIGGERING EVENTS

While the FASB did not provide additional guidance on what constitutes interim reporting, in paragraph BC28 of ASU 2021-03, it noted that many private companies provide *"some level of financial information more frequently than annually that indicates that it complies with the recognition and measurement principles of GAAP."* Therefore, we believe that providing financial statements or other financial information that is compliant with U.S. GAAP is considered interim reporting, regardless of whether the financial statements or financial information is filed with a regulatory agency. For example, financial information such as EBITDA measures or other financial metrics provided to a lender or other investor (for example, to lenders to satisfy debt covenants) that purports to be in compliance with U.S. GAAP may preclude an entity from electing the accounting alternative for the evaluation of triggering events.

Examples 7-2 and 7-2A illustrates the application of the triggering event accounting alternative.

EXAMPLE 7-2: INTERIM TRIGGERING EVENTS FOR PRIVATE COMPANY THAT ELECTED THE TRIGGERING EVENT ALTERNATIVE

FACTS

- As of June 30, 2020, Travel Destination Group (TDG) has experienced a decline in bookings and an increase in cancellations because of travel restrictions resulting from the COVID-19 pandemic.
- There are also new regulations and restrictions on travel in areas where TDG usually plans and books vacations and excursions for its customers.
- Over the past six months, TDG has experienced a significant decline in actual versus planned revenue.
- TDG operates in a single segment, which also represents its only reporting unit. Before the pandemic, TDG performed a fair value analysis to determine the value of stock options granted to employees. Based on that analysis, TDG's fair value was approximately 10% higher than its carrying value.
- TDG is a private company and has elected the private company alternative to perform goodwill impairment triggering event evaluations only as of the end of each reporting period.
- TDG must provide U.S. GAAP-compliant financial statements to its bank semiannually on June 30 and December 31.
- TDG has not elected to amortize its goodwill, and it performs an annual impairment assessment of its goodwill as of the beginning of the fourth quarter.

CONCLUSION

TDG must assess whether a triggering event has occurred as of June 30.

ANALYSIS

Because TDG must provide U.S. GAAP-compliant financial statements to its bank semiannually, it must perform a triggering events assessment on the interim reporting date (June 30). If a triggering event has occurred as of that date, TDG would need to perform a goodwill impairment assessment because it is more likely than not that the carrying value of the reporting unit is greater than its fair value.

EXAMPLE 7-2A: INTERIM TRIGGERING EVENTS FOR PRIVATE COMPANY THAT ELECTED THE TRIGGERING EVENT ALTERNATIVE

FACTS

Assume the same facts as in Example 7-2, except that TDG is not required to provide U.S. GAAP-compliant financial statements to its bank semiannually on June 30 and December 31; instead, it must provide to its lender quarterly financial information that consists of EBITDA for the three-month period, calculated in accordance with U.S. GAAP. It must also provide an interest coverage ratio calculated as defined in the debt agreement, which excludes specific nonrecurring items, including any goodwill impairment charges.

CONCLUSION

TDG must assess whether a triggering event has occurred as of June 30.

ANALYSIS

TDG is not required to provide financial statements to its lender on an interim basis, but it is required to provide two metrics: EBITDA and an interest coverage ratio. Because EBITDA in this example is calculated in compliance with U.S. GAAP, and thus any goodwill impairment charge would affect the earnings number used to calculate the metric, the presentation of EBITDA on a quarterly basis represents interim financial reporting. Therefore, TDG must assess whether a triggering event has occurred as of June 30.

We note that the interest coverage ratio is not calculated in compliance with U.S. GAAP. Notably, any goodwill impairment charges would be excluded. Therefore, if the only financial information that TDG provided to its lender on an interim basis were the interest coverage ratio, and TDG elected the private company alternative to only assess triggering event as of the reporting date, it would not have to assess whether a triggering event has occurred as of June 30 because it would not be considered to provide interim reporting under U.S. GAAP. Instead, TDG would assess whether a triggering event has occurred only as of the end of its annual reporting period (if different than its annual impairment testing date).

This accounting alternative also does not change the timing of the required triggering events assessment for long-lived assets. As such, entities that adopt this accounting alternative may still need to assess potential triggering events for other assets during the reporting period. Long-lived asset impairment triggering events may affect goodwill. In those situations, an entity must consider whether the impairment triggering events are still present as of the next goodwill impairment testing date. This accounting alternative also does not change the requirement to test goodwill in other situations (for example, upon disposal of a portion of a reporting unit or when goodwill is included in a held-for-sale disposal group).

7.2.4 Accounting Alternative: Intangible Assets (Private Companies and Not-for-Profit Entities)

FASB REFERENCES

ASC 805-20-15-1A through 15-4 and ASC 805-20-25-30

A private company or NFP that applies the acquisition method for a business combination may elect not to recognize specific intangible assets separately from goodwill. This election is also available for equity method investments and entities that adopt fresh-start reporting upon a reorganization.

If an entity elects this accounting alternative, all noncompete agreements are subsumed into goodwill. Further, customer-related intangible assets would be recognized separately only if they are capable of being sold or licensed independently from other assets of a business.

Once the alternative is adopted, an entity would apply it to all future transactions within the scope of this guidance, including business combinations, equity method investments, and fresh-start accounting. Entities that adopt this guidance would not retrospectively adjust the accounting for any previous transactions. In other words, existing customer-related intangible assets and noncompete agreements should not be subsumed into goodwill upon the adoption of this accounting alternative, but they would continue to be accounted for in accordance with the guidance in ASC 350.

An entity that elects the intangible assets accounting alternative also must adopt the accounting alternative for amortizing goodwill to prevent subsuming finite-lived intangible assets into indefinite-lived goodwill. However, an entity that elects either or both goodwill accounting alternatives discussed in Section 7.2 is not required to elect the intangible assets accounting alternative.

7.2.4.1 Customer-Related Intangible Assets (Private Companies and Not-for-Profit Entities)

FASB REFERENCES

ASC 805-20-25-31

Many acquired customer contracts and relationships cannot be sold or licensed independently from other assets of the acquired business. As such, an entity that adopts this accounting alternative would generally recognize fewer customer-related intangible assets separately from goodwill. Customer relationship assets that are nontransferable would be subsumed into goodwill. Therefore, an entity that adopts this accounting alternative must consider contractual limitations on transfer. For example, assets that cannot be transferred or sold without customer approval would be eligible for the accounting alternative.

However, the guidance provides several examples of customer-related intangible assets that can be sold or licensed independently from the other assets of the business and would continue to be recognized and measured separately from goodwill, including:

- Mortgage servicing rights
- Commodity supply contracts
- Core deposits
- Customer information that can be bought and sold (for example, names and contact information)

Entities that adopt the intangible assets accounting alternative must determine which assets can be sold or licensed independently are recognized separately. Sometimes companies do not distinguish between customer relationships and customer lists related to the same group of customers when measuring their acquired intangible assets. However, entities that adopt this accounting alternative must separately recognize and measure the intangible asset related to customer lists (which can be sold or licensed) while subsuming the asset related to customer relationships (which cannot be sold independently from other assets) into goodwill.

Example 7-3 illustrates the intangible assets accounting alternative.

EXAMPLE 7-3: APPLYING THE INTANGIBLE ASSETS ACCOUNTING ALTERNATIVE

FACTS

- Private Company A acquired Company B. The acquired business includes several identifiable intangible assets, including a trade name, technology, customer lists, and customer relationships.
- Customer lists include information in Jurisdictions A and Y about customer names, contact information, and ordering history. In Jurisdiction X, such customer information cannot be sold or licensed without the customers' consent. In Jurisdiction Y, there are no restrictions on transferring the customer information.
- Private Company A has elected to apply the intangible assets accounting alternative.

CONCLUSION

Private Company A recognizes separately identifiable intangible assets as follows:

- Trade name
- Technology
- Customer lists in Jurisdiction Y that can be independently sold or exchanged

The following intangible assets are not separately recognized, but are subsumed into goodwill:

- Customer lists in Jurisdiction X that cannot be sold or licensed because of transfer restrictions
- Customer relationships

ANALYSIS

Private Company A must separately recognize the trade name and technology because they are not within the scope of the intangible assets accounting alternative. It also must separately recognize and measure Company B's customer lists in Jurisdiction Y because they can be independently sold or exchanged. The customer lists in Jurisdiction X would not be recognized separately but would be subsumed into goodwill because they cannot be sold or licensed (because of transfer restrictions).

If Private Company A had not elected the intangible assets accounting alternative, it would have recognized an intangible asset for all customer lists (whether or not transferable), as well as a customer relationship intangible asset.

In some cases, a customer contract may include terms that are favorable or unfavorable relative to the market. Intangible assets related to the favorable (above-market) component of a customer contract would be subsumed into goodwill if the underlying contract is not capable of being sold or licensed independently. However, the below-market components of any unfavorable contracts cannot be subsumed into goodwill because the below-market component represents a liability, and the scope of the intangible assets accounting alternative includes only items that would otherwise be recorded as an intangible asset, as noted in paragraph BC20 of ASU 2014-18.

7.2.4.2 Noncompete Agreements (Private Companies and Not-for-Profit Entities)

The accounting alternative requires that all noncompete agreements acquired as part of a business combination to be subsumed into goodwill. However, any noncompete agreements that are accounted for as transactions separate from the business combination would not be eligible for this accounting alternative.[17]

An acquiree's preexisting noncompete arrangements that are assumed by the acquirer would typically meet the contractual-legal criterion for recognition as intangible assets in a business combination, so they would be in the scope of this accounting alternative and would be subsumed into goodwill.

Alternatively, an acquirer may enter noncompete agreements with the selling shareholders in connection with a business combination. Because noncompete agreements with selling shareholders are primarily for the acquirer's benefit, they are often accounted for as transactions separate from a business combination and would not be eligible for the intangible assets accounting alternative.

However, in paragraph BC 19 of ASU 2014-18, the FASB acknowledged that there may be diversity in views regarding whether noncompete agreements should be accounted for as part of the business combination or as a separate transaction, but that such diversity has not resulted in significantly different outcomes. If an entity concludes that a noncompete agreement is accounted for as part of the business combination it would be subsumed into goodwill under the intangible assets accounting alternative.

7.2.4.3 Contract Assets and Leases (Private Companies and Not-for-Profit Entities)

FASB REFERENCES

ASC 805-20-25-32 through 25-33

Contract assets as defined in ASC 606 and leases are not customer-related intangible assets for the intangible assets accounting alternative, so they must be recognized separately in a business combination and cannot be subsumed into goodwill.

7.2.4.4 Disclosures (Private Companies and Not-for-Profit Entities)

FASB REFERENCES

ASC 805-30-50-1(a)

The intangible assets accounting alternative does not introduce any incremental disclosure requirements, but entities that adopt it must comply with the disclosure requirements in ASC 805. Such disclosures include a qualitative description of intangible assets that do not qualify for separate recognition; therefore, the nature of all acquired intangible assets should be disclosed, even if the intangible assets have been subsumed into goodwill (see Sections 8.6.5.3 and 8.6.5.6).

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[17] ASU 2014-18, paragraph BC19

7.3 REVERSE ACQUISITIONS

FASB REFERENCES

ASC 805-40-30-1

ASC 805-40-20

Reverse Acquisition

> *An acquisition in which the entity that issues securities (the legal acquirer) is identified as the acquiree for accounting purposes based on the guidance in paragraphs 805-10-55-11 through 55-15. The entity whose equity interests are acquired (the legal acquiree) must be the acquirer for accounting purposes for the transaction to be considered a reverse acquisition.*

As discussed in Section 2.2.2, **if the legal acquiree is not a VIE**, the parties must determine which entity is the acquirer under the voting interest model. A reverse acquisition occurs when the legal acquirer is deemed the accounting acquiree and the legal acquiree is deemed the accounting acquirer. ASC 805-40 provides guidance for accounting for reverse acquisitions.

To determine whether to account for a transaction as a forward or a reverse acquisition, the consolidation guidance in ASC 810-10 is used to identify the acquirer. However, if that guidance does not clearly indicate which entity is the acquirer, the factors in section 2.2.2.1 through 2.2.2.4 are used to determine which entity is the acquirer. If the legal acquiree is a VIE, the primary beneficiary is always the accounting acquirer.

Once the accounting acquirer has been identified, it must assess whether the acquired set meets the definition of a business (see Chapter 3). If the accounting acquiree is not a business, the acquisition would not be accounted for as a business combination; instead, it would be accounted for as an asset acquisition or a capital transaction, depending on its substance. Appendix C provides guidance for accounting for asset acquisitions and recapitalizations. Sections 7.3.7 and 7.3.8 discuss public shell corporations and special purpose acquisition companies (SPACs).

All measurement principles applicable to business combinations apply to a reverse acquisition. As such, if the accounting acquiree is a business, the assets and liabilities of the accounting acquiree are recognized and measured using the guidance for business combinations in ASC 805 (see Chapter 4). However, measuring the consideration in a reverse acquisition is complex.

7.3.1 Measuring the Consideration (Reverse Acquisitions)

FASB REFERENCES

ASC 805-40-30-2 and ASC 805-30-30-2

In a reverse acquisition, the accounting acquirer does not typically issue any consideration for the acquiree. Instead, the legal acquirer issues its shares to the owners of the legal acquiree as consideration in the transaction. However, because the legal subsidiary is deemed the accounting acquirer, it must calculate the hypothetical consideration it would have transferred to obtain the same percentage of ownership interest in the combined entity. As such, when applying the acquisition method, the consideration for the business combination is based on the number of equity interests the legal subsidiary would have had to issue to give the owners of the legal parent the same percentage equity interest in the combined entity.

In some cases, the fair value of the accounting acquiree's equity interests might be more reliably measured than the fair value of the accounting acquirer's equity interests. If so, the determination of the consideration would be based on the fair value of the accounting acquiree's (legal acquirer's) stock. For example, if a public company legally acquires a private company, but the private company is determined to be the accounting acquirer, it would likely be appropriate to use the fair value of the public company stock to determine the consideration.

Example 7-4 illustrates how to determine the consideration in a reverse acquisition.

EXAMPLE 7-4 (ADAPTED FROM ASC 805-40-55-10): DETERMINING CONSIDERATION IN A REVERSE ACQUISITION

FACTS

- Entity A and Entity B merge in a transaction accounted for as a business combination by exchanging shares of Entity A for all the outstanding shares of Entity B.
- Entity A is the legal acquirer and Entity B is not a VIE.
- Based on an analysis of the factors in ASC 805-10-55-11 through 55-15, Entity B is determined to be the accounting acquirer.
- Immediately before the business combination, Entity A had 100 common shares outstanding with a quoted market price of $16, and Entity B had 60 common shares outstanding with an estimated fair value of $41 per share.
- Entity A (legal parent, accounting acquiree) issued 150 of its shares to Entity B to effect the business combination.
- Assume Entity A’s common share price is a more reliable measure than Entity B’s common share fair value.

CONCLUSION

The fair value of the consideration effectively transferred is based on the most reliable measure, which is $1,600, measured using the market price of Entity A’s shares (100 shares X $16 per share).

ANALYSIS

After the transaction, Entity B’s shareholders ownership percentage is calculated as follows:

- 150 common shares issued by Entity A to Entity B / 250 (100 Entity A common shares outstanding immediately before the transaction + 150 Entity A shares issued to effect the transaction) = 60%
- The remaining 100 shares (40%) are owned by Entity A’s shareholders.
- The consideration in a reverse acquisition is based on the number of equity interests the legal subsidiary would have had to issue to give the owners of the legal parent the same percentage equity interest in the combined entity that results from the reverse acquisition. Because Entity B holds a 60% interest in the combined entity after the transaction, the consideration is based on the number of shares Entity B would have had to issue to the former owners of Entity A for them to hold a 40% interest in the combined entity.

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. In this case, Entity B shareholders’ ownership percentage in the combined entity would be calculated as follows:

- 60 common shares outstanding immediately before the transaction / 100 (60 Entity B common shares outstanding immediately before the transaction + 40 hypothetical Entity B shares issued to effect the transaction) = 60%

As such, there are two possibilities for determining the consideration at the acquisition date. The consideration could be measured based on the equity value of Entity A or Entity B. Based on the estimated fair value of Entity B’s common shares, the fair value of the consideration effectively transferred by Entity B is $1,640 (40 shares X $41 per share). Based on the quoted market price of Entity A’s shares, the fair value of the consideration effectively transferred by Entity B is $1,600 (100 Entity A common shares X $16 per share).

The fair value of the consideration effectively transferred is based on the most reliable measure. In this case, the quoted market price of Entity A’s shares is more reliable than the estimated fair value of the shares in Entity B; therefore, the consideration is $1,600.

7.3.1.1 Cash Payments in a Reverse Acquisition

In some reverse acquisitions, the accounting acquiree issues cash or other consideration, as well as shares, to acquire the accounting acquirer. The payment of cash or other assets to the shareholders of the accounting acquirer is accounted for as a distribution of capital and thus a reduction of shareholders' equity of the accounting acquirer.

7.3.1.2 Contingent Consideration in a Reverse Acquisition

ASC 805-40 does not provide specific guidance regarding contingent consideration in a reverse acquisition.

BDO INSIGHTS — CONTINGENT CONSIDERATION IN A REVERSE ACQUISITION

We believe the accounting for contingent consideration arrangements depends on the nature of the payments and to whom the contingent payments will be made.

- Contingent amounts that are **payable to the former shareholders of the accounting acquiree** must be evaluated using the guidance in ASC 805-10-55-25 (see Section 6.4.2) to determine whether they must be accounted for as contingent consideration in the business combination or as compensation for services. Arrangements accounted for as contingent consideration in the business combination would follow the guidance in ASC 805, so they would be accounted for initially at fair value with subsequent accounting being dependent upon whether the contingent consideration is classified as a liability (or an asset) or as equity. Section 5.4.5 discusses the accounting for contingent consideration payable to the former shareholders of the accounting acquiree.
- Contingent consideration arrangements that are **payable to parties other than the former shareholders of the accounting acquiree** should not be accounted for as consideration in a business combination. Such arrangements should be accounted for as transactions separate from the business combination and accounted for based on their nature.
  - Contingent amounts **payable to employees or service providers** may be compensatory and should be evaluated under the appropriate compensation guidance (for example, ASC 710 or ASC 718).
  - If contingent consideration is **payable to the former owners of the accounting acquirer** on a pro rata basis, it may be appropriate to recognize the initial fair value of the contingent consideration as a dividend.

7.3.1.3 Share-Based Payments (Reverse Acquisitions)

It is not uncommon for an acquirer in a business combination to issue replacement awards in exchange for the outstanding share-based compensation awards of the acquiree. Section 6.4.3 provides guidance for accounting for the exchange of share-based payment awards in a business combination.

In a reverse acquisition the dynamic is different because it is typically the accounting acquiree, rather than the accounting acquirer, that issues the replacement awards. As a result, from a legal perspective, the share-based payment awards held by the grantees of the accounting acquiree have not changed. However, from an accounting perspective, the substance is that the awards held by the accounting acquiree's grantees have been exchanged for awards of the accounting acquirer. Regardless of the legal form, the accounting acquirer should account for the substance of the transaction by applying the guidance in Section 6.4.3 to determine the portions of the acquisition-date fair value of the accounting acquiree's awards that must be included in consideration and postcombination compensation.

On the other hand, the legal exchange of share-based payment awards held by the accounting acquirer's grantees represents a transaction that is separate from the business combination. As such, no portion of the exchange of awards is included in the consideration for the business combination; rather it is accounted for separately as a modification of the accounting acquirer's share-based payment awards under ASC 718.

7.3.2 Remeasuring Previously Held Equity Interests (Reverse Acquisitions)

FASB REFERENCES

ASC 805-10-25-10

In some reverse acquisitions, the accounting acquirer may own shares of the accounting acquiree before the business combination. Such shares represent a previously held equity interest that should be remeasured at fair value as of the acquisition date and added to the consideration for the business combination (see Section 7.3.1 for measurement of consideration in a reverse acquisition). Section 5.5 discusses the accounting for a remeasurement of an acquirer's previously held equity interests for a business combination achieved in stages.

7.3.3 Noncontrolling Interests (Reverse Acquisitions)

FASB REFERENCES

ASC 805-40-25-2 and ASC 805-40-30-3

In some reverse acquisitions a portion of the legal acquiree's shareholders do not participate in the transaction. These nonparticipating shareholders retain their equity interests in the legal acquiree rather than exchanging their interests for shares of the legal acquirer. These noncontrolling interest holders only have legal rights to participate in the earnings of the subsidiary and not the earnings of the combined entity. After the reverse acquisition, these equity interests in the legal subsidiary represent noncontrolling interests (if they are equity classified in accordance with U.S. GAAP).

Because the assets and liabilities of the legal acquiree are measured and recognized at their precombination carrying amounts, the NCI reflects only the noncontrolling shareholders' proportionate interest in the precombination carrying amounts of the legal acquiree's net assets. Any changes to the outstanding NCI after the acquisition date are accounted for in accordance with ASC 810.

ACCOUNTING FOR NCI IS DIFFERENT FOR A REVERSE ACQUISITION THAN FOR A FORWARD ACQUISITION

The accounting for NCI is different for a reverse acquisition than for a forward acquisition. For a forward acquisition, NCI is recognized at fair value (see Section 4.5). The accounting for NCI in the legal acquiree at historical cost is unique to reverse acquisition accounting.

7.3.4 Financial Statement Presentation (Reverse Acquisitions)

FASB REFERENCES

ASC 805-40-45-1 through 45-2

In a reverse acquisition, the financial statements represent a continuation of the accounting acquirer with the acquisition of the accounting acquiree reflected as a business combination. As such, the accounting acquirer's historical financial statements are presented, and the results of acquired entity's operations are included in the financial statements of the combined company beginning on the acquisition date. However, because the capital structure of the combined company is legally the capital of the accounting acquiree, the accounting acquiree's financial statements must be adjusted to reflect the legal capital of the accounting acquiree (legal parent). The adjustment to reflect the capital structure of the accounting acquiree is made retroactively to all periods presented.

After the business combination, the accounting acquirer's assets and the liabilities continue to be recognized at their historical carrying amounts, while the accounting acquiree's assets and liabilities are recognized and measured using the guidance for business combinations in ASC 805.

The following table summarizes the financial statement presentation of the combined entity at the acquisition date:

	PRESENTATION
Assets and Liabilities	▶ Accounting acquirer's assets and liabilities are presented at carryover basis. ▶ Accounting acquiree's assets and liabilities are recognized and measured using the business combination guidance in ASC 805 (see Chapter 4).
Retained Earnings and Other Equity	Accounting acquirer's precombination carrying amount is presented, proportionately reduced by any NCI.
Issued Equity (Par Value and Additional Paid-In Capital)	Total issued equity is the sum of (1) the carryover basis of the issued equity interests of the accounting acquirer, less NCI plus (2) the fair value of the legal parent (the hypothetical consideration). The number and type of equity instruments issued reflects the equity structure of the accounting acquiree at par value, including the equity interests issued to effect the combination. Any difference is reflected in the additional paid-in capital (APIC) account.
NCI	NCI is measured as its proportionate share of the accounting acquirer's precombination retained earnings, issued equity, and other equity balances.
Prior Periods	Comparative information is retroactively adjusted to reflect the accounting acquiree's legal capital. The number of shares outstanding for prior periods is determined using the exchange ratio established in the acquisition agreement.

7.3.5 Earnings Per Share (Reverse Acquisitions)

FASB REFERENCES

ASC 805-40-45-3 through 45-5

In a reverse acquisition, the combined entity's financial statements (including comparative periods) reflect the accounting acquiree's equity structure. As such, the earnings-per-share calculations are based on the capital structure of the accounting acquiree. See Section 7.3.4 for a discussion of adjustments to the equity structure for a reverse acquisition. The historical weighted-average number of common shares used for the EPS calculation (the weighted-average from the beginning of the reporting period to the acquisition date) is determined using the exchange ratio established in the acquisition agreement.

For reverse acquisitions that result in an accounting acquirer NCI (see Section 7.3.3), the historical EPS would not reflect the NCI as there was not an accounting acquirer NCI before the business combination. Instead, historical EPS would be presented in the same manner as if all the shares of the accounting acquirer were exchanged.

7.3.6 Illustrative Examples (Reverse Acquisitions)

ASC 805-40 provides the following examples to illustrate the guidance for reverse acquisitions:

EXAMPLE 7-5: ACCOUNTING FOR A REVERSE ACQUISITION

(Quoted from ASC 805-40-55-2 through 55-23)

ASC 805-40-55-2

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).

ASC 805-40-55-3

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.

ASC 805-40-55-4

The statements of financial position of Entity A and Entity B immediately before the business combination are as follows.

	ENTITY A (LEGAL PARENT, ACCOUNTING ACQUIREE) $	ENTITY B (LEGAL SUBSIDIARY, ACCOUNTING ACQUIRER) $
Current assets	500	700
Noncurrent assets	1,300	3,000
Total assets	1,800	3,700
Current liabilities	300	600
Noncurrent liabilities	400	1,100
Total liabilities	700	1,700
Shareholders' equity		
Retained earnings	800	1,400
Issued equity		
100 common shares	300	–
60 common shares	–	600
Total shareholders' equity	1,100	2,000

Total liabilities and shareholders' equity	*1,800*	*3,700*

ASC 805-40-55-5

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.

ASC 805-40-55-6

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.*

ASC 805-40-55-7

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

ASC 805-40-55-8

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).

ASC 805-40-55-9

The calculation of the fair value of the consideration transferred follows.

ASC 805-40-55-10

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.

ASC 805-40-55-11

Goodwill is measured as follows.

ASC 805-40-55-12

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.

	$	$
Consideration effectively transferred		*1,600*
Net recognized values of Entity A's identifiable assets and liabilities		
Current assets	*500*	
Noncurrent assets	*1,500*	
Current liabilities	*(300)*	
Noncurrent liabilities	*(400)*	*(1,300)*
Goodwill		*300*

ASC 805-40-55-13

The consolidated statement of financial position immediately after the business combination is as follows.

	$
Current assets ($700 + $500)	*1,200*
Noncurrent assets ($3,000 + $1,500)	*4,500*
Goodwill	*300*
Total assets	*6,000*
Current liabilities ($600 + $300)	*900*
Noncurrent liabilities ($1,100 + $400)	*1,500*
Total liabilities	*2,400*
Shareholders' equity	
Retained earnings	*1,400*
Issued equity	
250 common shares ($600 + $1,600)	*2,200*
Total shareholders' equity	*3,600*
Total liabilities and shareholders' equity	*6,000*

ASC 805-40-55-14

In accordance with paragraph 805-40-45-2(c) through 805-10, 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.

ASC 805-40-55-15

The calculation of EPS follows.

ASC 805-40-55-16

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.

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)	*150*
Number of shares outstanding from the acquisition date to December 31, 20X6	*250*
Weighted-average number of common shares outstanding ([150 x 9 ÷ 12] + [250 X 3 ÷ 12])	*175*
EPS ($800 ÷ 175)	*$ 4.57*

ASC 805-40-55-17

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

ASC 805-40-55-18

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.

ASC 805-40-55-19

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.

ASC 805-40-55-20

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.*

ASC 805-40-55-21

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).

ASC 805-40-55-22

The consolidated statement of financial position at September 30, 20X6, reflecting the noncontrolling interest is as follows.

	$
Current assets ($700 + $500)	*1,200*
Noncurrent assets ($3,000 + $1,500)	*4,500*
Goodwill	*300*
Total assets	*6,000*
Current liabilities ($600 + $300)	*900*
Noncurrent liabilities ($1,100 + $400)	*1,500*
Total liabilities	*2,400*
Shareholders' equity	
Retained earnings ($1,400 X 93.3%)	*1,306*
Issued equity	
240 common shares ($560 + $1,600)	*2,160*
Noncontrolling interest	*134*
Total shareholders' equity	*3,600*
Total liabilities and shareholder's equity	*6,000*

ASC 805-40-55-23

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).

7.3.7 Public Shell Corporations

FASB REFERENCES

ASC 805-40-05-2

SEC STAFF GUIDANCE

According to Section 12220.1 of the SEC Financial Reporting Manual:

A shell company is a registrant (other than an asset-backed issuer) that has no or nominal operations and either has:

1. no or nominal assets,

2. assets consisting solely of cash and cash equivalents, or

3. assets consisting of any amount of cash and cash equivalents and nominal other assets.

In some cases, an operating company merges with a nonoperating public shell company to enable the operating company to raise capital and become public without going through an IPO process. In such transactions, the shell company is typically the legal acquirer, but the owners and management of the operating company control the combined entity. Such a merger does not qualify as a business combination because the operating company is deemed the accounting acquirer, and the public shell company (the accounting acquiree) does not meet the definition of a business under ASC 805.

The SEC staff considers a reverse acquisition of a public shell corporation to be a capital transaction in substance. In effect, the transaction is the equivalent of the issuance of stock by the private company for the net monetary assets of the shell corporation, accompanied by a recapitalization. The accounting for this type of transaction is similar to a reverse acquisition, except that no goodwill or other intangible assets should be recorded. Instead, any excess of the fair value of the shares issued by the private entity over the value of the net monetary assets of the public shell company is recognized as a reduction to equity. In other words, the operating company records the transaction by crediting equity for the fair value of the net monetary assets of the shell company.

Transaction costs directly attributable to this in-substance capital transaction are recognized as costs of raising equity and are typically recognized as a reduction of the total amount of equity raised.

BDO INSIGHTS — EXCESS TRANSACTION COSTS

Shareholder redemptions or other factors may result in the amount of proceeds being lower than originally anticipated. If transaction costs exceed the total equity raised, the excess transaction costs should be expensed.

There may also be transactions in which a private company merges into a public company that does not meet the definition of a public shell company because its assets other than cash are not assessed as “nominal”. Such transactions should be assessed to determine whether the substance of the transaction is a business combination, asset acquisition, or capital transaction. Appendix C provides guidance for accounting for asset acquisitions and recapitalizations.

7.3.8 Special Purpose Acquisition Companies

A SPAC (or blank check company) is a newly formed company that raises cash in an IPO with the intent of using the funds to acquire an existing company within a defined period (for example, two years). If an acquisition is not completed within the specified period, the funds raised in the IPO are returned to the SPAC investors. SPAC mergers are typically structured with the SPAC as the legal acquirer of an operating company.

Because a SPAC engages in significant precombination activities, it is generally considered substantive; therefore, a SPAC merger must be evaluated to determine which entity is the accounting acquirer. Chapter 2 provides guidance for identifying the accounting acquirer.

If the operating company is the accounting acquirer, the transaction is accounted for in the same manner as a reverse acquisition of a public shell company. That is because a SPAC typically does not have any assets other than cash raised in the IPO, so the transaction is in substance a reverse recapitalization. As such, the operating company records the transaction by crediting equity for the fair value of the SPAC's net monetary assets.

On the other hand, if the SPAC is the accounting acquirer, it must evaluate whether the operating company meets the definition of a business. If so, the transaction is accounted for as a business combination under ASC 805; otherwise, it is accounted for as an asset acquisition.

Appendix C provides guidance for accounting for asset acquisitions and recapitalizations.

BDO INSIGHTS — THE PRIMARY BENEFICIARY RULE

Determining which entity is the accounting acquirer in a business combination depends on whether the entity being acquired meets the definition of a variable interest entity. If so, the primary beneficiary is always the accounting acquirer (see Section 2.2.1) and none of the guidance for reverse acquisitions applies.

This outcome is not always intuitive. For example, consider the following fact pattern:

- A SPAC legally acquires an LLC operating company in an umbrella partnership – C corporation (UP-C) structure.
- The operating company's equity holders retain 70% of the units of the newly formed LLC operating company,
- The SPAC becomes the managing member of the LLC operating company and obtains the remaining 30% of the units in the merger transaction.
- All the operating company's management will remain in place upon consummation of the merger, and the operating company's equity holders have the right to nominate a majority of the SPAC's board members.

If the LLC were a voting entity, the entities would apply the guidance in ASC 805-10-55-11 through 55-15 (see Section 2.2.2), and the operating company would likely be the accounting acquirer (resulting in carryover basis for the operating company's net assets). However, if the LLC is the functional equivalent of a limited partnership and there are no kickout or participating rights held by the non-managing members, it would be a VIE, and the primary beneficiary (the SPAC) would be the acquirer (and would apply the acquisition method to recognize the operating company's net assets).

EITF AGENDA — IDENTIFYING THE ACCOUNTING ACQUIRER IN A BUISNESS COMBINATION WHEN THE LEGAL ACQUIREE IS A VIE

In April 2024, the EITF added a topic to its agenda on how the accounting acquirer in a business combination is determined when the legal acquiree is a variable interest entity. Readers should monitor developments.

Chapter 8 — Presentation and Disclosures

8.1 OVERVIEW

ASC 805 provides disclosure objectives and specific disclosure requirements designed to help users of the financial statements understand the effects of a business combination. Disclosures are required for material business combinations, as well as for immaterial business combinations that in the aggregate are material to the financial statements.

8.2 BALANCE SHEET PRESENTATION

FASB REFERENCES

ASC 805-30-25-6 through 25-7

ASC 805 does not provide specific balance sheet presentation requirements for most assets acquired and liabilities assumed in a business combination. Entities should present such assets and liabilities based on their nature.

However, ASC 805 requires contingent consideration in a business combination to be classified as a liability (or asset) or as equity depending on its nature. Section 5.4.5.2 provides guidance for determining the classification of contingent consideration in a business combination.

8.3 INCOME STATEMENT PRESENTATION

FASB REFERENCES

ASC 220-20-45-1 and ASC 805-20-25-27 through 25-28

ASC 805 does not provide income statement presentation requirements; however, there are several items related to a business combination that must be recognized in income, including:

- Transaction costs
- Compensation arrangements
- Adjustments to indemnification assets

- Changes in fair value of contingent consideration
- Adjustments to acquired contingencies
- Gain or loss on previously held equity interests
- Bargain purchase gains
- Transactions separate from the business combination

BDO INSIGHTS — INCOME STATEMENT CLASSIFICATION FOR ITEMS RELATED TO A BUSINESS COMBINATION

Entities must exercise professional judgment to determine where items should be classified in the income statement. Generally, we believe that items related to the business combination should be classified based on their nature and that the classification should be consistent with similar items that are not related to a business combination. As such, in most instances we believe it would be appropriate to reflect these items as components of operating income.

Because bargain purchases are expected to be rare, we believe that it would be appropriate to present a bargain purchase gain as an unusual or infrequently occurring item.

In some business combinations, the acquirer may be indemnified by the seller for income tax liabilities that arose before the business combination. ASC 805 requires that indemnification assets be recognized at the same time and measured on the same basis as the indemnified item (see Section 4.4.1.4.2). However, any adjustments to an indemnification asset related to an income tax liability should be recorded in pretax income, not as a part of income tax expense. This is because the potential payments to be received under the indemnification agreement are not due to, or from, a taxing authority. Rather, they constitute an agreement between the acquirer and the acquiree's former owners. As such, even though an adjustment to an income tax liability and related indemnification asset might be neutral to the income statement as a whole, it would affect both income tax expense and pretax income.

8.4 STATEMENT OF CASH FLOWS PRESENTATION

FASB REFERENCES

ASC 230-10-45-13

The cash paid to acquire a business, net of any cash acquired, is presented as a single line in the cash flows from investing activities section of the statement of cash flows. The unit of account is the business combination; therefore, the acquisition of individual assets and liabilities is not reflected in the individual line items in the statement of cash flows.

The noncash effects of a business combination, including any noncash consideration for the business combination and the total effects on the acquirer's assets and liabilities, also must be disclosed.

After the business combination, the cash flows of the newly acquired business are combined with the cash flows of the existing business and within operating, investing, and financing cash flows as appropriate.

8.4.1 Acquisition-Related Costs - Statement of Cash Flows

FASB REFERENCES

ASC 230-10-45-17(f)

As discussed in Section 6.3, acquisition-related costs are accounted for separate from a business combination.

BDO INSIGHTS — CLASSIFICATION OF TRANSACTION COSTS IN STATEMENT OF CASH FLOWS

Because acquisition-related costs are deemed to be a transaction separate from a business combination and must be expensed as incurred, we believe they should be presented within cash flows from operating activities.

In some cases, a party that terminates a business combination may be required to pay the other party a termination payment or "break-up fee". Because these fees do not result in raising funds from a financing transaction, they do not qualify for capitalization as debt or equity financing costs. Further, ASC 230-10-45-17(f) states that cash outflows for operating activities include "*all other cash payments that do not stem from transactions defined as investing or financing activities.*" Therefore, such termination payments should be classified within cash flows from operating activities.

8.4.2 Contingent Consideration - Statement of Cash Flows

FASB REFERENCES

ASC 230-10-45-13(d), ASC 230-10-45-15(f), and ASC 230-10-45-17(ee)

Contingent consideration in a business combination is classified initially (on the acquisition date) as a non-cash investing activity. Subsequent changes in the fair value of liability- (or asset-) classified contingent consideration for a business combination should be reflected as an adjustment to reconcile net income to cash flows from operating activities when following the indirect method.

The classification of subsequent cash payments to settle contingent consideration liabilities related to a business combination depends on the timing and the amount of the payments. ASC 230, *Statement of Cash Flows*, requires that payments made by the acquirer soon after the acquisition date to settle a contingent consideration liability be included in cash flows from investing activities. As such, payments to settle contingent consideration shortly after the acquisition date (for example, up to three months) are classified as cash flows from investing activities.

Payments to settle contingent consideration liabilities that do not occur within a short period after the business combination should be reflected as follows:

- Settlement amounts that are less than or equal to the acquisition-date fair value of the contingent consideration (including measurement period adjustments) should be presented as cash flows from financing activities.
- Settlement amounts in excess of the acquisition-date fair value of the contingent consideration (including measurement period adjustments) should be reflected within cash flows from operating activities.

8.4.2.1 Working Capital Adjustments

Acquisition agreements commonly include provisions that require an adjustment to the consideration for the business combination if the working capital balances of the acquiree are above or below a targeted amount. Because working capital is determined at the acquisition date and is not dependent upon the outcome of an uncertain future event, working capital adjustments do not represent contingent consideration. Instead, such adjustments affect the consideration transferred if an adjustment is made after the acquisition date but before the end of the measurement period; therefore, they are reflected within cash flows from investing activities. Working capital adjustments that occur after the measurement period are recognized in the income statement; therefore, they are reflected within cash flows from operating activities.

8.4.3 Extinguishment of Debt in Connection With a Business Combination - Statement of Cash Flows

An acquirer may settle the acquiree's debt in connection with a business combination. A question arises regarding whether the cash outflow to settle the debt should be classified as a financing activity or an investing activity. The answer depends on whether the acquirer legally assumes the debt.

If the acquirer does not legally assume the debt, the repayment on behalf of the sellers represents consideration for the business combination and the cash outflow would be included within cash flows from investing activities.

If the acquirer legally assumes the debt, the liability would be recognized as a liability assumed as part of the business combination and the subsequent repayment of the debt would be classified as a cash outflow from financing activities, consistent with the classification of debt repayments unrelated to a business combination.

BDO INSIGHTS — CASH FLOW PRESENTATION OF DEBT ASSUMED FOR ADMINISTRATIVE CONVENIENCE

If debt is legally assumed for administrative convenience but repaid immediately (within one day of the business combination), we believe it is acceptable to classify the cash outflow as an investing activity.

An entity that presents the cash outflow as an investing activity should characterize it as part of the consideration for the business combination throughout the financial statements. It would be inconsistent to reflect such debt as a liability assumed in the business combination.

8.4.4 Constructive Cash Flows

It is not uncommon for a bank or other financial institution or escrow agent to serve as an intermediary on behalf of reporting entities for cash transfers. Consequently, a reporting entity may have transactions that do not actually flow through its cash account; however, the same economic results are achieved as if cash did pass through the entity's bank account. These situations are known as constructive receipts and disbursements. In essence, the economics are the same regardless of whether cash actually flowed through the entity's account. For example, when an entity secures a loan to pay the selling shareholders or to pay off an existing lender, the financial institution or transfer agent will disburse the funds directly to the selling shareholders or an existing lender. Neither the new loan proceeds nor the payoff amounts enter or leave the reporting entity's bank account.

BDO INSIGHTS — REFLECTING CONSTRUCTIVE CASH FLOWS IN STATEMENT OF CASH FLOWS

We believe the substance of the transactions, including their constructive cash flows, should generally be reported in the statement of cash flows.

However, we are aware of an alternative view that such funds should be presented as noncash financing or investing activities rather than presented as a constructive cash flow on the statement of cash flows. Based on this approach, transactions that affect recognized assets or liabilities but that do not result in actual cash receipts or payments should be disclosed as noncash investing and financing activities either in a schedule or narrative form on the face of the statement of cash flows or in the notes to the financial statements. Reaching a conclusion on the presentation of constructive cash flows requires the application of professional judgment based on the facts and circumstances.

8.5 DISCLOSURE OBJECTIVES

FASB REFERENCES

ASC 805-10-50-1, ASC 805-10-50-5, and ASC 805-10-50-7

ASC 805 provides two disclosure objectives for business combinations. These disclosure objectives are meant to provide financial statement users with sufficient information to:

- Evaluate the nature and financial effect of a business combination that occurs either during the current reporting period or after the reporting date but before the financial statements are issued.
- Evaluate the financial effects of adjustments recognized in the current reporting period that relate to previous business combinations.

To satisfy those objectives, ASC 805 provides detailed disclosure requirements. However, if the specific disclosures required by ASC 805 and other U.S. GAAP are not sufficient to meet the disclosure objectives, the acquirer must disclose whatever additional information is necessary to meet those objectives.

8.5.1 Assessing Materiality

Entities must provide separate disclosures for each material business combination that occurs during the reporting period (or after the reporting date but before the financial statements are issued). Also, if there are business combinations that are individually immaterial but are material collectively, disclosures must be provided for the business combinations in the aggregate.

BDO INSIGHTS — ASSESSING MATERIALITY

ASC 805 does not provide guidance for assessing whether a business combination (or group of business combinations in the aggregate) is material. The acquiring entity must consider both quantitative and qualitative factors when making this determination.

Quantitative factors may include measures such as:

- Net assets of the acquiree as a percentage of the acquirer's total equity
- Total assets of the acquiree as a percentage of the acquirer's total assets
- Income from continuing operations of the acquiree as a percentage of the acquirer's income from continuing operations

Qualitative factors may also indicate that a business combination (or group of business combinations) is material, even if the quantitative measures are less than the acquirer's materiality threshold. For example, extensive disclosures about a business combination in management's discussion and analysis, press releases, or on the acquirer's website might indicate that the business combination is important to investors, and thus material. Professional judgment must be used when evaluating the materiality of a business combination (or group of business combinations).

8.5.2 Aggregation of Individually Immaterial Business Combinations

FASB REFERENCES

ASC 805-10-50-3, ASC 805-20-50-2, ASC 805-20-50-4, and ASC 805-30-50-2

ASC 805 requires that disclosures be provided for individually immaterial business combinations that are material collectively. Nearly all disclosures that are required for a business combination that is individually material must be provided for a group of business combinations that is material in the aggregate. The general information disclosures discussed in Section 8.6.1 can be excluded, but the disclosures specified in the following paragraphs are required:

- ASC 805-10-50-2(e)-(h)
- ASC 805-20-50-1
- ASC 805-20-50-4A
- ASC 805-30-50-1

8.6 REQUIRED DISCLOSURES

To satisfy the disclosure objectives outlined in Section 8.5, ASC 805 and ASC 350 provide specific required disclosures, as discussed in this chapter. These disclosures must be presented in the annual or interim[18] period that a business

[18] ASC 270-10-50-5 and ASC 270-10-50-7(a) indicate that business combination disclosures are required for interim financial statements.

combination occurs. This is true, even if the business combination occurs after the balance sheet date but before the financial statements are issued, as discussed in Section 8.9.

8.6.1 General Information

FASB REFERENCES

ASC 805-10-50-2

To meet the objective in the preceding paragraph, the acquirer shall disclose the following information for each business combination that occurs during the reporting period:

a. The name and a description of the acquiree

b. The acquisition date

c. The percentage of voting equity interests acquired

d. The primary reasons for the business combination and a description of how the acquirer obtained control of the acquiree…

ASC 805 requires the acquirer to provide general information about each material business combination. However, this information does not have to be provided for business combinations that are individually immaterial but are material as a group.

8.6.2 Disclosures for Consideration Transferred

FASB REFERENCES

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.

ASC 805 requires the acquirer to disclose the acquisition-date fair value of the consideration transferred in total and by each major class of consideration. As discussed in Chapter 5, such consideration may include cash or other assets, the acquirer’s equity interests, and liabilities payable to the sellers (such as contingent consideration or notes payable to the sellers). Entities often disclose this information both in the text of the footnotes and in a table that reconciles the consideration to the acquired assets and liabilities.

An acquirer may settle the acquiree’s debt in connection with a business combination. As discussed in Section 8.4.3, debt that is not legally assumed by the acquirer (or is legally assumed for administrative convenience and immediately repaid) is reflected as part of the consideration for the business combination rather than as an assumed liability.

Section 8.4 discusses the requirements for presenting the cash and noncash elements of consideration in the statement of cash flows.

8.6.2.1 Disclosures for Contingent Consideration

FASB REFERENCES

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…

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…

ASC 805-30-50-4

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 requires the acquirer to disclose information about contingent consideration at the acquisition date of a business combination. Such information should enable the financial statement users to understand how the fair value of the contingent consideration was determined and the estimated range of potential outcomes if it can be estimated. If it cannot be estimated, the acquirer must disclose the reasons why.

In periods after the acquisition, the acquirer must provide additional disclosures about the contingent consideration until it is settled. Such information should enable the financial statement users to understand the changes in fair value of the contingent consideration and changes in the range of potential outcomes. The acquirer must also provide the fair value disclosures required by ASC 820.

8.6.3 Disclosures for Noncontrolling Interests (Partial Acquisitions)

FASB REFERENCES

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…

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:

1. The fair value of the noncontrolling interest in the acquiree at the acquisition date

2. The valuation technique(s) and significant inputs used to measure the fair value of the noncontrolling interest.

For a partial acquisition (an acquisition in which the acquirer holds less than 100% of the acquiree's equity interests), the acquirer must disclose the fair value of the NCI and the valuation techniques and inputs used to measure the fair value.

Section 4.5 discusses the accounting for NCI at the acquisition date.

8.6.4 Disclosures for Business Combinations Achieved in Stages

FASB REFERENCES

ASC 805-10-50-2

To meet the objective in the preceding paragraph, 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…

ASC 805 requires the acquirer to disclose the fair value of the previously held equity interest at the acquisition date, the amount of gain or loss recognized from remeasuring such equity interests at fair value, and the line item in the income statement where the gain or loss is included. The acquirer also must provide information about the valuation techniques and inputs used for the fair value measurement.

Section 5.5 discusses the accounting for previously held equity interests at the acquisition date.

8.6.5 Disclosures of Assets Acquired and Liabilities Assumed

FASB REFERENCES

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])…

ASC 805 requires the acquirer to disclose the amounts recognized as of the acquisition date for each major class of assets acquired and liabilities assumed. This information is often presented in a table that reconciles the consideration for the business combination to the acquired assets and liabilities.

Further, ASC 805 and ASC 350 require specific disclosures for the following assets and liabilities:

- Indemnification assets
- Acquired receivables
- Intangible assets
- Assets and liabilities arising from contingencies
- Contract assets and liabilities
- Goodwill or bargain purchase gains

8.6.5.1 Disclosures for Indemnification Assets

FASB REFERENCES

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…

ASC 805 requires the acquirer to disclose information about indemnification assets, including a description of the indemnification arrangement, the amount recognized at the acquisition date, and the basis for determining the amount of payment and the estimated range of outcomes (if it can be estimated). If the range cannot be estimated, the acquirer must disclose the reasons why.

Section 4.4.1.4 discusses the accounting for indemnification assets in a business combination.

8.6.5.2 Disclosures for Acquired Receivables

FASB REFERENCES

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 326-20 relating to purchased financial assets with credit deterioration, 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…

ASC 805 requires the acquirer to disclose information about the receivables acquired in a business combination, including the gross contractual amounts of the receivables, their fair value, and an estimate of the contractual cash flows not expected to be collected.

The acquirer must also follow the disclosure requirements in ASC 326 for receivables within the scope of that guidance.

8.6.5.3 Disclosures for Intangible Assets

FASB REFERENCES

ASC 350-30-50-1

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.*

ASC 350 requires the acquirer to provide disclosures about intangible assets acquired in a business combination. These disclosures are intended to provide information about the nature of the intangible assets and the periods they are expected to benefit the acquirer. Disclosures must be provided separately for each material business combination or in the aggregate for individually immaterial business combinations.

Section 4.4.2.7 discusses the accounting for intangible assets in a business combination.

8.6.5.3.1 In-Process Research and Development Disclosures

BDO INSIGHTS — IPR&D DISCLOSURES

ASC 805 and ASC 350 do not provide specific disclosure requirements for acquired IPR&D. However, the acquirer should consider providing information about the nature of the IPR&D, the methods and assumptions used to determine the fair value, and the acquirer's expectations regarding the IPR&D. Entities may also consider the non-authoritative disclosure guidance in chapter 5 of the AICPA's Accounting & Valuation Guide, *Assets Acquired to Be Used in Research and Development Activities*.

Section 4.4.2.8 discusses the accounting for IPR&D in a business combination.

8.6.5.4 Disclosures for Assets and Liabilities Arising From Contingencies

FASB REFERENCES

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…*
>
> *d. For contingencies, the following disclosures shall be included in the note that describes the business combination:*
>
> *1. For assets and liabilities arising from contingencies recognized at the acquisition date:*
>
> *i. The amounts recognized at the acquisition date and the measurement basis applied (that is, at fair value or at an amount recognized in accordance with Topic 450 and Section 450-20-25)*
>
> *ii. The nature of the contingencies.*
>
> *An acquirer may aggregate disclosures for assets or liabilities arising from contingencies that are similar in nature.*
>
> *2. For contingencies that are not recognized at the acquisition date, the disclosures required by Topic 450 if the criteria for disclosures in that Topic are met.*

An acquirer may aggregate disclosures for assets and liabilities arising from contingencies that are similar in nature…

ASC 805 requires the acquirer to disclose information about preacquisition contingencies. These disclosures are intended to provide information about the nature of the contingencies, any amounts recognized (if any), and the measurement basis of such amounts. For any contingencies that are not recognized at the acquisition date, the disclosures required by ASC 450 should be provided.

Section 4.4.1.1 discusses the accounting for preacquisition contingencies in a business combination.

8.6.5.5 Disclosures for Contract Assets and Liabilities in a Business Combination

FASB REFERENCES

ASC 805-20-50-5

For any of the practical expedients in paragraph 805-20-30-29 that an acquirer uses, the acquirer shall disclose all of the following information:

a. The expedients that have been used

b. To the extent reasonably possible, a qualitative assessment of the estimated effect of applying each of those expedients.

Entities that have adopted ASU 2021-08 can apply several practical expedients when recognizing contract assets and contract liabilities in a business combination. If the acquirer applies any of these practical expedients, it must disclose the expedients used and, to the extent reasonably possible, a qualitative assessment of the estimated effect of applying each of those expedients.

Section 4.4.1.6 discusses the accounting for contract assets and contract liabilities in a business combination after the adoption of ASU 2021-08.

8.6.5.6 Goodwill Disclosures

FASB REFERENCES

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…*

ASC 805-30-50-4

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…

FASB REFERENCES

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.

ASC 350-20-50-1A

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.

ASC 805 and ASC 350 require the acquirer to provide the following disclosures about goodwill acquired in a business combination:

- A qualitative description of the factors that make up the goodwill, such as expected synergies, intangible assets that do not qualify for separate recognition, or other factors

- The total amount of goodwill that is expected to be deductible for income taxes
- Goodwill by reportable segment (if the acquirer is required to disclose segment information)
- A reconciliation of the carrying amount of goodwill at the beginning and end of the reporting period as required by ASC 350-20-50-1

For entities that provide segment information in accordance with ASC 280, *Segment Reporting*, the disclosures for goodwill should be provided for each reportable segment. If the assignment of goodwill to a reporting unit is not complete at the financial statement issuance date, the reporting entity should disclose this fact and the unallocated goodwill amount.

Section 5.2 discusses the calculation of goodwill in a business combination.

8.6.5.7 Disclosures for Bargain Purchase Gains

FASB REFERENCES

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…

f. In a bargain purchase (see paragraphs 805-30-25-2 through 25-4), both of the following:

1. *The amount of any gain recognized in accordance with paragraph 805-30-25-2 and the line item in the income statement in which the gain is recognized*
2. *A description of the reasons why the transaction resulted in a gain.*

ASC 805 requires the acquirer to disclose the amount of the bargain purchase gain, the line item in the income statement where the gain is included, and a description of the reasons for the bargain purchase gain. Section 5.3 provides guidance regarding a bargain purchase in a business combination.

BDO INSIGHTS — CLASSIFICATION OF BARGAIN PURCHASE GAINS

Because bargain purchases are expected to be rare, we believe that it would be appropriate to present a bargain purchase gain as an unusual or infrequently occurring item in accordance with ASC 220-20-45-1.

8.6.5.8 Disclosures Regarding Fair Value Measurements

ASC 820 provides disclosure requirements for assets and liabilities measured at fair value in the financial statements. Many of the assets and liabilities recognized as part of the business combination are initially recognized at fair value but are not recognized at fair value in periods after the business combination. Such assets and liabilities would be subject to the disclosure requirements in ASC 820 for nonrecurring fair value measurements.

Other assets and liabilities recognized in the business combination are recognized both initially and in subsequent periods at fair value. Such assets and liabilities would be subject to the disclosure requirements in ASC 820 for recurring fair value measurements. Contingent consideration classified as an asset or liability, derivatives, and financial instruments for which the fair value option is elected are examples of assets and liabilities that must provide disclosures for recurring fair value measurements.

8.6.6 Pro Forma Disclosures for Public Entities

FASB REFERENCES

ASC 805-10-50-2

To meet the objective in the preceding paragraph, 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.

If the acquirer is a public entity, ASC 805 requires it to disclose the actual amount of revenues and earnings of the acquiree and unaudited supplemental pro forma information since the acquisition date.

The acquiree's actual revenues and earnings after the acquisition date must be provided during the year of the acquisition. The FASB concluded that the information needed to provide the disclosure during that period will generally be available but did not require this information to be provided for a longer period as the FASB observed that the usefulness of the separate information diminishes as the operations of the acquiree are integrated with the combined entity.[19]

The unaudited supplemental pro forma information that must be disclosed differs depending on whether the acquirer will present comparative financial statements or a single period:

	ASC 805 SUPPLEMENTAL PRO FORMA INFORMATION (UNAUDITED)
Single-Period Presentation	Present revenue and earnings of the combined entity for the current reporting period as though the acquisition date for all business

[19] FAS 141(R), Basis of Conclusions, paragraph B425

	ASC 805 SUPPLEMENTAL PRO FORMA INFORMATION (UNAUDITED)
	combinations that occurred during the year had been as of the beginning of the annual reporting period.
Comparative Financial Statements	Present revenue and earnings of the combined entity as though the business combinations that occurred during the current year had occurred as of the beginning of the comparable prior annual reporting period. 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).

ASC 805 requires disclosure of the nature and amount of any material, nonrecurring pro forma adjustments directly attributable to the business combinations that are included in the reported pro forma revenue and earnings. However, ASC 805 does not provide guidance on how to determine the pro forma revenue and earnings amounts that must be presented. As such, some entities apply the principles in Regulation S-X, Article 11, *Pro Forma Financial Information* to prepare their ASC 805 pro forma disclosures. While this may be acceptable in some cases, the requirements of Article 11 are different than the requirements under ASC 805 (see Section 8.6.6.2). As such, some adjustments allowed under Article 11 would not be appropriate under ASC 805.

BDO INSIGHTS — PRESENTATION OF PRO FORMA AMOUNTS IN ACCORDANCE WITH ASC 805

When determining the pro forma amounts under ASC 805, we believe the acquiree's historical financial statements should generally be added to those of the acquirer after adjusting the following:

ASC 805 PRO FORMA ADJUSTMENTS	
Conforming accounting policies	If the acquiree adopts the acquirer's accounting policies, it would be appropriate to adjust the pro forma amounts for the effects of the change in accounting policies as if the acquisition had occurred at the beginning of the current or comparative period. Section 4.3.1.3 provides guidance for conforming the acquiree's accounting policies to those of the acquirer.
The effects of fair value adjustments	The effects of adjustments to the acquired assets and liabilities in accordance with ASC 805 should be reflected as if the acquisition had occurred at the beginning of the current or comparative period. For example, the effects of amortization and depreciation of assets stepped-up in the business combination should be reflected as if the acquisition had occurred at the beginning of the current or comparative period.
The effects of the combined entity's tax structure	The combined entity must evaluate the tax effects of the acquisition and related adjustments as if the acquiree had been part of the reporting entity since the beginning of the current or comparative period.
Financial structure	Changes to the entity's capital structure may result in pro forma adjustments. For example, the issuance (or repayments) of debt or equity in connection with the acquisition would be reflected as if the acquisition had occurred at the beginning of the current or comparative period.

Acquisition-related costs	The combined entity may need to include acquisition-related costs related to a business combination as if the acquisition had occurred at the beginning of the current or comparative period.

Adjustments that are not factually supportable or are not directly related to the business combination should not be included. For example, estimated cost savings and synergies expected to result from the business combination should not be included in the pro forma amounts.

8.6.6.1 Definition of a Public Entity

FASB REFERENCES

ASC 805-10-20 Glossary

Public Entity - 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 805 definition of the term "public entity" is different than that used elsewhere in the accounting standards codification (such as ASC 470-20-20 and ASC 718-10-20). It also diffs from the definition of the term "public business entity" in ASC 805-20-20, which is used to determine whether the entity qualifies for the private company accounting alternatives (see Section 7.2.1). As such, an acquirer could be a public entity under those standards but would not be a public entity under ASC 805. If the acquirer does not meet the ASC 805 definition of a public entity, pro forma disclosures are not required.

In other words, the requirements to disclose pro forma information apply only to the public entity's financial statements, not to a subsidiary's financial statements of a subsidiary. For example, if a subsidiary (that is not itself a public entity) acquires another entity in a business combination, the disclosure of pro forma information would not apply to the acquiring subsidiary's standalone financial statements.

8.6.6.2 Regulation S-X, Article 11 Pro Forma Financial Information

Regulation S-X, Article 11 requires an SEC registrant to provide pro forma financial information for a significant business acquisition that has occurred or is probable of occurring. The form and content of the pro forma financial information required by Article 11 is different than the supplemental pro forma financial information required under ASC 805. As such, a registrant must comply with the requirements of both Article 11 and ASC 805. The filing of Article 11 pro forma financial information does not satisfy the requirement to include ASC 805 pro forma disclosures in the footnotes, and vice versa. Also, the definition of a business for SEC reporting differs from that under ASC 805 (see Section 3.7). As such, Article 11 pro forma financial information may be required for some acquisitions (or probable acquisitions) that do not meet the definition of a business under ASC 805. See BDO's publication, **Pro Forma Financial Information: A Snapshot.**

The following table illustrates key differences between the ASC 805 and Article 11 requirements:

	ASC 805	REGULATION S-X, ARTICLE 11
Materiality or significance	▶ Disclosure requirements are based on materiality to the financial statements.	▶ Pro forma financial information requirements are triggered when a completed business acquisition is more than 20% significant to the registrant based on the quantitative significance tests prescribed by Regulation S-X, Rule 1-02(w).[20]
Periods to present	▶ Pro forma financial information for revenues and earnings should be provided for the current period and the comparable prior period (if comparative statements are provided).	▶ Regulation S-X, Rule 11-02(c)(1), requires that a pro forma condensed balance sheet be presented as of the date of the latest balance sheet required to be filed (unless the acquisition is already reflected in the historical balance sheet). ▶ Regulation S-X, Rule 11-02(c)(2)(i) requires pro forma condensed income statements to be presented for the latest fiscal year and subsequent interim period required to be filed. Comparative prior year interim period information is permissible, but not required. ▶ For transactions that must be accounted for by retrospectively revising the historical income statements (for example, a combination of entities under common control or discontinued operations), Regulation S-X, Rule 11-02(c)(2)(ii) requires that pro forma condensed income statement information be provided for all periods for which the registrant's historical financial statements are required.
Pro forma acquisition date	▶ If comparative financial statements are not presented, the combined entity's revenue and earnings are presented 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. ▶ If comparative financial statements are presented, the combined entity's revenue and earnings are presented as though the business combinations that occurred during the current year had occurred as of the beginning of	▶ Regulation S-X, Rule 11-02(a)(6)(i)(B) indicates that adjustments depicted in the pro forma income statements must be reflected assuming those adjustments were made as of the beginning of the fiscal year presented. Accordingly, pro forma adjustments for both the annual and interim periods presented should be computed assuming that the acquisition occurred at the beginning of the annual period presented. A registrant that is required to update its pro forma financial information to include a more recently completed fiscal year must update the assumed acquisition date to the beginning of that year. As a result, the assumed acquisition date will change if pro forma financial information

[20] Pro forma financial information may also be required for **probable** business acquisitions that are individually more than 50% significant to the registrant or for individually insignificant acquisitions that are more than 50% significant to the registrant in the aggregate.

	ASC 805	REGULATION S-X, ARTICLE 11
	the comparable prior annual reporting period. The hypothetical acquisition date would not be revised in future periods when additional financial statement periods are presented.	related to the business acquisition must be provided in a future year. • For example, if a registrant completes a significant acquisition in June 20X2, for which pro forma income statements for the fiscal year ended December 31, 20X1, and the three months ended March 31, 20X2, are required, the pro forma adjustments for the business acquisition would be reflected as if the acquisition occurred on January 1, 20X1. Subsequently, if a pro forma income statement for the fiscal year ended December 31, 20X2 is required, the pro forma adjustments for the business acquisition would be reflected as if the acquisition occurred on January 1, 20X2. ▶ For the pro forma balance sheet, any adjustments must be made as if the transaction occurred on the balance sheet date.
Format	▶ Pro forma revenues and earnings amounts must be disclosed, but no specific format is required.	▶ Regulation S-X, Rule 11-02(a) discusses the form and content of pro forma financial information. ▶ Pro forma statements are ordinarily in columnar format showing condensed historical statements, pro forma adjustments, and the pro forma results. ▶ Pro forma financial information must be accompanied by an introductory paragraph that describes the transactions for which pro forma effects are being presented, the entities involved, periods for which the pro forma financial information is presented, and an explanation of what the pro forma financial information shows. ▶ Pro forma financial information should include major captions prescribed by Regulation S-X (however, combining some captions may be permissible). ▶ Pro forma financial information must disclose income (loss) from continuing operations and income (loss) from continuing operations attributable to the controlling interest.
Adjustments	▶ Adjustments that are not factually supportable or not directly related to the business combination should not be included. For example, estimated cost savings and	▶ Regulation S-X, Rule 11-02(a)(6) and Rule 11-02(a)(7) discuss three types of pro forma adjustments that may be made: • Transaction accounting adjustments are made to demonstrate what the historical financial statements may have looked like if

	ASC 805	REGULATION S-X, ARTICLE 11
	synergies expected to result from the business combination should not be included in the pro forma amounts.	the transaction had been included at the balance sheet date or for the full income statement period presented. The adjustments related to a business combination would typically be consistent with adjustments provided under ASC 805. • Autonomous entity adjustments are required only if the registrant was previously part of another entity and investors need to see what the registrant would have looked like as a standalone entity. • Management's adjustments are permitted (but not required) to depict synergies and dis-synergies of the acquisitions and dispositions reflected in the pro forma financial information if, in management's opinion, the adjustments would enhance an understanding of the pro forma effects of the transaction. Management must have a reasonable basis for including such adjustments, which may only be presented in the explanatory notes. These types of adjustments should not be included in the ASC 805 pro forma information.
Footnotes	▶ ASC 805 requires disclosure of 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.	▶ Generally, each adjustment shown in the pro forma balance sheet and income statements should be accompanied by an explanatory note that clearly explains its basis and the assumptions and methods used to calculate it. ▶ Regulation S-X, Rule 11-02(a)(11)(i) requires disclosure of revenues, expenses, gains and losses, and related tax effects which will not recur in the income of the registrant more than 12 months after the transaction. ▶ For transaction accounting adjustments, Regulation S-X, Rule 11-02(a)(11)(ii) requires a table showing the total consideration transferred or received, including its components and how they were measured. Additional disclosures are required for contingent consideration and if the accounting for the acquisition is incomplete. ▶ For autonomous entity adjustments, Regulation S-X, Rule 11-02(a)(11)(iii), requires a description of the adjustment, the material assumptions, the calculation of the adjustment, and additional qualitative information about the adjustment necessary to give a fair and balanced presentation of the pro forma financial information.

	ASC 805	REGULATION S-X, ARTICLE 11
		▶ For management's adjustments, Regulation S-X, Rule 11-02(a)(7)(ii)(d), requires disclosure of the basis for, and material limitations of, each adjustment, including any material assumptions or uncertainties, an explanation of the method of the calculation of the adjustment, if material, and the estimated time frame for achieving the synergies and dis-synergies of such adjustment.
Per-share data	▶ ASC 805 does not require pro forma EPS data.	▶ Regulation S-X, Rule 11-02(a)(9), requires the registrant to present historical and pro forma basic and diluted EPS on the face of the pro forma income statements. Such pro forma EPS calculations can give effect only to the transaction accounting adjustments and autonomous entity adjustments. ▶ The weighted average number of shares outstanding during the period must be adjusted to give effect to any shares that have been (or will be) issued to consummate the transaction as if the shares were outstanding as of the beginning of the period presented. The potential dilutive effect of any convertible securities issued (or to be issued) in the transaction must also be considered.
Probable business combinations and other transactions	▶ ASC 805 does not allow adjustments for other significant transactions (for example, disposal of a business or probable business acquisitions).	▶ Regulation S-X, Article 11, may require pro format financial information for probable business acquisitions and other significant transactions (such as a completed or probable significant business disposition).
How long disclosures must be retained	▶ Pro forma disclosures should be repeated as long as the year or interim period of the acquisition is presented.	▶ A pro forma condensed balance sheet is not required if an acquisition is already reflected on the historical balance sheet. ▶ A pro forma condensed income statement is no longer required (and cannot be provided) once the historical statement of comprehensive income reflects the transaction for the entire period.

8.7 DISCLOSURE OF TRANSACTIONS SEPARATE FROM THE BUSINESS COMBINATION

FASB REFERENCES

ASC 805-10-50-2

To meet the objective in the preceding paragraph, 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…

ASC 805 requires the acquirer to provide disclosures about any transactions that are recognized separate from the business combination. Such disclosures are meant to inform the financial statement users about the nature and amounts of each transaction.

Chapter 6 provides guidance for accounting for transactions that should be accounted for separate from the business combination.

8.7.1 Disclosure of Acquisition-Related Costs

FASB REFERENCES

ASC 805-10-50-2

To meet the objective in the preceding paragraph, 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) 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…

ASC 805 requires the acquirer to disclose the acquisition-related costs incurred in connection with the business combination, including the amounts and line items in the income statement where such costs are recognized. Any debt- or equity-issuance costs recognized in connection with a business combination also must be disclosed.

Section 6.3 provides guidance for accounting for acquisition-related costs of the business combination.

8.7.2 Disclosure of Changes in the Acquirer's Valuation Allowances as a Result of a Business Combination

FASB REFERENCES

ASC 805-740-50-1

Paragraph 805-740-30-3 describes a situation where an acquirer reduces its valuation allowance for deferred tax assets as a result of a business combination. Paragraph 740-10-50-9(h) requires disclosure of adjustments of the beginning-of-the-year balance of a valuation allowance because of a change in circumstances that causes a change in judgment about the realizability of the related deferred tax asset in future years. That would include, for example, any acquisition-date income tax benefits or expenses recognized from changes in the acquirer's valuation allowance for its previously existing deferred tax assets as a result of a business combination.

Sometimes an acquirer's deferred tax valuation allowances may change as a result of a business combination. For example, an acquirer with a preexisting valuation allowance may acquire a target that generates taxable income that would allow for the release of all or part of the acquirer's valuation allowance. Any adjustments to the acquirer's income tax accounts that result from an acquisition are not accounted for as part of the business combination because the acquirer's assets and liabilities are not part of the assets acquired and liabilities assumed.

ASC 805 and ASC 740 require the acquirer to disclose any adjustments to its deferred tax valuation allowance that result from the business combination.

8.8 MEASUREMENT PERIOD AND DISCLOSURES WHEN INITIAL ACCOUNTING FOR THE BUSINESS COMBINATION IS INCOMPLETE

FASB REFERENCES

ASC 805-20-50-4A

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.

ASC 805 provides the acquirer with a measurement period of up to one year to finalize its acquisition accounting. Before finalizing the accounting, the acquirer must provide provisional amounts based on the best information available to the acquirer. If the accounting for a business combination is not complete at the reporting date, the acquirer must disclose why the initial accounting is incomplete, as well as the specific assets, liabilities, equity interests, or items of consideration for which the initial accounting is incomplete. These disclosures should provide sufficient details about the items whose measurements are incomplete (and the information the acquirer is waiting for) to enable the financial statement users to understand the potential effects on the financial statements in the postacquisition periods.

Further, for any measurement period adjustments recognized in periods after the business combination, ASC 805 requires the acquirer to disclose the nature and amount of the adjustments. Such disclosures must include 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. In other words, the “out-of-period” effects of the adjustments on the income statement line items must be disclosed.

Section 4.6 provides guidance regarding the measurement period in connection with a business combination.

8.9 DISCLOSURES FOR BUSINESS COMBINATIONS THAT OCCUR AFTER THE BALANCE SHEET DATE

FASB REFERENCES

ASC 805-10-50-4, ASC 805-20-50-3, and ASC 805-30-50-3

ASC 805 requires the acquirer to provide disclosures when a business combination is completed after the balance sheet date but before the financial statements are issued (or are available to be issued). The disclosure requirements are the same as if the business combination were completed before the balance sheet date; however, if the initial accounting for the business combination is incomplete, the acquirer must describe which disclosures could not be made and why.

8.10 ILLUSTRATION OF DISCLOSURE REQUIREMENTS

The following example is reprinted from ASC 805:

EXAMPLE 8-1: ILLUSTRATION OF DISCLOSURE REQUIREMENTS

(Quoted from ASC 805-10-55-37 through 55-44)

ASC 805-10-55-37

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.

ASC 805-10-55-38

Paragraph 805-10-50-2(a) through 55-25

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.*

ASC 805-10-55-39

Paragraph 805-30-50-1(a) and 805-30-50-1(e)

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.

ASC 805-10-55-40

Paragraph 805-30-50-1(d)

None of the goodwill recognized is expected to be deductible for income tax purposes.

ASC 805-10-55-41

Paragraphs 805-10-50-2, 805-20-50-1, and 805-30-50-1

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

REFER TO PARAGRAPH(S)		***$***
ASC 805-30-50-1(b)	***Consideration***	
ASC 805-30-50-1(b)(1)	*Cash*	*5,000*
ASC 805-30-50-1(b)(4)	*Equity instruments (100,000 common shares of Acquirer)*	*4,000*
ASC 805-30-50-1(b)(3), 805-30-50-1(c)(1)	*Contingent consideration arrangement*	*1,000*
	Fair value of total consideration transferred	*10,000*
ASC 805-10-50-2(g)(1)	***Fair value of Acquirer's equity interest in Target held before the business combination***	*2,000*
		12,000
ASC 805-10-50-2(e), 805-10-50-2(f)	***Acquisition-related costs*** *(including in selling, general, and administrative expenses in Acquirer's income statement for the year ending December 31, 20X2)*	*1,250*
ASC 805-20-50-1(c)	***Recognized amounts of identifiable assets acquired and liabilities assumed***	
	Financial assets	*3,500*
	Inventory	*1,000*
	Property, plant, and equipment	*10,000*
	Identifiable intangible assets	*3,300*
	Financial liabilities	*(4,000)*

	Liability arising from a contingency	*(1,000)*
	Total identifiable net assets	*12,800*
ASC 805-20-50-1(e)(1)	***Noncontrolling interest in Target***	*(3,300)*
	Goodwill	*2,500*
		12,000

ASC 805-10-55-42

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.

ASC 805-10-55-43

Paragraph 805-30-50-1(b)(3) and 805-30-50-1(c), and paragraph 805-30-50-4(a)

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.

ASC 805-10-55-44

Paragraph 805-20-50-1(b)

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.

ASC 805-10-55-45

Paragraph 805-10-50-6

The fair value of the acquired identifiable intangible assets of $3,300 is provisional pending receipt of the final valuations for those assets.

ASC 805-10-55-46

Paragraph 805-20-50-1(d)

A liability of $1,000 has been recognized at fair value for expected warranty claims on products sold by Target during the last 3 years. Acquirer expects that the majority of this expenditure will be incurred in 20X3 and that all will be incurred by the end of 20X4.

ASC 805-10-55-47

Paragraph 805-20-50-1(e)

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 805-10-55-48

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.

ASC 805-10-55-49

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.

REFER TO PARAGRAPH		REVENUE	EARNINGS
ASC 805-10-50-2(h)(1)	Actual from 6/30/20X2 – 12/31/20X2	$ 4,090	$ 1,710
ASC 805-10-50-2(h)(2)	20X2 supplemental pro forma from 1/1/20X2 – 12/31/20x2	$ 27,670	$ 12,870
ASC 805-10-50-2(h)(3)	20X2 supplemental pro forma from 1/1/20X2 – 12/31/20X2	$ 27,670	$ 14,770
	20X1 supplemental pro forma from 1/1/20X1 – 12/31/20X1	$ 26,985	$ 12,325

ASC 805-10-55-50

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.

8.11 DISCLOSURE REQUIREMENTS FOR PRIVATE COMPANIES

The disclosure requirements of ASC 805 apply to both public and private companies, except that the disclosures and reporting requirements related to pro forma financial information apply only to SEC registrants.

However, there are different disclosure requirements for entities that adopt the private company accounting alternative for goodwill. Section 7.2.2.1.7.2 provides the disclosure requirements for entities that elect the goodwill accounting alternative for private companies and NFPs. Section 7.2.4.4 discusses the disclosure requirements for entities that adopt the intangible asset accounting alternative for private companies and NFPs.

Appendix A — Pushdown Accounting

A.1 OVERVIEW

FASB REFERENCES

ASC 805-50, *Pushdown Accounting Subsections*

When an acquirer accounts for a business combination, it recognizes the acquiree's assets and liabilities at fair value (with limited exceptions) rather than at their previous carrying amounts. This change in the amounts of the assets and liabilities is commonly referred to as a "step-up" or a "new basis". For an acquirer's financial statements, the recognition of a new basis for the acquired assets and liabilities is not optional. Chapter 4 and Chapter 5 discuss the acquirer's initial recognition of the assets acquired and liabilities assumed, including goodwill.

The question arises, however, about whether this new basis of accounting should also be reflected in the acquiree's standalone financial statements. ASU 2014-17, *Business Combinations (Topic 805): Pushdown Accounting, a Consensus of the FASB Emerging Issues Task Force,* amended ASC 805-50 to provide guidance in this area. Under this guidance, the acquiree in a business combination may elect to continue to recognize its assets and liabilities at carryover basis or it may choose to recognize its assets and liabilities at the acquirer's basis. The use of the acquirer's basis in the preparation of an acquiree's separate financial statements is called "pushdown accounting."

This appendix discusses the requirements that must be met to elect pushdown accounting, as well as the accounting, presentation, and disclosure requirements when such an election has been made.

A.2 SCOPE

FASB REFERENCES

ASC 805-10-15-4, ASC 805-50-15-10 through 15-11, and ASC 805-50-25-4

Pushdown accounting guidance is optional and can be elected for the separate financial statements of an acquiree (and its subsidiaries) when an acquirer obtains control of the acquiree that is a business or a nonprofit activity (see Chapter 3 for guidance on the definition of a business). Thus, an acquiree can elect pushdown accounting when[21] there has been a business combination, but not when there has been an asset acquisition or recapitalization transaction. The pushdown guidance can be applied by both public and private entities.

Pushdown accounting does not apply to any of the following transactions:

- The formation of a joint venture, which is addressed in ASC 805-60 (see Appendix D)
- The acquisition of an asset or group of assets that does not constitute a business or a nonprofit activity (see Appendix C)
- A combination between entities, businesses, or nonprofit activities under common control (see Appendix B)
- An acquisition by an NFP entity whose acquisition date is before December 15, 2009 or a merger of not-for-profit entities
- A transaction or other event in which an NFP entity obtains control of an NFP entity but does not consolidate that entity, as described in ASC 958-810-25-4

[21] Pushdown accounting may also be elected in a subsequent period. See Section A.3.1.

- 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 ASC 810

BDO INSIGHTS — PUSHDOWN ELECTION IN FRESH-START ACCOUNTING

We believe that pushdown accounting can be elected by a subsidiary whose parent emerges from bankruptcy and applies fresh-start accounting under ASC 852, *Reorganizations*, because the emergence from bankruptcy represents a change-in-control event.

A.3 PUSHDOWN ELECTION IS AVAILABLE UPON A CHANGE IN CONTROL

FASB REFERENCES

ASC 805-50-25-4 through 25-6 and ASC 805-50-30-10

Pushdown accounting may be applied by an acquiree (or its subsidiary) only when an acquiree that is a business undergoes a change-in-control event in which an acquirer obtains control of the acquiree. In other words, an entity cannot apply pushdown accounting solely because its parent loses control of the entity; to apply pushdown accounting, an acquirer must obtain control of the acquiree.

ASC 810-10 indicates that a controlling financial interest generally results when an entity, either directly or indirectly, obtains more than 50% of the voting interest 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 variable interest entity. See our Blueprint, Control and Consolidation Under ASC 810, for guidance on determining control.

It is important to appropriately identify the acquirer, especially if there are multiple layers in the organization structure of the combined business. As discussed in Chapter 4, the acquirer in a business combination must recognize a new basis for the assets acquired and liabilities assumed (it is not optional). An acquiree, on the other hand, has a choice to apply pushdown accounting or not. Section 2.2 provides guidance for identifying the acquirer.

In many transactions, one of the combining entities forms one or more new entities to facilitate the business combination. Those new entities, referred to as “NewCos”, are often formed for legal, tax, or other business reasons. As discussed in Section 2.2.1, if the legal acquiree is a VIE, the primary beneficiary is always the accounting acquirer. As such, a NewCo that becomes the primary beneficiary of the legal acquiree is the accounting acquirer. Otherwise, regardless of which entity forms the NewCo to effect the business combination, an analysis must be performed to determine whether the NewCo is substantive (and therefore may be the accounting acquirer) or if the NewCo is nonsubstantive and should be disregarded (in which case, one of the other entities that existed prior to the business combination would be the acquirer). A NewCo that has no precombination activities other than issuing its equity interests to effect an acquisition is not considered substantive.

If a NewCo is substantive and is determined to be the accounting acquirer, acquisition accounting (rather than pushdown accounting) would be applied in the NewCo financial statements, resulting in a new basis of accounting. On the other hand, if the NewCo is not substantive, one of the combining entities that existed before the business combination would be the acquirer. For example, if the parent of the NewCo is deemed the accounting acquirer, it must recognize a new basis for the assets acquired and liabilities assumed, but the NewCo would have the option to elect (or not elect) pushdown accounting in its separate financial statements. Section 2.2.2.4 provides guidance for evaluating whether a NewCo is substantive.

The decision by an acquiree (or its subsidiary) to apply pushdown accounting is not an accounting policy choice that must be applied to future transactions. An acquiree (or its subsidiary) can make the election to apply pushdown accounting whenever an acquirer obtains control of it. For example, an acquiree may apply pushdown accounting the first time it is acquired but elect not to apply pushdown accounting if it is acquired a second time, or vice versa.

There may be situations in which an acquirer does not apply acquisition accounting. For example, the acquirer might be an individual who does not prepare financial statements or an investment company that accounts for its investments at fair value. In such cases, the acquiree is not precluded from applying pushdown accounting and could still elect to apply pushdown accounting as if the acquirer had accounted for the acquisition under ASC 805.

A.3.1 Pushdown Elected in a Subsequent Period

FASB REFERENCES

ASC 805-50-25-7

An acquiree that does not immediately elect pushdown accounting can elect it in a subsequent reporting period as a change in accounting principle if such change is preferable. Regardless of when a pushdown accounting election is made, the acquiree must apply the accounting as of the most recent change-in-control event. In other words, the acquiree must recognize the acquirer's basis in its assets and liabilities beginning on the most recent date that an acquirer obtained control over the acquiree.

As such, the acquiree must retrospectively adjust the basis of its assets and liabilities as of the date of the change-in-control event. The acquiree must then roll forward those balances to the reporting date, reflecting the effects of the step-up in basis (such as additional depreciation, amortization, and potential impairments) that would have been recognized between the acquisition date and reporting date.

A.3.2 Subsequent Common Control Transaction

FASB REFERENCES

ASC 805-50-30-5

An acquiree is not required to apply pushdown accounting. However, if the acquiree transfers assets to (or exchanges shares with) another entity under common control, ASC 805-50 requires the receiving entity to recognize the transferred assets and liabilities at the historical cost of the parent (acquirer) rather than at the transferring subsidiary's basis. Therefore, the receiving entity must recognize the transferred assets and liabilities at the parent's (acquirer's) stepped-up basis (as if pushdown accounting had been applied by the acquiree) (see Appendix B, Sections B.2.1 and B.3.2).

PRIVATE EQUITY-BACKED MERGERS

Sometimes, a private equity fund combines two or more businesses that it controls to increase economies of scale or market share or to generate other synergies. If pushdown accounting has not previously been elected, the transfer of assets and liabilities between entities under common control would require such assets and liabilities to be recognized at the parent's historical cost under ASC 805-50-30-5. That may cause delays due to the need to obtain third-party valuations to properly reflect the parent's basis in the combined entity. Entities contemplating such transactions should plan accordingly.

In other cases, a private equity group may combine two or more businesses from different funds or transfer a business between funds. Transactions that involve different private equity funds may not be common control transactions. Reaching a conclusion on whether entities are under common control requires the application of professional judgment based on the facts and circumstances.

A.4 PUSHDOWN ELECTION IS IRREVOCABLE

FASB REFERENCES

ASC 805-50-25-9

The decision to elect (or not elect) pushdown accounting usually depends on the information needs of the acquiree's stakeholders, including both investors and lenders. As discussed in Section A.3.1, an acquiree that does not immediately elect pushdown accounting can elect it in a subsequent reporting period as a change in accounting principle if such change is preferable. However, that flexibility does not exist for an entity that elects pushdown accounting; once an entity has elected pushdown accounting for a specific change-in-control event, the election is irrevocable.

A.5 SUBSIDIARY'S SEPARATE PUSHDOWN ELECTION

FASB REFERENCES

ASC 805-50-25-8

Each subsidiary of an acquiree is eligible to elect (or not elect) pushdown accounting if it prepares separate financial statements, irrespective of the acquiree's election. In the basis of conclusions for ASU 2014-17, the EITF observed that *"such optionality could be operably challenging"* for entities, but that *"each entity has different users and their perspectives may be different from one another and, therefore, each entity within the group of entities acquired by the acquirer should be allowed to separately evaluate whether pushdown accounting applies to their separate financial statements."*

DIFFERENT PUSHDOWN ELECTIONS BETWEEN AN ACQUIREE AND ITS SUBSIDIARY

If an acquiree's subsidiary elects pushdown accounting but the acquiree itself does not elect pushdown accounting, the financial statements of the acquiree (which include the subsidiary) must reflect the acquiree's historical cost. As such, it may be operationally difficult for a subsidiary that has elected pushdown accounting to unwind the effects of its election for consolidation by the acquiree. Therefore, the acquiree should decide whether to allow its subsidiary to make a different pushdown election.

A.6 APPLYING PUSHDOWN ACCOUNTING — INITIAL RECOGNITION AND MEASUREMENT

FASB REFERENCES

ASC 805-50-30-10

If an acquiree elects 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 acquisition date (or if the acquirer was not required to apply ASC 805, the amounts that would have been recognized if the acquirer had applied ASC 805).

An acquiree that elects pushdown accounting must apply it in its entirety, meaning the acquiree cannot elect pushdown accounting for some assets or liabilities and not others. However, some assets and liabilities recognized by the acquirer should not be recognized by the acquiree.

Assets or liabilities that are the legal right or obligation of the acquirer rather than the acquiree should not be pushed down to the acquiree unless they must be recognized in the acquiree's financial statements in accordance with other U.S. GAAP. For example, expenses incurred by the acquirer (such as acquisition-related costs) are not part of the acquirer's basis in the assets acquired and liabilities assumed and should not otherwise be pushed down to the acquiree's separate financial statements unless the acquirer incurred such expenses on behalf of the acquiree.

Sections A.6.1 through A.6.6 provide guidance regarding the recognition (or nonrecognition) of specific assets and liabilities of the acquirer when the acquiree applies pushdown accounting.

A.6.1 Goodwill

FASB REFERENCES

ASC 805-50-30-11

If the acquirer recognizes goodwill in the business combination, an acquiree that elects pushdown accounting must typically recognize the same amount of goodwill in its standalone financial statements. Because some items (such as liabilities that are not the acquiree's legal obligation) are not recognized in the acquiree's financial statements (see Section A.6.3), the pushdown of goodwill balances may require the acquiree to record an adjustment to additional paid-in capital so the acquiree's goodwill equals the acquirer's goodwill.

If an acquiree has multiple subsidiaries (or the transaction is structured so that the acquirer obtains control of multiple direct subsidiaries in the business combination), each acquiree subsidiary that elects pushdown accounting would recognize only a portion of the goodwill from the acquisition.

BDO INSIGHTS — ALLOCATING GOODWILL TO MULTIPLE ACQUIRED SUBSIDIARIES

To determine the goodwill that should be allocated to each of the acquiree subsidiaries, we believe the total amount of goodwill recognized by the acquirer should be allocated among the acquiree subsidiaries as if all the subsidiaries had elected pushdown accounting. The allocation method should be reasonable and supportable and consistent with the methodology used for allocating goodwill to reporting units for impairment testing.

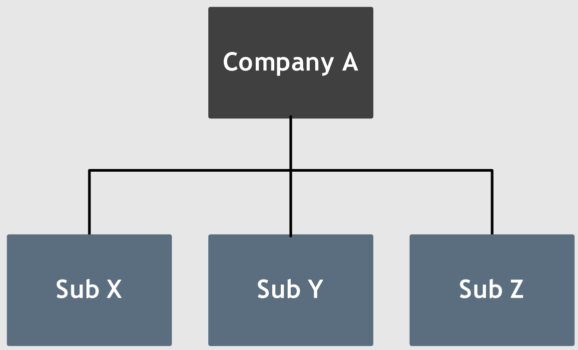
If the acquiree and all its subsidiaries apply pushdown accounting, the total goodwill recognized by the acquiree and its subsidiaries will equal the goodwill recognized by the acquirer. However, if only a portion of the acquiree and its subsidiaries elect pushdown accounting, the total goodwill recognized by the acquiree and its subsidiaries may be less than the goodwill recognized by the acquirer.

Example A-1 illustrates this concept.

EXAMPLE A-1: PUSHDOWN OF GOODWILL – NOT ALL SUBSIDIARIES ELECT PUSHDOWN

FACTS

- Company A acquires 100% of Company B, which consists of three subsidiaries (Sub X, Sub Y, Sub Z), in a business combination for $100 million.
- As the acquirer, Company A recognizes $40 million of net identifiable assets and liabilities of Company B using the guidance in ASC 805 and recognizes goodwill of $60 million.
- After the business combination the structure of Company A is:



- For their standalone financial statements, Sub X and Sub Y elect to apply pushdown accounting, but Sub Z elects to continue to recognize its assets and liabilities at carryover basis.

CONCLUSION

Because not all subsidiaries elected pushdown accounting, the total goodwill recognized by the acquiree subsidiaries that elected purchase accounting is less than the goodwill recognized by the acquirer.

ANALYSIS

The total amount of goodwill recognized by the acquirer should be allocated among the acquiree subsidiaries as if all the subsidiaries had applied pushdown accounting. The allocation method should be reasonable and supportable and consistent with the methodology used for allocating goodwill to reporting units for impairment testing.

Based on its allocation methodology, Company A determines that for purposes of pushdown accounting the goodwill should be allocated to the subsidiaries as follows:

- Sub X: $10 million
- Sub Y: $30 million
- Sub Z: $20 million

As a result, the $40 million of goodwill recognized by Sub X and Sub Y (the subsidiaries that applied pushdown accounting) is less than the $60 million of goodwill recognized by Company A. However, when combined with the $20 million that would be allocated to Sub Z if it applied pushdown accounting, the total goodwill recognized by the acquiree subsidiaries equals the goodwill recognized by the acquirer.

GOODWILL ALLOCATION AND IMPAIRMENT TESTING

When pushdown accounting has been elected by the acquiree, the total amount of goodwill recognized by the acquirer for the business combination must be pushed down to the acquiree. However, the guidance in ASC 350 may require a different allocation of goodwill for the acquirer's impairment testing. Under ASC 350, goodwill is assigned to reporting units that are expected to benefit from the synergies of the business combination. As such, a portion of the acquirer's goodwill may be allocated to reporting units other than the reporting unit that includes the acquiree. In such cases, the goodwill recognized for the acquiree's separate financial statements may differ from the goodwill allocation for the acquirer's impairment testing.

A.6.2 Bargain Purchase Gain

FASB REFERENCES

ASC 805-50-30-11

Bargain purchase gains recognized by the acquirer are not recognized in the acquiree's income statement. Instead, the acquiree recognizes the bargain purchase gains recognized by the acquirer as an adjustment to additional paid-in capital (or net assets of an NFP acquiree).

A.6.3 Acquisition-Related Liabilities

FASB REFERENCES

ASC 805-50-30-12

Liabilities incurred by the acquirer in connection with a business combination are accounted for differently than the acquiree's liabilities assumed by the acquirer. While liabilities assumed in the business combination are recognized at fair value (with limited exceptions), an acquisition-related liability incurred by the acquirer is not recognized in the acquiree's separate financial statements unless it represents an obligation of the acquiree in accordance with other applicable U.S. GAAP. Therefore, the acquirer's acquisition-related liabilities are not pushed down to the acquiree (or its subsidiary) unless the acquiree (or its subsidiary) is required to recognize the liability under other applicable U.S. GAAP, such as the guidance in ASC 405-40, *Liabilities – Obligations Resulting from Joint and Several Liability Arrangements*.

Because liabilities that are not the legal obligation of the acquiree are not recognized in the acquiree's separate financial statements, the pushdown of goodwill balances may result in an adjustment to additional paid-in capital, so the goodwill of the acquiree will equal the goodwill of the acquirer. For example, if the acquirer issues a note payable to the selling shareholders as consideration for the business combination and the acquiree is not an obligor the liability would not be reflected on the acquiree's books. Therefore, the acquiree would recognize an adjustment to additional paid-in capital, so the goodwill of the acquiree will equal the goodwill of the acquirer.

PUSHDOWN ACCOUNTING: PAST AND PRESENT

Before the effective date of ASU 2017-14 (codified in the *Pushdown Accounting* subsections in ASC 805-50), U.S. GAAP provided limited guidance on pushdown accounting. For public entities, the guidance in SAB Topic 5J required or allowed pushdown accounting for some entities and prohibited it for other entities upon a change-in-control event. SAB Topic 5J also required the acquirer's acquisition-related debt to be reflected in the acquiree's financial statements if specific conditions were met. SAB Topic 5J was rescinded by the SEC staff when ASU 2017-14 was issued. As a result, it is no longer appropriate to push down debt to the acquiree unless the debt represents an obligation of the acquiree.

There may be situations in which an acquiree is required to recognize the acquirer's debt or other liabilities in its separate financial statements even if it does not elect pushdown accounting. For example, if the acquirer assigns debt to the acquiree or the acquiree is named as a borrower in the debt arrangement, the acquiree would be required to recognize the obligation in its separate financial statements (for example, following the guidance regarding joint and several liabilities under ASC 405-40) even if pushdown accounting is not elected.

A.6.3.1 Contingent Consideration

FASB REFERENCES

ASC 805-50-30-12

ASC 805-50 does not specifically address whether contingent consideration should be recognized by an acquiree (or its subsidiary) that elects pushdown accounting. However, consistent with the guidance for acquisition-related liabilities, contingent consideration should not be recognized by the acquiree unless it represents a legal obligation (or a legal right if it is a contingent asset) of the acquiree. In most situations, the contingent consideration does not represent an obligation (or right) of the acquiree. If contingent consideration is not pushed down to the acquiree's separate financial statements, the acquiree would not subsequently recognize any changes in the fair value of the acquirer's contingent consideration.

Because contingent consideration that is not the legal obligation of the acquiree is not recognized in the acquiree's financial statements, the pushdown of goodwill balances may result in an adjustment to additional paid-in capital, so the goodwill of the acquiree will equal the goodwill of the acquirer.

A.6.4 Acquisition-Related Costs

The acquirer's acquisition-related costs are not part of the acquiree's new basis and must be expensed by the acquirer (see Section 6.3). As such, the acquirer's acquisition related costs should not be pushed down to the acquiree because they would not typically be for the acquiree's benefit, even if the acquirer requires the acquiree to reimburse those costs. If an acquiree reimburses the acquirer's acquisition-related costs, the reimbursement should not be recognized as an expense of the acquiree but instead as a distribution to the acquirer.

Transaction costs incurred by the acquiree should be expensed by the acquiree in the periods the services are received, whether or not pushdown accounting is elected. Section 6.3.3 provides guidance for an acquiree's acquisition-related costs. Section A.9.1 discusses provides guidance for recognizing specific acquiree transaction costs "on the black line."

A.6.5 Expenses Incurred on Subsidiary's Behalf

FASB REFERENCES

ASC 220-10-S99-3 through S99-4 and ASC 718-10-15-4

Sometimes a parent company may incur expenses on behalf of, or for the benefit of, its subsidiary. In these cases, the subsidiary should recognize such expenses in its separate financial statements with a corresponding credit to contributed (paid-in) capital, whether or not pushdown accounting is elected. SAB Topic 1.B.1, *Costs Reflected in Historical Financial Statements*, and SAB Topic 5.T, *Accounting for Expenses or Liabilities Paid by Principal Stockholder* (codified in ASC 220-10-S99-3 through S99-4), provide guidance that requires the subsidiary to recognize all the costs of doing business, even if such costs are paid by a shareholder or other economic interest holder.

BDO INSIGHTS — APPLICATION OF SAB TOPIC 1.B.1 AND SAB TOPIC 5.T TO PRIVATE COMPANIES

Although SEC *Staff Accounting Bulletins* provide guidance for public entities, we believe the concepts in SAB Topic 1.B.1 and SAB Topic 5.T should be applied by all entities, including private entities by analogy to ASC 718-10-15-4.

A.6.6 Income Taxes

A.6.6.1 Income Taxes for Separate Financial Statements of Acquiree

FASB REFERENCES

ASC 740-20-45-11(g)

If an acquiree (or its subsidiary) elects pushdown accounting, the deferred tax assets and liabilities recognized by the acquiree in its separate financial statements would generally be consistent with those recognized by the acquirer.

If an acquiree (or its subsidiary) does not elect pushdown accounting, the book bases of the assets and liabilities in the separate financial statements of the acquiree (or its subsidiary) will be different from the book bases recognized by the acquirer, but the tax bases recognized by the acquiree (or its subsidiary) will generally be the same as the tax bases recognized by the acquirer. As a result, the deferred tax assets and liabilities recognized by the acquiree in its separate financial statements will also differ from the acquirer's deferred tax balances. In the acquiree's financial statements, the initial deferred tax balances resulting from the transaction, including any change in valuation allowance, would be recorded in equity because the change in tax bases of the assets and liabilities was caused by a transaction among shareholders. The subsequent changes in valuation allowance in future periods should be recorded in the income statement.

A.6.7 Measurement Period

FASB REFERENCES

ASC 805-50-50-6(d)

As discussed in Section 4.6, the accounting for a business combination may be incomplete at the end of the interim or annual financial reporting period in which the combination occurs. ASC 805 allows an acquirer to recognize provisional amounts for which the accounting is incomplete for up to one year after the acquisition date. That measurement period allows the acquirer a reasonable amount of time to obtain the information necessary to identify and measure the various elements necessary to account for the business combination (including the identifiable assets acquired, liabilities assumed, noncontrolling interests, equity interests previously held by the acquirer, and the consideration transferred).

BDO INSIGHTS — MEASUREMENT PERIOD ADJUSTMENTS IN PUSHDOWN ACCOUNTING

We believe that if the acquiree elects pushdown accounting, the measurement period also applies to the acquiree's separate financial statements. As such, any measurement period adjustments made by the acquirer should also be reflected in the acquiree's separate financial statements. We believe that the acquiree's separate financial statements should also comply with the disclosures required when the initial accounting for the business combination is incomplete (see Section 8.8) consistent with ASC 805-50-50-6(d).

A.7 APPLYING PUSHDOWN — SUBSEQUENT MEASUREMENT

FASB REFERENCES

ASC 805-50-35-2

ASC 805-50 does not provide specific subsequent-measurement guidance for assets, liabilities, and equity instruments recognized in an acquiree's separate financial statements. Instead, it requires that the acquiree follow the subsequent measurement guidance provided elsewhere in U.S. GAAP, including in ASC 805-20 and ASC 805-30.

A.7.1 Fair Value Option When Pushdown Is Elected

FASB REFERENCES

ASC 825-10-25-5

A business combination creates an election date for the fair value option, so the acquirer may elect the fair value option for qualifying financial instruments beginning on the acquisition date. Similarly, if the acquiree (or its subsidiary) elects pushdown accounting, it also may elect the fair value option for any eligible financial instruments.

A.7.2 Goodwill Impairment Testing

As discussed in Section A.6.1, the total amount of goodwill recognized by the acquirer for the business combination must be pushed down to the acquiree (or hypothetically pushed down to all the acquiree subsidiaries as if they all applied pushdown accounting). However, the guidance in ASC 350 may require a different allocation of goodwill for the acquirer's impairment testing. Under ASC 350, goodwill is assigned to reporting units that are expected to benefit from the synergies of the business combination. Thus, a portion of the acquirer's goodwill may be allocated to reporting units other than the reporting unit that includes the acquiree. In such cases, the goodwill recognized for the acquiree's separate financial statements may differ from the goodwill allocation for the acquirer's impairment testing.

Example A-2 illustrates this concept.

EXAMPLE A-2: GOODWILL ASSIGNED TO REPORTING UNITS DIFFERS FROM GOODWILL PUSHED DOWN TO ACQUIREE

FACTS

- Company A acquires 100% of Company B and recognizes $50 million of goodwill.

- Company A assigns Company B to a new Reporting Unit 2 that is expected to create synergies with Company A's existing Reporting Unit 1.
- Company B elects pushdown accounting for its separate financial statements.

CONCLUSION

The amount of goodwill recognized by the acquiree in its separate financial statements differs from the assignment of goodwill for the acquirer's impairment testing.

ANALYSIS

When applying pushdown accounting, Company B must recognize the entire $50 million of goodwill in its separate financial statements. However, ASC 350 requires the goodwill to be assigned to the reporting units that are expected to benefit from the synergies of the combination. As such, for impairment testing, Company A assigns $12.5 million to Reporting Unit 1 and $37.5 million to Reporting Unit 2. Thus, Company B recognizes $50 million of goodwill in its separate financial statements but is assigned only $37.5 million of goodwill in Company A's consolidated financial statements.

The parent and subsidiary must separately test goodwill for impairment based on their own reporting unit structures. A goodwill impairment recognized in the separate financial statements of a subsidiary will not always result in an impairment in the parent's consolidated financial statements, or vice versa. However, a goodwill impairment at the subsidiary may represent a triggering event for testing goodwill of the parent, or vice versa.

A.8 DISCLOSURE

FASB REFERENCES

ASC 805-50-50-5

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.

ASC 805-50-50-6

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.*

ASC 805-50 provides specific disclosure requirements for an entity that elects pushdown accounting. However, it indicates that these requirements are not exhaustive, and it requires the entity to disclose whatever information is necessary to enable the financial statement users to evaluate the effect of pushdown accounting. An entity must determine whether any of the additional disclosures that are required for an acquirer in a business combination are necessary to meet this objective. Chapter 8 discusses the required disclosures for the acquirer in a business combination.

There are no required disclosures for an entity that does not elect pushdown accounting, so an entity does not have to disclose that there was a change-in-control event nor that it decided not to elect pushdown accounting.

A.9 FINANCIAL STATEMENT PRESENTATION

The application of pushdown accounting results in a new basis of accounting for the acquiree's assets and liabilities after the business combination. It is as if the old reporting entity was terminated and a new one was created. As such, it is not appropriate to combine the preacquisition and postacquisition periods when presenting a single set of financial statements. Rather, the financial statements should be separated into precombination and postcombination periods, commonly referred to as the "predecessor" and "successor" periods, respectively. Further, the predecessor's equity structure (including retained earnings and other accumulated comprehensive income) is not carried forward; rather, the new equity structure is presented in the successor period.

To highlight this change in reporting entity, the successor and predecessor periods are often separated by a vertical black line in the acquiree's standalone financial statements. For example, if an entity was acquired on June 1 and the acquiree elected to apply pushdown accounting, the acquiree's December 31 statements would include a five-month predecessor period and a seven-month successor period, separated by a black line. The notes to the financial statements would reflect the relevant information separately for the predecessor and successor periods, and they must alert readers to the fact that pushdown accounting has been applied and that the predecessor and successor periods are not comparable.

Example A-3 illustrates the presentation of black line financial statements.

EXAMPLE A-3: BLACK LINE FINANCIAL STATEMENT PRESENTATION

FACTS

- Company A acquires 100% of Company B on June 1, 20X2.
- Company B elects pushdown accounting and wants to present financial statements that include both the predecessor and successor periods in 20X2 with comparative financial statements for the year ended December 31, 20X1.

CONCLUSION

The acquiree's financial statements should be separated into predecessor and successor periods (which are typically separated by a black line). The notes to the financial statements (including any tables) must reflect the relevant information separately for the predecessor and successor periods, and they must alert readers to the fact that pushdown accounting has been applied and that the predecessor and successor periods are not comparable.

The following table illustrates the format of the columns that would be included in the statement of operations for the predecessor and successor periods.

Consolidated Statements of Operations

	Successor		Predecessor	
	Period from June 1, 20X2 through December 31, 20X2		Period from January 1, 20X2 through May 31, 20X2	Year ended December 31, 20X1
Net Revenue	$ XX		$ XX	$ XX
Cost of Sales	XX		XX	XX
Selling, General, and Administrative	XX		XX	XX
Depreciation and Amortization	XX		XX	XX
Income From Operations	XX		XX	XX
Interest Expense, net	XX		XX	XX
Pretax Income	XX		XX	XX
Income Tax Expense	XX		XX	XX
Net Income	$ XX		$ XX	$ XX

The same formatting would be applied to the balance sheet and the statements of comprehensive income and cash flows. Similarly, the statement of changes in equity for the successor period would be presented separately from the predecessor period using a horizontal black line.

A.9.1 Recognizing Contingent Expenses "on the Black Line"

An acquiree may incur expenses, such as investment banking fees and share-based payments that accelerate upon a change in control, that are contingent upon the closing of a business combination. When an acquiree elects pushdown accounting, questions arise regarding which period these contingent expenses should be recognized or whether it would be appropriate to exclude them from both the predecessor and successor periods.

One view is that these costs should be recognized in the predecessor period immediately before the closing of the transaction, because the services related to the contingent expenses were performed in the predecessor period and there is no longer any uncertainty about whether the business combination will occur. Another view is that the contingent expenses should not be recognized in either the predecessor period (because the accounting for the business combination is excluded from the predecessor period) or the successor period (because the acquiree's transaction expenses should not be reflected in the acquirer financial statements).

The following excerpt from an SEC staff speech discusses this topic.

SEC STAFF GUIDANCE

[Remarks before the 2014 AICPA Conference on Current SEC and PCAOB Developments]

Carlton E. Tartar, Associate Chief Accountant, Office of the Chief Accountant

December 8, 2014

Blackline expense presentation

> *The staff has received a number of questions regarding the appropriate presentation of expenses that are incurred contingent upon a business combination, when financial statements reflecting the application of pushdown are presented. The staff understands that such presentation typically includes predecessor and successor income statement periods, with a "blackline" separating the periods to visually illustrate the change in basis resulting from the change-in-control event. The staff encourages 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.*
>
> *The staff has also become aware that certain expenses that are incurred contingent upon a change-in-control event are in some cases reflected in neither the predecessor or successor income statement periods, but instead are presented "on the line". When registrants have demonstrated that certain expenses were contingent upon the change-in-control event, the staff has not objected to such presentation, provided that transparent and disaggregated disclosure of the nature and amount of such expenses was made. If such presentation is elected, registrants should ensure that all disclosed amounts were fully contingent on the consummation of the change-in-control event.*
>
> *To summarize, when pushdown financial statements are presented, registrants should determine whether each expense relating to the change-in-control event is most appropriately reflected in the predecessor period, successor period or "on the line", and disclose the amounts recorded in each period and the basis for determining the amounts included in each category.* [Footnotes omitted]

As noted in this speech, the SEC staff has not objected to a presentation of expenses that are contingent upon a business combination "on the line" if *"transparent and disaggregated disclosure of the nature and amount of such expenses was made"* and if "*all disclosed amounts were fully contingent on the consummation of the change-in-control event."* As such, for expenses that are fully contingent upon the consummation of the change-in-control event the acquiree can choose to recognize such expenses in the predecessor period or "on the line" as a policy election that should be consistently applied.

For expenses that are not fully contingent upon the consummation of the change-in-control event, the acquiree must recognize them either in the predecessor or successor period, as appropriate. For example, an employment agreement may include terms that require payment or accelerate vesting upon a change in control and a second defined event such as a termination of employment after a change in control. Such dual-trigger arrangements are typically accounted for as transactions separate from the business combination that are for the acquirer's benefit. Thus, the expense (or acceleration of expense) should typically be reflected in the successor period (see Section 6.4.1.2). Similarly, bonus payments paid to an acquiree's employees at the acquirer's discretion would be accounted for as transactions separate from the business combination that are for the acquirer's benefit and would also be recognized in the successor period.

Separately, an acquirer's acquisition-related costs that are contingent upon the business combination should be recognized in the acquirer's financial statements in the period that includes the business combination.

BDO INSIGHTS — APPLICATION OF "BLACK LINE" GUIDANCE BY PRIVATE COMPANIES

Although the SEC staff speech that discussed blackline expense presentation was directed toward public entities, it is also acceptable for private companies to apply this guidance. As such, for expenses that are fully contingent upon the consummation of the change-in-control event the acquiree can choose to recognize such expenses in the predecessor period or "on the line" as a policy election that should be consistently applied.

A.9.2 Reflecting Discontinued Operations in Predecessor Period

Pushdown accounting represents the termination of the old accounting entity and the creation of a new one. Because the predecessor and successor are separate reporting entities, any reorganizations; changes in segment reporting; or changes in accounting policies or principles, including the adoption of new accounting standards elected by the successor, should not be "pushed back" to the predecessor.

Section 13210.2 of the SEC's Financial Reporting Manual provides an exception to this rule: It requires the predecessor financial statements be retrospectively reclassified to reflect the impact of a successor's discontinued operations. However, this guidance should not be applied by analogy to the successor's other accounting policies or principles.

A.9.3 Blackline Presentation in the Statement of Equity

Because 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; instead, the new equity structure is presented in the successor period. The statement of changes in equity for the successor period would be presented separately from the predecessor period using a horizontal black line.

The application of pushdown accounting should be recorded in the opening balances of the successor period (that is, on the acquisition date). Because there is a new basis of accounting, it would not be appropriate to roll forward the balances in the predecessor period to the successor period. Rather, the equity recorded as an offset to the entity's net assets represents the opening balance of the successor period. An acceptable alternative is to present a beginning balance of zero in the successor period and recognize the equity recorded as an offset to the entity's net assets as the first activity reported in the statement of equity. Whichever alternative is chosen, the presentation of opening balances in the statement of equity should generally be consistent with the presentation of opening balances in the statement of cash flows as discussed in Section A.9.4.

Example A-4 illustrates these alternatives.

EXAMPLE A-4: BLACK LINE FINANCIAL STATEMENT PRESENTATION

FACTS

- Company A acquires 100% of Company B on June 1, 20X2.
- Company B elects pushdown accounting and wants to present financial statements that include both the predecessor and successor periods in 20X2 with comparative financial statements for the year ended December 31, 20X1.

CONCLUSION

The acquiree's financial statements must be separated into predecessor and successor periods (which are typically separated by a black line). The notes to the financial statements (including any tables) must reflect the relevant information separately for the predecessor and successor periods, and they must alert readers to the fact that pushdown accounting has been applied and that the predecessor and successor periods are not comparable.

The following table illustrates two potential alternatives for presenting the statement of changes in member's equity for the predecessor and successor periods.

Consolidated Statements of Changes in Members' Equity

	Common Stock Par	Common Stock APIC	Accumulated Other Comprehensive Income (Loss)	Retained Earnings	Total
Balance, December 31, 20X1	XX	$ XX	$ (XX)	$ XX	$ XX
Dividends	-	-	-	(XX)	-
Net Income	-	-	-	XX	-
Foreign currency translation adjustment	-	-	XX	-	-
Balance, May 31, 20X2, Predecessor	XX	$ XX	$ XX	$ XX	$ XX
Balance, June 1, 20X2, Successor (capital contributions made with business combination (see Note 2))	XX	$ XX	$ -	$ -	$ XX
Net loss	-	-	-	(XX)	(XX)
Foreign currency translation adjustment	-	-	(XX)	-	(XX)
Balance, December 31, 20X2, Successor	XX	$ XX	$ (XX)	$ -	$ XX

Alternative Presentation
Consolidated Statements of Changes in Members' Equity

	Common Stock Par	Common Stock APIC	Accumulated Other Comprehensive Income (Loss)	Retained Earnings	Total
Balance, December 31, 20X1	XX	$ XX	$ (XX)	$ XX	$ XX
Dividends	-	-	-	(XX)	-
Net Income	-	-	-	XX	-
Foreign currency translation adjustment	-	-	XX	-	-
Balance, May 31, 20X2, Predecessor	XX	$ XX	$ XX	$ XX	$ XX
Balance, June 1, 20X2, Successor	-	$ -	$ -	$ -	$ -
Capital contributions made with business combination (see Note 2)	XX	XX	-	-	XX
Net loss	-	-	-	(XX)	(XX)
Foreign currency translation adjustment	-	-	(XX)	-	(XX)
Balance, December 31, 20X2, Successor	XX	$ XX	$ (XX)	$ -	$ XX

A.9.4 Pushdown Accounting in the Statement of Cash Flows

Because the application of pushdown accounting is akin to the creation of a new reporting entity, the successor period is presented separately from the predecessor period using a black line.

When an acquiree elects pushdown accounting, it is indirectly reflecting the new basis of accounting in its financial statements rather than directly applying the acquisition method under ASC 805. As such, the cash flows (in the successor period) may be reflected differently for an entity that applies pushdown accounting than for an acquirer in a business combination.

When applying pushdown accounting, the initial recognition of the net assets by the acquiree in the successor period is generally a noncash activity that does not affect the statement of cash flows. It represents a contribution of noncash assets and liabilities by the parent/acquirer to the subsidiary/acquiree in exchange for the subsidiary's equity.

However, predecessor cash balances that carry over to the successor entity will affect the statement of cash flows. Some successor entities present beginning cash equal to the predecessor's ending cash balance. Other entities present beginning cash of zero and a cash receipt equal to the predecessor's ending cash balance as a financing activity (that is, a contribution from the acquirer). Either is acceptable, but the presentation of opening balances in the statement of cash flows should generally be consistent with the presentation of opening balances in the statement of equity as discussed in Section A.9.3.

BDO INSIGHTS — PRESENTATION OF CASH FLOWS IN PUSHDOWN ACCOUNTING

In some cases, the acquiree may participate directly in the cash flows used to finance the business combination. For example, an acquiree may issue debt[22] in connection with a business combination. If so, the cash inflow is presented as a financing activity, which is consistent with the way the acquirer accounts for debt proceeds.

[22] If the acquiree is not the legal obligor, the acquiree does not recognize the debt in its financial statements (see Section A.6.3).

However, we generally believe the cash flows associated with distributing debt proceeds to the selling shareholders is in substance a dividend to the acquirer (for the acquirer to use the proceeds to purchase the business) and would be presented as a financing cash outflow rather than as an investing cash outflow because an acquiree cannot acquire itself. Similarly, any other cash consideration paid by the acquiree to effect the acquirer's business combination should generally be presented as a financing cash flow (a distribution to the acquirer) rather than as an investing cash flow. However, there may be other acceptable alternatives.

The differences between the cash flow presentation for an acquirer and an acquiree that applies pushdown accounting are illustrated in the following table:

PRESENTATION OF CASH FLOWS RELATED TO A BUSINESS COMBINATION		
	ACQUIRER'S ACCOUNTING FOR BUSINESS COMBINATION (SEE SECTION 8.4)	ACQUIREE'S PUSHDOWN ACCOUNTING (SUCCESSOR PERIOD)
Initial recognition of the acquiree's assets and liabilities	Investing activity	Noncash activity
Cash inflow from raising debt when acquiree is not the legal obligor	Financing activity	Not applicable. The acquiree does not recognize a liability unless the acquiree is the legal obligor.
Cash inflow from raising debt when acquiree is the legal obligor	Financing activity	Financing activity
Cash outflow for acquisition of business	Investing activity	Not applicable. The acquiree cannot acquire itself, so cash paid by the acquiree to effect the acquirer's business combination is reflected as a distribution to the parent (acquirer).
Cash distributions to parent/acquirer to effect the business combination	Not applicable	Financing activity

A.9.4.1 Constructive Cash Flows

It is not uncommon for a bank or other financial institution or escrow agent to serve as an intermediary on behalf of reporting entities for cash transfers. Consequently, a reporting entity may have transactions that do not actually flow through its cash account; however, the same economic results are achieved as if cash did pass through the entity's bank account. These situations are known as constructive receipts and disbursements. In essence, the economics are the same regardless of whether cash actually flowed through the entity's account. For example, when an entity secures a loan to pay the selling shareholders or to pay off an existing lender, the financial institution or transfer agent will disburse the funds directly to the selling shareholders or an existing lender. Neither the new loan proceeds nor the payoff amounts enter or leave the reporting entity's bank account.

BDO INSIGHTS — REFLECTING CONSTRUCTIVE CASH FLOWS IN STATEMENT OF CASH FLOWS

We believe the substance of the transactions, including their constructive cash flows, should generally be reported in the statement of cash flows.

However, we are aware of an alternative view that such funds should be presented as noncash financing or investing activities rather than presented as a constructive cash flow on the statement of cash flows. Based on this approach, transactions that affect recognized assets or liabilities but that do not result in actual cash receipts or payments should be disclosed as noncash investing and financing activities either in a schedule or narrative form on the face of the statement of cash flows or in the notes to the financial statements. Reaching a conclusion on the presentation of constructive cash flows requires the application of professional judgment based on the facts and circumstances.

Appendix B — Common Control Transactions

B.1 OVERVIEW

FASB REFERENCES

ASC 805-50-05-4 through 05-5

Common control transactions involve the transfer of net assets (including businesses) or the exchange of equity interests among entities under the control of the same ultimate parent, which could be an entity; individual; or common control group, such as a married couple. Although common control transfers of businesses have similar characteristics as business combinations, there is one key difference: Common control transactions do not involve a change in control (that is, at the ultimate parent or controlling shareholder level), which is required to apply business combination accounting. As such, the guidance onto business combinations does not apply to combinations among entities or businesses under common control.

ASC 805-50 provides guidance for transactions between entities under common control. Unlike accounting for business combinations, accounting for common control transactions does not typically result in a step-up in basis; rather, common control transactions are accounted for at the ultimate parent's carrying amount of the net assets or equity interests transferred. Further, the common control transfer of a business may result in a change in reporting entity, which may require retrospective adjustments to the receiving entity's financial statements (see Section B.3.8).

Common control transactions have no effect (other than potential income tax effects) on the ultimate 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 separate financial statements of the transferring and receiving entities but is eliminated in consolidation. No gain or loss is recognized by the ultimate parent. As such, the guidance in this Appendix is primarily relevant for the separate financial statements of the receiving and transferring entities.

B.2 SCOPE

FASB REFERENCES

ASC 805-50-15-5 through 15-6B

The guidance for common control transactions applies to combinations between entities or businesses under common control, other than the initial measurement by the primary beneficiary of a variable interest entity. Even so, the guidance for the initial measurement of a VIE is similar to the guidance in the ASC 805-50 subsections on transactions between entities under common control in that it also requires the primary beneficiary to recognize the assets, liabilities, and noncontrolling interests of the VIE at the ultimate parent's carrying amounts (see Section B.3.2).

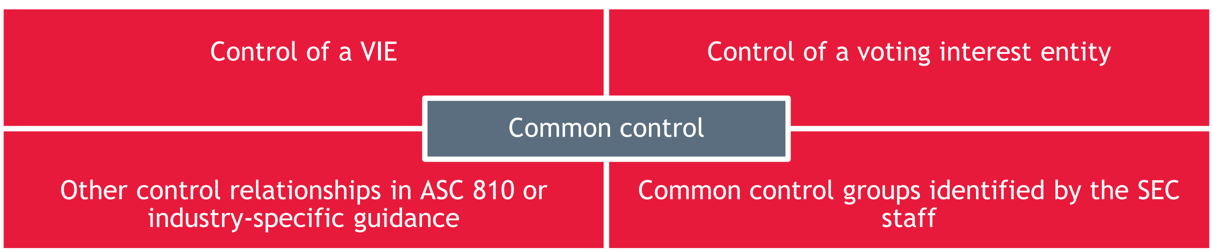
ASC 805-50 provides the following examples of common control transactions:

- An entity charters a newly formed entity and then transfers some or all of its net assets to that newly chartered entity.
- A parent transfers the net assets of a wholly owned subsidiary into the parent and liquidates the subsidiary. That transaction is a change in legal organization but not a change in the reporting entity.

- A parent transfers its controlling interest in several partially owned subsidiaries to a new wholly owned subsidiary. That also is a change in legal organization but not in the reporting entity.
- A parent exchanges its ownership interests or the net assets of a wholly owned subsidiary for additional shares issued by the parent's less-than-wholly-owned subsidiary, thereby increasing the parent's percentage of ownership in the less-than-wholly-owned subsidiary but leaving all the existing NCI outstanding.
- A parent's less-than-wholly-owned subsidiary issues its shares in exchange for shares of another subsidiary previously owned by the same parent, and the noncontrolling shareholders are not party to the exchange. That is not a business combination from the parent's perspective.
- A limited liability company is formed by combining entities under common control.
- Two or more NFP entities 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.

B.2.1 Common Control and Common Control Groups

U.S. GAAP does not define the term "common control". Judgment must be applied to determine whether common control exists. As discussed in our Blueprint, Control and Consolidation Under ASC 810, ASC 810 includes two models for evaluating control – the VIE model and the voting model. It also describes other control relationships (such as control by contract), and U.S. GAAP includes industry-specific guidance for identifying control (for example, in ASC 958-810, *Not-for-Profit Entities – Consolidation* (ASC 958-810)). Therefore, when evaluating whether common control exists, an entity must consider all forms of control as depicted in the following graphic. For example, if an ultimate parent, equity holder, or common control group controls one entity using the voting model and another legal entity using the VIE model, the legal entities are under common control.



In some cases, the entities may not be controlled by a single entity or individual; they may be controlled by a group of family members or entities that are affiliated in some other manner. The EITF discussed this issue in EITF Issue No. 02-5 but did not reach a consensus. The SEC staff's views are excerpted below.

SEC STAFF GUIDANCE

EITF Abstract Issue No. 02-5, paragraph 3

Definition of 'Common Control' in Relation to FAS 141

> *The FASB staff understands that the SEC staff has indicated that common control exists between (or among) separate entities only in the following situations:*
>
> *a. An individual or enterprise holds more than 50 percent of the voting ownership interest of each entity.*
>
> *b. 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.*
>
> *c. 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.* [Footnotes omitted]

BDO INSIGHTS – IDENTIFYING COMMON CONTROL RELATIONSHIPS

A reporting entity generally should not extend the definition of common control beyond the immediate family member relationships discussed in EITF 02-5, paragraph 3(b). For example, a common control group excludes shares held by in-laws. Because of the lack of other authoritative guidance, both public and private companies apply the views of the SEC staff. Reaching a conclusion about whether common control exists requires the application of professional judgment based on the facts and circumstances.

In complex organizational structures, it may be necessary to understand the nature of the relationship between upper tier entities directly or indirectly involved with a VIE, including whether they are under common control. For example, in asset management, private equity, and similar industries, it often is necessary to determine whether investors, general partners, managing members, or similar roles are under common control to determine whether a lower tier entity participates in a common control transaction.

It can be challenging to determine whether common control exists for entities with which management has no direct involvement, and this analysis may require professional judgment based on the facts and circumstances. A reporting entity cannot assume that they are under common control just because two legal entities have the same general partner, managing member, or are managed by the same (group of) advisors or funds.

BDO INSIGHTS – COMMON CONTROL IS NARROWLY APPLIED

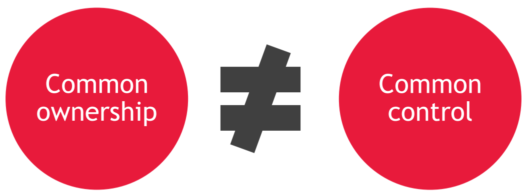
In issuing the accounting alternative for private companies under common control (see our Blueprint, Control and Consolidation Under ASC 810, Section 1.4.5.2), the FASB stated that it:

> *…continues to believe that the term common control should be broader than what the SEC observed in Issue 02-5. For example, an entity owned by a grandparent and an entity owned by a grandchild could, on*

> *the basis of facts and circumstances, be considered entities under common control for the purposes of applying the private company accounting alternative.*[23]

However, we believe the FASB’s statement applies only when evaluating whether a legal entity qualifies for the private company accounting alternative and not when identifying related parties under common control to apply other aspects of the VIE model. That is, we believe common control exists when legal entities have a common ultimate parent (identified using the VIE model, the voting model, or other guidance in ASC 810) or are controlled by a common control group as described by the SEC staff. A conclusion that common control exists in other fact patterns requires the application of professional judgment based on the facts and circumstances. funds.

Common ownership, which is when two or more parties own the same legal entities in the same or different proportions, is not synonymous with common control unless the parties have an agreement to vote in concert or proxy their votes to one another. Therefore, legal entities with a high degree of common ownership (but are not under common control) cannot apply the common control guidance in ASC 810.



AGREEMENTS TO VOTE IN CONCERT

When common ownership exists, a reporting entity should be alert for the possibility of a common control group. It should consider all evidence, including voting agreements and proxy rights, particularly when a key person (for example, a founder) is involved with the legal entities. However, the mere pattern of voting in concert without an agreement to do so does not mean a common control group exists.

B.2.2 Entities With a High Degree of Common Ownership

There are often times when multiple shareholders hold similar ownership interests in multiple entities, but no single shareholder controls the entities. In such cases, the entities have common ownership. Transfers of net assets or equity interests among entities with common ownership, even if there is a high degree of common ownership, are not common control transactions. However, they may be accounted for like common control transactions if the transfer lacks economic substance.

For the transaction to lack economic substance, the entities must have identical owners and the same relative ownership percentages before and after the transaction. Such fact patterns are unusual because even small changes in ownership percentages would cause the transaction to have economic substance. If the transaction does not lack economic substance, it must be accounted for as a business combination or an asset acquisition under ASC 805 rather than as a common control transaction.

Examples B-1 and B-2 illustrate this concept.

[23] ASU 2018-17, paragraph BC19

EXAMPLE B-1: TRANSFER BETWEEN ENTITIES WITH COMMON OWNERSHIP – NO ECONOMIC SUBSTANCE

FACTS

Shareholders A, B and C own Companies X and Y with the following ownership percentages:

	Company X	Company Y
Shareholder A	30%	30%
Shareholder B	30%	30%
Shareholder C	40%	40%

These shareholders agree to merge the two companies and exchange their shares in the individual companies for the shares in a new combined Company XY. After the transaction Shareholders A, B, and C own Company XY with the following ownership percentages:

	Company XY
Shareholder A	30%
Shareholder B	30%
Shareholder C	40%

CONCLUSION

The transaction is accounted for like a common control transaction.

ANALYSIS

Because the shareholders have exactly the same ownership interests before and after the merger, the transaction lacks economic substance. As such, Company XY must recognize the assets and liabilities of Company X and Company Y at their historical carrying amounts.

EXAMPLE B-2: TRANSFER BETWEEN ENTITIES WITH COMMON OWNERSHIP – ECONOMIC SUBSTANCE

FACTS

Shareholders A, B, and C own Companies X and Y, which are both businesses, with the following ownership percentages:

	Company X	Company Y
Shareholder A	35%	30%
Shareholder B	25%	30%
Shareholder C	40%	40%

These shareholders agree to merge the two companies and exchange their shares in the individual companies for the shares in a new combined Company XY. After the transaction Shareholders A, B and C own Company XY with the following ownership percentages:

	Company XY
Shareholder A	32%
Shareholder B	28%
Shareholder C	40%

CONCLUSION

The transaction is accounted for as a business combination.

ANALYSIS

Because the shareholders do not have the same relative ownership interests before and after the merger, the transaction has economic substance. As such, the transaction is accounted for as a business combination with one of the companies being identified as the acquirer and required to apply the acquisition method as discussed in Chapter 2. See Section 1.1.3 for examples of accounting for a roll-up transaction.

B.2.2.1 Addition of Upstream Parent

It is not uncommon for an entity to reorganize its company structure for tax planning or other purposes. In some cases, a new parent company is added to an existing company structure by setting up a new holding company above an existing company. The shareholders of the existing company exchange their shares for shares in the new holding company in proportion to their existing ownership interests so that they maintain the same ownership percentages in the new holding company that they held in the existing company prior to the transaction. In such a reorganization, the transaction lacks economic substance and would be accounted for as a common control transaction, as discussed in Section B.2.2.

B.3 ACCOUNTING BY THE RECEIVING ENTITY

FASB REFERENCES

ASC 805-50-25-2 and ASC 805-50-30-5

ASC 805-50 requires the receiving entity to initially recognize the assets and liabilities transferred at the ultimate parent's carrying amounts at the date of the transfer. Because there is not a change-in-control event, there is generally no change in the basis recognized for book purposes (see Sections B.3.4 and B.3.5 for limited exceptions). Differences between any cash transferred and the carrying amounts of the net assets received are recognized in equity in the receiving entity's separate financial statements. If the receiving entity issues equity interests in the exchange, the equity interests are recognized at an amount equal to the carrying amount of the net assets transferred.

Although the guidance requires net assets received to be recognized at the transfer date, if those assets constitute a business, the receiving entity may be required to retrospectively adjust its financial statements to present a change in reporting entity, as discussed in Section B.3.8.

B.3.1 Initial Consolidation of a Variable Interest Entity Under Common Control

FASB REFERENCES

ASC 805-50-15-6A and ASC 810-10-30-1

The guidance for common control transactions does not apply to the initial measurement by the primary beneficiary of a VIE. However, if the primary beneficiary and VIE are under common control, the guidance for the initial measurement of the VIE is like the guidance in the ASC 805-50 subsections on transactions between entities under common control in that it also requires the primary beneficiary to recognize the assets, liabilities, and noncontrolling interests of the VIE at the ultimate parent's carrying amounts.

BDO INSIGHTS - PRESENTING A CHANGE IN REPORTING ENTITY FOR A COMMON CONTROL TRANSFER OF A VIE THAT IS A BUSINESS

Although not specifically addressed in ASC 810, if the net assets of a VIE that is transferred between entities under common control constitute a business, we believe that the receiving entity should retrospectively adjust its financial statements to present a change in reporting entity as discussed in Section B.3.8.

B.3.2 Different Carrying Amounts Between Parent and Transferring Entity

FASB REFERENCES

ASC 805-50-30-5

There may be instances in which the carrying amount of the net assets held by the transferring entity differs from the ultimate parent's carrying amounts. For example, the net assets being transferred may have been previously acquired in a business combination, but the subsidiary did not elect pushdown accounting (see Appendix A, Section A.3.2). In such case, the receiving entity in a common control transaction must recognize the net assets at the ultimate parent's carrying amounts, regardless of the carrying value recognized by the transferring entity.

PRIVATE EQUITY-BACKED MERGERS

Sometimes, a private equity fund combines two or more businesses that it controls to increase economies of scale or market share or to generate other synergies. If pushdown accounting has not previously been elected, the transfer of assets and liabilities between entities under common control would require such assets and liabilities to be recognized at the parent's historical cost under ASC 805-50-30-5. That may cause delays due to the need to obtain third-party valuations to properly reflect the parent's basis in the combined entity. Entities contemplating such transactions should plan accordingly.

In other cases, a private equity group may combine two or more businesses from different funds or transfer a business between funds. Transactions that involve different private equity funds may not be common control transactions. Reaching a conclusion on whether entities are under common control requires the application of professional judgment based on the facts and circumstances.

B.3.3 Common Control Transfers of Financial Assets

ASC 860 provides guidance on the recognition of transfers of financial assets, which must be applied for common control transfers of financial assets, rather than the guidance in the ASC 850-50 subsections on transactions between entities under common control.

B.3.3.1 Transfers of Financial Assets Between Subsidiaries

FASB REFERENCES

ASC 860-10-55-78 and ASC 860-10-40-5 and ASC 860-20-30-2

A transfer of financial assets from one subsidiary to another subsidiary of a common parent would be accounted for as a sale in each subsidiary's separate financial statements if all the conditions for recognizing a sale of financial assets in ASC 860-10-40-5 are met and the transferee is not consolidated into the transferor's financial statements. The transferor subsidiary does not consider its parent's involvement with the transferred financial assets when applying the guidance in ASC 860. As such, for common control transfers of financial assets between subsidiaries, the transferring entity would recognize a sale and the receiving entity would recognize the transferred assets at fair value if all the conditions in ASC 860-10-40-5 are met.

B.3.3.2 Transfer of Financial Assets from Parent to Subsidiary

FASB REFERENCES

ASC 860-10-55-17D

The guidance in Section B.3.3.1 does not apply to common control transfers of financial assets from a parent to its consolidated subsidiary. Instead, ASC 860 prohibits the recognition of a sale by the transferring entity (that is, the parent) but allows recognition of the transferred financial assets in the separate financial statements of the receiving entity (the subsidiary) unless the nature of the transfer is a secured borrowing with a pledge of collateral.

B.3.4 Common Control Transfers of Inventory

For routine transfers of inventory (and similar recurring transactions) between entities under common control for which valuation is not in question, the transferring entity typically recognizes a gain in its separate financial statements, and the receiving entity recognizes the assets at its cost. This treatment represents an exception to the general rule that requires common control transactions to be accounted for at carryover basis.

This exception is based on the comments made by the SEC Observer in connection with deliberations for EITF 85-21. Although the EITF did not reach a consensus on EITF 85-21, the views provided by the SEC Observer below are applied in practice. However, this exception does not apply to a transfer of net assets.

SEC STAFF GUIDANCE

Changes in Ownership Resulting in a New Basis of Accounting (EITF 85-21)

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]

B.3.5 Deferred Taxes from Common Control Transactions

B.3.5.1 Increase in Tax Basis from Common Control Transactions

FASB REFERENCES

ASC 740-20-45-11(g)

Some common control transactions result in a taxable transfer of net assets, so the tax bases of the assets and liabilities are adjusted to fair value for the receiving entity. Because new bases are not established for financial reporting, the change in tax bases results in temporary differences for which deferred taxes must be recognized. Because the change in tax bases is caused by a transaction among or with shareholders, the deferred taxes, including the effect of valuation allowances initially required upon recognition of the deferred tax assets, are recognized in equity.

B.3.5.1.1 Last-In, First-Out Inventories in Common Control Transactions

FASB REFERENCES

ASC 740-20-45-11(g)

In a nontaxable transfer of net assets or exchange of equity interests between entities under common control, any LIFO inventories are generally carried over at the historical LIFO basis and with the same LIFO layers as the transferring entity for both financial reporting and income taxes. As a result, the deferred taxes of the receiving entity should be the same as those of the transferring entity before the common control transfer.

In a taxable transfer or exchange, LIFO inventories are carried over at the historical LIFO basis and with the same LIFO layers as the transferring entity for financial reporting. However, for income taxes, the LIFO inventories of the receiving entity are stepped up and considered purchases of the current year. Deferred taxes arising from differences in the financial reporting and income tax bases of LIFO inventories resulting from a common control transfer or exchange must be recognized in equity.

B.3.6 Change in Noncontrolling Interest in a Common Control Transaction

FASB REFERENCES

ASC 810-10-45-23

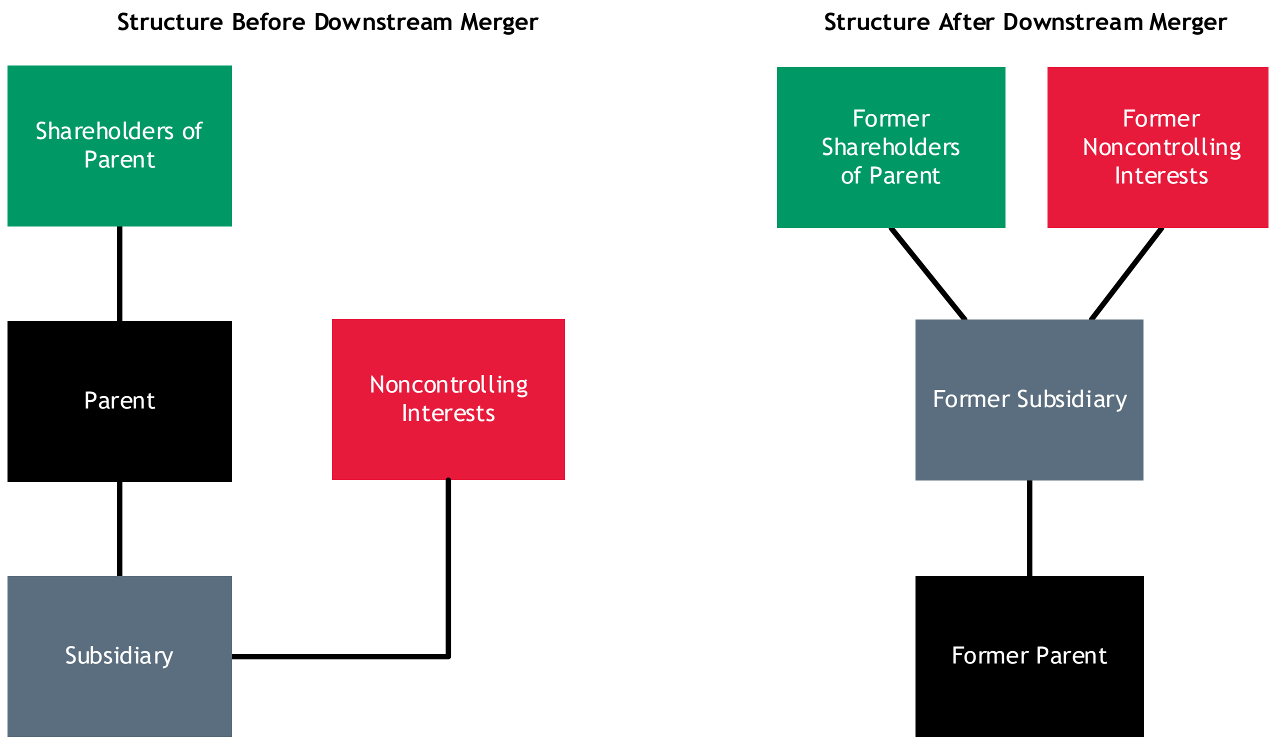
Some common control transactions result in a change in NCI. Changes in NCI while the parent retains its controlling financial interest are accounted for as equity transactions. Although NCI is recorded at fair value in a business combination, it is not recognized at fair value for a common control transaction because there is not a change in control. Instead, the carrying amount of NCI is adjusted to reflect the change in ownership in the subsidiary, with any differences between the consideration received (or paid) and the NCI adjustment recognized in equity attributable to the parent.

B.3.6.1 Downstream Mergers

FASB REFERENCES

ASC 810-10-45-23

A downstream merger is a common control transaction in which a partially owned subsidiary exchanges its common shares for its parent's outstanding voting common shares. As a result, the consolidated net assets are owned by a single stockholder group that consists of both the former shareholders of the parent and the former shareholders of the noncontrolling interest in the subsidiary.



Despite 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 like the reporting 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 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 giving effect to the acquisition of the NCI, which is accounted for as an equity transaction.

B.3.7 Nature of the Common Control Transfer

FASB REFERENCES

ASC 805-50-05-5 and ASC Master Glossary: Change in the Reporting Entity

The financial statement presentation of a common control transfer differs depending upon the nature of what is transferred or exchanged. In some cases, the transferred assets are accounted for by the receiving entity prospectively from the date of transfer. In other cases (for example, for transfers of businesses), the common control transfer results in a change in the reporting entity, which requires the receiving entity to present a retrospective combination of the entities for all periods presented as if the combination had been in effect since the inception of common control.

Common control transfer of assets →	The receiving entity accounts for the assets prospectively from the date of transfer.
Common control transfer of net assets (for example, a business) →	The receiving entity accounts for a change in the reporting entity, which requires the receiving entity to present a retrospective combination of the entities for all periods presented as if the combination had been in effect since the inception of common control.

The ASC Master Glossary provides the following definition:

FASB REFERENCES

ASC Master Glossary

Change in the reporting entity

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 VIE pursuant to Topic 810 is a change in reporting entity.

There is no specific guidance to differentiate asset transfers (which are accounted for prospectively) from net asset transfers (which represent a change in reporting entity that is presented retrospectively). In practice, transfers of businesses generally result in a change in reporting entity, while nonbusiness transfers are typically accounted for prospectively.

B.3.8 Presenting a Change in Reporting Entity

FASB REFERENCES

ASC 805-50-45-1 through 45-5, ASC 250-10-45-21

If the common control transaction does not result in a change in reporting entity (see Section B.3.7), the receiving entity accounts for the assets prospectively, beginning on the date of the transfer. However, if the common control transaction results in a change in reporting entity, the receiving entity begins reporting the net assets transferred on the date of the transfer, but it must present a retrospective combination of the entities for all periods presented as if the combination had been in effect since the inception of common control.

The method used to present a change in reporting entity is similar to the pooling-of-interests method discussed in Accounting Principles Board (APB) Opinion 16. Although FAS 141 eliminated the pooling-of-interests method for business combinations, the principles below, described in APB Opinion 16, should be followed when preparing financial statements for a change in reporting entity:

- The receiving entity recognizes the assets and liabilities at the ultimate parent's carrying amounts at the date of the transfer. No step-up in basis or new goodwill is recognized.
- The equity accounts of the entities are combined.
    - The retained earnings or deficits are combined and reflected as retained earnings of the combined entity.
    - The capital stock and APIC accounts are combined, with adjustments as needed, to reflect the capital structure of the legal entity after the merger. If par or stated value exceeds the total amount of capital stock of the separate combining companies, the excess should be deducted first from APIC and then from the combined retained earnings.
    - Any difference between consideration paid by the receiving entity and the carrying amounts of the net assets received is recognized in equity.

- The results of operations of the entities are combined in the period in which the transfer occurs as if the entities had been combined as of the beginning of the period (or from the inception of common control if they were not under common control for the full period).
- Intercompany balances and transactions between the transferring and receiving entities are eliminated.
- If comparative periods are presented, they should be presented as if the entities had always been combined, beginning at the inception of common control.

B.3.8.1 Determining the Receiving Entity

The legal form of a common control transaction does not necessarily determine which entity is deemed the receiving entity for accounting purposes or the predecessor[24] entity for financial statement presentation. Sometimes, the entity that legally receives the transferred net assets is deemed the transferor and the legal transferor is deemed the receiving entity for accounting purposes.

In most cases, the entity that was first controlled by the ultimate parent is deemed the receiving entity for accounting purposes and the predecessor entity for financial statement presentation. However, if the first entity controlled by the ultimate parent is insignificant or lacks substance, it may be appropriate to identify a different entity as the receiving entity or predecessor.

If both entities are under common control for all periods presented, and both entities recognized their assets and liabilities at the ultimate parent's basis, it is not necessary to determine which entity is the receiving entity or predecessor as it has no effect on the retrospectively adjusted financial statements.

Example B-3 illustrates this concept.

EXAMPLE B-3: COMMON CONTROL FOR ALL PERIODS – PUSHDOWN ACCOUNTING PREVIOUSLY APPLIED

FACTS

- Parent has two wholly owned subsidiaries. It acquired Subsidiary A in 20X1 and Subsidiary B in 20X2.
- Both subsidiaries applied pushdown accounting in their separate financial statements.
- In 20X8, Parent merges the subsidiaries to form Subsidiary AB, which will present financial statements for 20X8 and 20X7.

CONCLUSION

For the financial statements of Subsidiary AB, it is not necessary to determine which entity is the receiving entity or predecessor entity.

ANALYSIS

Because both subsidiaries were under common control for all periods presented and both recognized their assets and liabilities at the ultimate parent's basis, it does not matter which entity is deemed the receiving entity because it has no effect on the retrospectively adjusted financial statements.

The 20X7 and 20X8 financial statements would reflect the combined results of the two entities as if the combination had been in effect since the inception of common control (which began in 20X2). As a result, there is no predecessor period to present because the periods presented include the results of the combined entities for the entire period.

There are two circumstances in which it is necessary to determine the receiving or predecessor entity:

[24] Financial statements for the periods prior to the inception of common control are often referred to as "predecessor" financial statements.

The combining entities were not under common control for all periods being presented.	Because the receiving entity's financial statements are adjusted retrospectively to the inception of common control period, it is necessary to determine which entity is the predecessor because the financial statements for periods preceding the common control period would reflect the standalone financial statements of the predecessor entity.
One or more of the combining entities did not reflect the ultimate parent's basis before the common control transaction (for example, because pushdown accounting was not applied).	It is necessary to determine the receiving entity because the net assets transferred in a common control transaction must be recognized at the ultimate parent's carrying amounts (see Section B.3.2). As such, if the transferring entity did not previously recognize its assets and liabilities at the ultimate parent's basis (for example, if it had not applied pushdown accounting when it was acquired), the transferred amounts would need to be adjusted when preparing financial statements for a change in reporting entity.

Example B-4 illustrates a scenario in which common control does not exist for all periods presented.

EXAMPLE B-4: COMMON CONTROL DOES NOT EXIST FOR ALL PERIODS PRESENTED

FACTS

- Parent has two wholly owned subsidiaries.
- Sub A was acquired on September 1, 20X1 and elected pushdown accounting for its separate financial statements.
- Sub B was acquired on June 1, 20X2 but did not apply pushdown accounting.
- In 20X3, Parent merges the subsidiaries to form Sub AB, which will present financial statements for 20X3 and 20X2.

CONCLUSION

Sub A would likely be deemed the receiving entity and predecessor for the financial statements of Sub AB.

ANALYSIS

Absent information that would indicate that Sub A is insignificant or lacks substance, Sub A would likely be the receiving entity because it was acquired by the parent before Sub B. Thus, the assets and liabilities of Sub B would need to be adjusted to reflect the ultimate parent's basis.

If Sub A is deemed to be the predecessor, the period from January 1, 20X2 through May 31, 20X2 would reflect Sub A's standalone operations and results on a historical cost basis. The periods from June 1, 20X2 through December 31, 20X2 and the year ended December 31, 20X3, would reflect the combined results of Sub AB (as adjusted to reflect the assets and liabilities of Sub B at the ultimate parent's carrying basis) because June 1, 20X2 was the inception of common control.

For SEC reporting, registrants must also determine which entity's financial statements should be presented for periods before inception of common control. At the 2006 AICPA Conference on Current SEC and PCAOB Developments, the SEC staff 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."* As such, the predecessor for SEC reporting is generally the same as the predecessor for accounting purposes, but occasionally, there could be differences. At the 2015 AICPA Conference on Current SEC and PCAOB Developments, the SEC staff also highlighted the following factors for registrants to consider in determining the predecessor entity:

	The order in which the parent acquired the entities
	The size of the entities
	The fair value of the entities
	The ongoing management structure

B.3.8.2 Conforming Accounting Policies

FASB REFERENCES

ASC 805-50-30-6

Although subsidiaries of a common parent typically have similar accounting policies, U.S. GAAP does not require them to be the same. As such, subsidiaries that merge in a common control transaction may have different accounting policies. ASC 805-50 allows the receiving entity to adjust the basis of accounting for the transferred assets and liabilities to match its accounting policies only if the change would be preferable. If the accounting policy applied by the receiving entity is not preferable, the receiving entity can either adopt the transferring entity's preferable accounting policy for all its assets and liabilities or continue to apply the transferring entity's policy to the transferred assets and liabilities. A change in accounting principle should be applied retrospectively unless it is impractical to do so.

B.3.8.3 Changes in Deferred Tax Valuation Allowances for Change in Reporting Entity

BDO INSIGHTS - CHANGES IN DEFERRED TAX VALUATION ALLOWANCES FOR A CHANGE IN REPORTING ENTITY

ASC 805-50 does not provide specific guidance for accounting for deferred taxes when retrospectively combining prior period financial statements to reflect the change in reporting entity. However, paragraphs 270-272 of FASB Statement No. 109 (FAS 109) previously provided guidance when accounting for income taxes in a business combination accounted for as a pooling of interests. That guidance was not codified because the pooling-of-interests method was eliminated by FAS 141. However, because the accounting and reporting required for a change in reporting entity are consistent with the pooling-of-interests method, we believe this guidance should continue to be applied when presenting a change in reporting entity as a result of a common control transaction. That guidance indicated:

> *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.

As noted in this guidance, the retrospective combination of the entities for all periods they were under common control must be considered when determining whether to adjust the historical valuation allowances. Although the current income taxes recognized in each period before to the common control transaction cannot be adjusted (that is, because consolidated tax returns cannot be filed for those periods), the realizability of deferred tax assets may be affected if the combined entity expects to file consolidated tax returns in the future. In such cases, the future taxable income of both entities on a combined basis may enable realization of deferred tax assets that were not deemed to be realizable for an individual entity. Thus, the valuation allowance for the combined entity may be less than the sum of the valuation allowances in the separate financial statements of the combining entities before the date of the common control merger. If the transfer or exchange causes a change in the combined entities' valuation allowance, the change should be recognized as part of the adjustment to recast the entities' prior period financial statements on a combined basis.

B.3.8.4 Disclosures by the Receiving Entity

FASB REFERENCES

ASC 805-50-50-3

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:

a. The name and brief description of the entity included in the reporting entity as a result of the net asset transfer or exchange of equity interests

b. The method of accounting for the transfer of net assets or exchange of equity interests.

ASC 805-50-50-4

The receiving entity also shall consider whether additional disclosures are required in accordance with Section 850-10-50, which provides guidance on related party transactions and certain common control relationships.

ASC 805-50 provides required disclosures for common control transactions. ASC 250 outlines the following additional disclosures to be provided when there is a change in the reporting entity.

FASB REFERENCES

ASC 250-10-50-6

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.3.8.5 Goodwill and Reporting Unit Assessment Upon Change in Reporting Entity

FASB REFERENCES

ASC 350-20-40-1 through 40-7 and ASC 350-20-35-45

If the net assets or equity interests transferred do not constitute a business, no goodwill is transferred to the receiving entity. If the net assets or equity interests transferred constitute a business, the goodwill to be recognized by the receiving entity is determined using the guidance in ASC 350 for derecognizing goodwill when a transferring entity disposes of a business (see Section B.4.1).

However, a question arises about how the goodwill recognized by the receiving entity should be tested for impairment in periods before the common control transfer. There is no specific guidance to answer this question but in practice two approaches have been applied:

UTILIZE THE HISTORICAL REPORTING STRUCTURES OF EACH OF THE COMBINED ENTITIES TO PERFORM GOODWILL IMPAIRMENT TESTING	REASSESS REPORTING UNITS AND PERFORM GOODWILL IMPAIRMENT TESTING AS IF THE TRANSFERRED ENTITY HAS BEEN RECOGNIZED BY THE RECEIVING ENTITY AT THE INCEPTION OF COMMON CONTROL
This approach does not require management to make hypothetical judgments about the operations and management of the combined entity for periods before the combination. However, for impairment testing after the date of the common control transaction, management must evaluate the combined entity's reporting structure and determine the appropriate allocation of goodwill based on the new reporting structure.	This approach is based on the guidance in ASC 805-50 that requires the combined entity's financial statements to be retrospectively adjusted for a change in reporting entity. It requires the allocation of goodwill to be performed at the inception of common control. Under this approach, the combined entity must make assumptions about how the entity's financial reporting would have been structured and managed in historical periods, which may be different than the way the entities were actually managed.

Based on diversity in practice either approach is acceptable.

REALLOCATING GOODWILL AT PARENT UPON A CHANGE IN REPORTING UNITS

Regardless of the method used for the separate financial statements of the subsidiary, the parent entity's consolidated financial statements will account for any change affecting the composition of one or more reporting units prospectively. In those circumstances, goodwill is reassigned to the affected reporting units using a relative fair value approach in accordance with ASC 350-20-35-45.

B.4 ACCOUNTING BY THE TRANSFERRING ENTITY

ASC 805-50 provides measurement guidance for the receiving entity but not for the transferring entity. However, in practice, the transferring entity generally derecognizes the net assets transferred at their carrying amounts and recognizes no gains or losses. Any difference between 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, there are some exceptions to the general principle that assets and liabilities should be transferred at their historical carrying amounts, as noted in the following sections:

Exception	Reference
Common control transfers of financial assets	Sections B.3.3 – B.3.3.2
Common control transfers of inventory	Section B.3.4
Allocation of goodwill by transferring entity	Section B.4.1

B.4.1 Allocation of Goodwill by Transferring Entity

FASB REFERENCES

ASC 350-20-40-1 through 40-7 and ASC 350-20-35-45

If neither the net assets nor equity interest transferred constitutes a business, no goodwill would be transferred to the receiving entity.

If either the net assets or equity interest transferred constitutes a business, the goodwill to be derecognized by the transferring entity is determined using the guidance in ASC 350. In accordance with this guidance, for a common control transfer of an entire reporting unit, all the goodwill associated with that reporting unit is transferred to the receiving entity. When only a portion of a reporting unit that constitutes a business is transferred, the goodwill allocated to the receiving entity is generally based on the relative fair values of the business being transferred compared to the business being retained by the transferring entity.

In some cases, it may be acceptable for an entity to allocate goodwill to the transferred business using a historical cost approach (based on the specifically identified original goodwill value of the contributed business from the original acquisition). However, before using this approach, the entity should evaluate whether the transferred business had previously been integrated into the reporting unit, as discussed in ASC 350-20-40-4 through 40-6.

Regardless of the method used to allocate goodwill between the transferring and receiving entities, the transferring entity should evaluate whether the transfer triggers a goodwill impairment assessment. If there is an impairment, it would be recognized by the transferring entity before the transfer occurs.

B.4.2 Long-Lived Assets Impairments for the Transferring Entity

FASB REFERENCES

ASC 360-10-40-4

BDO INSIGHTS – LONG-LIVED ASSETS IMPAIRMENTS FOR THE TRANSFERRING ENTITY

Although there is no specific guidance on how the transferring entity assesses impairment of long-lived assets to be transferred in a common control transaction, in practice entities typically account for the transfer as a disposal pursuant to ASC 360-10-40-4. Under this guidance, a long-lived asset to be disposed of in an exchange measured based on the recorded amount of the nonmonetary asset relinquished is accounted for as held and used until it is disposed of. As such, impairment testing should use estimates of future cash flows based on the use of the asset for its remaining useful life under the assumption that the disposal transaction will not occur. If the asset (group) is not recoverable, any impairment losses should be recognized before transferring the long-lived asset to the receiving entity. It may also be appropriate to recognize an additional loss on disposal if the carrying amount of the disposal group exceeds its fair value at the date of the transfer.

B.4.3 Financial Statement Presentation by the Transferring Entity

FASB REFERENCES

ASC 360-10-40-4 and ASC 505-60-S99-1

ASC 805-50 does not provide guidance regarding how a transferring entity should present a common control transfer in its separate financial statements. As such, the question arises about whether the transferring entity should apply the guidance for a change in reporting entity to retrospectively derecognize the net assets and operations in the historical periods (sometimes referred to as a "depooling") or if the derecognition should be presented only at the date of the transfer.

The transferring entity should generally recognize the transfer as a disposal transaction under the guidance in ASC 360, which requires long-lived assets that are to be disposed of other than by sale to be classified as held and used until the disposal date. If the disposal group qualifies as a component of the transferring entity, the disposal should also be assessed to determine if it qualifies for reporting as discontinued operations at the disposal date.

In most circumstances it would not be appropriate to depool the assets and operations of the transferred net assets in periods before the transfer. The SEC staff has provided guidance in SAB Topic 5.Z.7 which addresses whether an entity may present a spinoff as a change in the reporting entity and restate its historical financial statements to exclude the subsidiary (see Section B.6.1.2). While this guidance addresses the financial statement presentation for a spinoff, in practice these concepts are also applied to common control transfers.

BDO INSIGHTS – A TRANSFERRING ENTITY WILL RARELY QUALIFY FOR DEPOOLING TREATMENT

To recognize the transferred net assets as a depooling, all the requirements in SAB Topic 5.Z.7 must be met. As such, we believe that it will be rare that a transferring entity would qualify to present its financial statements as a depooling.

B.4.3.1 Disclosures by the Transferring Entity

FASB REFERENCES

ASC 805-50-50-3 through 50-4, ASC 250-10-50-6, ASC 360-10-50-3 through 50-3A, ASC 205-20-50-1 through 50-7

ASC 805-50 does not include any specific disclosure requirements for the transferring entity.

BDO INSIGHTS – DISCLOSURES BY THE TRANSFERRING ENTITY

Although ASC 805-50 does not require specific disclosures for the transferring entity, we believe that the transferring entity should provide sufficient disclosures for users of its separate financial statements to understand the nature of and accounting for the transfer. We believe the transferring entity should consider providing disclosures similar to those required by the receiving entity (see Section B.3.8.4).

The transferor must also provide the disclosures required by ASC 360-10 for long-lived assets that are disposed of, as well as the disclosures required by ASC 205-20, *Presentation of Financial Statements – Discontinued Operations* if the disposal qualifies for presentation as a discontinued operation.

B.5 TRANSACTION COSTS FOR COMMON CONTROL TRANSACTIONS

BDO INSIGHTS — ACCOUNTING FOR TRANSACTION COSTS FOR COMMON CONTROL TRANSACTIONS

ASC 805-50 does not provide guidance for accounting for transaction costs related to the combination of entities under common control. However, we believe that transaction costs should generally be expensed. This is consistent with the principle that the net assets transferred to the receiving entity are recognized at carryover basis. This is also consistent with the guidance that was previously applicable for transaction costs in a pooling of interests.[25]

Determining which entity must recognize the expense requires judgment. For example, a subsidiary may pay transaction costs on behalf of its parent, which do not benefit the subsidiary. If facts and circumstances clearly demonstrate that such transaction costs are incurred solely for the parent's benefit of the parent, it may be appropriate for the subsidiary to reflect the payment of such transaction costs as a dividend rather than as an expense. In any case, the parent would recognize the expense in its consolidated financial statements.

B.6 NONRECIPROCAL TRANSFERS TO OWNERS

FASB REFERENCES

ASC 845-10-20

Nonreciprocal Transfer

> *A transfer of assets or services in one direction, either from an entity to its owners (whether or not in exchange for their ownership interests) or to another entity, or from owners or another entity to the entity.*

Some nonreciprocal transfers are common control transactions that should be accounted for as discussed in this appendix. For example, a transfer of nonmonetary assets by a subsidiary to its controlling shareholder, or vice versa would represent a common control transaction that is typically accounted for at historical carrying value (see Sections B.3 and B.4).

However, many nonreciprocal transfers to owners are not common control transactions because the shareholders do not individually control the transferred assets before and after the transaction. ASC 845-10 and ASC 505-60, *Equity - Spinoffs and Reverse Spinoffs*, provide guidance to account for nonreciprocal transfers to owners. The accounting depends on the nature of the transfer.

TRANSACTION	BASIS FOR DERECOGNITION	SECTION
Pro rata spinoff of a business or an equity method investment	Recorded amount (after reduction, if appropriate, for an indicated impairment of value)	B.6.1
Non-pro-rata split-off	Fair value	B.6.2
Dividends in-kind	Fair value	B.6.3
Nonreciprocal transfers of nonmonetary assets to owners	Fair value if it is objectively measurable and would be clearly realizable to the distributing entity in an outright sale at or near the time of the distribution	B.6.3

[25] APB 16, paragraph 58

OTHER NONRECIPROCAL TRANSFERS TO OWNERS

Section B.6 discusses the accounting for several common types of nonreciprocal transfers and other exchanges with owners, but it does not address all potential structures or transactions. Determining the appropriate accounting requires the application of professional judgment based on the facts and circumstances and considering the applicable scope requirements of other U.S. GAAP.

B.6.1 Spinoffs

FASB REFERENCES

ASC 505-60-25-2, ASC 845-10-30-10, ASC 360-10-40-4, and ASC 830-30-40-1

ASC 505-60-20

Spinoff

> *The transfer of assets that constitute a business by an entity (the spinnor) into a new legal spun-off entity (the spinnee), followed by a distribution of the shares of the spinnee to its shareholders, without the surrender by the shareholders of any stock of the spinnor.*

Pro rata spinoffs are accounted for based on the recorded amount of the assets transferred (after reduction, if appropriate, for impairments). To be accounted for at the recorded amount, it must be a pro rata distribution, and the entity distributed to the shareholders must be a business (see Chapter 3). Similarly, a pro rata distribution to owners of shares of an equity method investee is accounted for as a spinoff.

If the assets transferred do not constitute a business, the transaction is not a spinoff, even if the distribution is pro rata. Instead, it would be accounted for in accordance with other guidance in ASC 845.

The FASB provided the following example.

EXAMPLE B-5: ILLUSTRATION OF A SPINOFF TRANSACTION
(Quoted from ASC 505-60-55-2)

ASC 505-60-55-2

> *Big Company owns and operates a mall and a retail store that occupies the anchor store position in that mall. The mall and the store are managed by two separate divisions. The shareholders of Big Company would like to split Big Company into two entities so that each can focus on its own operations. To achieve this, Big Company transfers the mall's assets and operations into a newly created subsidiary, Mall Company, and distributes the shares of Mall Company to its shareholders on a pro rata basis in a spinoff.*

Before the spinoff, long-lived assets to be included in the spinoff must be accounted for as held and used until the date of the spinoff. As such, any long-lived asset impairment tests before the spinoff date must be based on the estimates of future cash flows that assume the use of the assets for their remaining useful lives as though the spinoff will not occur. Further, at the spinoff date, the reporting entity must recognize an impairment loss if the carrying amount of the disposal group exceeds its fair value. After recognizing any impairment losses, the spinnor derecognizes the assets and liabilities at their carrying amounts at the spinoff date.

If the spinnee includes a foreign entity, the spinnor's cumulative translation adjustment account for that foreign entity is released at the spinoff date in accordance with ASC 830. However, because the spinoff is recognized at its carrying amount, the spinnor does not recognize a gain or loss in earnings. It instead eliminates the cumulative translation adjustment balances as part of the net adjustment to stockholders' equity (for example, against APIC).

B.6.1.1 Reverse Spinoffs

FASB REFERENCES

ASC 505-60-25-7 through 25-8, and ASC 505-60-45-1

ASC 505-60-20

Reverse Spinoff

> *A spinoff of a subsidiary to an entity's shareholders in which the legal form of the transaction does not match its substance such that the new legal spun-off entity (the spinnee) will be the continuing entity.*

There is a rebuttable presumption that a spinoff should be accounted for based on its legal form. However, in some circumstances it is appropriate to account for the transaction as a reverse spinoff (the legal spinnor is deemed the accounting spinee and the legal spinee is deemed the accounting spinnor). Reverse spinoff accounting is appropriate if treatment of the legal spinnee as the accounting spinnor results in the most accurate depiction of the substance of the transaction for shareholders and other users of the financial statements.

The FASB provided the following example.

EXAMPLE B-6: ILLUSTRATION OF A REVERSE SPINOFF TRANSACTION
(Quoted from ASC 505-60-55-5**)**

ASC 505-60-55-5

> *Snack Food Company owns two subsidiaries—Ice Cream Subsidiary and Snack Subsidiary. Ice Cream Subsidiary is significantly larger and more profitable than Snack Subsidiary. The shareholders of Snack Food Company would like to continue the ice cream operations and dispose of the snack food operations. To facilitate this, Snack Food Company distributes the shares of Ice Cream Subsidiary to the shareholders thereby creating Ice Cream Company. The shareholders are then able to dispose of the operations of Snack Food Company (now solely comprising Snack Subsidiary operations) by selling the shares directly to a third party and, at the same time, retain ownership of the Ice Cream Company.*

ASC 505-60 provides several indicators to evaluate when determining whether a transaction is a reverse spinoff, including:

Size of the legal spinnor and legal spinnee	In a reverse spinoff, the accounting spinnor (legal spinnee) is generally larger than the accounting spinnee (legal spinnor). The determination of which entity is larger is based on a comparison of the assets, revenues, and earnings of the two entities. There are no bright lines to determine which entity is larger.
Fair values of the legal spinnor and legal spinnee	In a reverse spinoff, the accounting spinnor's (legal spinnee's) fair value is generally greater than the fair value of the accounting spinnee (legal spinnor).
Entity which retains the senior management of the formerly combined company	In a reverse spinoff, the senior management of the formerly combined entity generally stays with the accounting spinnor (legal spinnee). Senior management generally consists of the board chair, CEO, COO, CFO, and those divisional heads reporting directly to those executive or the executive committee, if one exists.
Length of time the entities are expected to be held by the shareholders	In a reverse spinoff, the shares of the accounting spinnor (legal spinnee) are generally held by the shareholders for a longer period than the shares of the accounting spinnee (legal spinnor). A proposed or approved plan to sell one of the entities concurrent with the spinoff may identify that entity as the accounting spinnee.

No single indicator is determinative; judgment is required in evaluating whether the presumption that the legal spinnor is the accounting spinnor is overcome.

Examples B-7 and B-8 illustrate the identification of the accounting spinnor and spinnee.

EXAMPLE B-7 (ADAPTED FROM ASC 505-60-55-7 THROUGH 55-9): LEGAL FORM OF SPINOFF SAME AS TRANSACTION SUBSTANCE

FACTS

- Retail Company, a retail store chain, has a wholly owned restaurant subsidiary.
- Operations of Retail Company and its restaurant subsidiary are independent of each other, with a small executive management team overseeing both.
- Retail Company's shareholders believe that the retail and restaurant operations should be separated via a spinoff to allow Retail Company and its subsidiary to pursue opportunities in their respective industries and maximize their individual value.
- Retail Company creates a new legal entity, Restaurant Company, and transfers assets and operations of the restaurant subsidiary into the new entity.
- The shares of Restaurant Company are distributed to Retail Company's shareholders on a pro rata basis. There are no planned or likely disposals of either Retail Company or Restaurant Company after the transaction.
- The executive management team of Retail Company is divided between the two entities.
- A comparison of the retail and restaurant businesses is as follows (amounts are in thousands):

	ASSETS	REVENUES	NET INCOME	FAIR VALUE
Retail	$ 500	$ 410	$ 150	$ 675
Restaurant	$ 100	$ 75	$ 21	$ 170

CONCLUSION

Retail Company accounts for the transaction as a spinoff in accordance with its legal form.

ANALYSIS

Retail Company evaluates the factors in ASC 505-60-25-8 to determine whether the transaction is a spinoff (meaning it must be accounted for based on its legal form) or a reverse spinoff (meaning the legal form of the transaction does not match its substance):

- **Size of the legal spinnor and legal spinee** - Retail Company's operations are larger than those of Restaurant Company.
- **Fair values of the legal spinnor and legal spinee** – The fair value of Retail Company is greater than the fair value of Restaurant Company.
- **Entity that retains the senior management of the formerly combined company** –The management team is allocated between Retail Company and Restaurant Company
- **Length of time the entities are expected to be held by the shareholders** - There are no planned or likely disposals of either Retail Company or Restaurant Company.

Based on the above assessment, Retail Company concludes that the transaction should be accounted for as a spinoff in accordance with its legal form because, in substance, Retail Company has spun off its Restaurant Company into a separate entity.

EXAMPLE B-8 (ADAPTED FROM ASC 505-60-55-10 THROUGH 55-12): LEGAL FORM OF SPINOFF DIFFERS FROM TRANSACTION SUBSTANCE

FACTS

- Retail Company, a retail store chain, has a wholly owned restaurant subsidiary.
- Operations of Retail Company and its restaurant subsidiary are independent of each other, with a small executive management team overseeing both.
- While the restaurant subsidiary has grown rapidly, the retail operations have deteriorated steadily because of increased competition.
- Retail Company's shareholders believe that the retail and restaurant operations should be separated via a spinoff. Management intends to dispose of the retail operations after the spinoff.
- Retail Company creates a new legal entity, Restaurant Company, and transfers assets and operations of the restaurant subsidiary into the new entity.
- The shares of Restaurant Company are distributed to Retail Company's shareholders on a pro rata basis.
- The executive management team is assigned to Restaurant Company with the intent to dispose of Retail Company.
- A comparison of the retail and restaurant businesses is as follows (amounts are in thousands):

	ASSETS	REVENUES	NET INCOME	FAIR VALUE
Retail	$ 300	$ 210	$ 35	$ 375
Restaurant	$ 600	$ 450	$ 150	$ 700

CONCLUSION

The transaction is accounted for as a reverse spinoff in accordance with its substance.

ANALYSIS

Retail Company evaluates the factors in ASC 505-60-25-8 to determine whether the transaction is a spinoff (meaning it must be accounted for based on its legal form) or a reverse spinoff (meaning the legal form of the transaction does not match its substance):

- **Size of the legal spinnor and legal spinee** - Restaurant Company's operations are larger than those of Retail Company.
- **Fair values of the legal spinnor and legal spinee** – The fair value of Retail Company is less than the fair value of Restaurant Company.
- Entity which retains the senior management of the formerly combined company – The management team is assigned to Restaurant Company.
- **Length of time the entities are expected to be held by the shareholders** – Management intends to dispose of Retail Company after finalizing the spinoff.

Based on the above assessment, Retail Company concludes that the transaction should be accounted for as a reverse spinoff, because, in substance, Retail Company has disposed of its retail operations and continued its restaurant operations.

B.6.1.2 Spinnor's Financial Statement Presentation of Spinoff

FASB REFERENCES

ASC 505-60-S99-1

A spinnor generally recognizes a spinoff as a disposal transaction in accordance with ASC 360, which requires long-lived assets that are to be disposed of other than by sale to be classified as held and used until the disposal date. The spinnor must also determine whether the spun-off business qualifies for reporting as discontinued operations at the disposal date.

In most circumstances, it is not appropriate for a spinnor to retrospectively adjust its historical financial statements to eliminate the assets and operations of the spinoff entity in periods before the spinoff. SAB Topic 5.Z.7 addresses whether a spinnor may present a spin-off as a change in the reporting entity and restate its historical financial statements to exclude the spun-off subsidiary.

SEC STAFF GUIDANCE

SAB Topic 5.Z.7, *Accounting for the Spin-off of a Subsidiary*

> ***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).* [Footnotes omitted]

A SPINNOR WILL RARELY QUALIFY TO PRESENT A SPINOFF AS A CHANGE IN REPORTING ENTITY

To present a spinoff as a change in reporting entity, all the requirements in SAB Topic 5.Z.T must be met. Because of the limited fact patterns for which the SEC staff has accepted presentation of a spinoff as a change in reporting entity, we would encourage entities to discuss their specific facts with the SEC staff before filing financial statements that exclude the results of the spinoff business in periods before the spinoff date.

BDO INSIGHTS – APPLICABILITY FOR PRIVATE COMPANIES

Although the guidance in SAB Topic 5.Z.T specifically applies to SEC registrants, we believe the concepts are equally relevant for private companies.

B.6.1.3 Allocation of Goodwill by Spinnor

FASB REFERENCES

ASC 350-20-40-1 through 40-7 and ASC 350-20-35-45

The spinnor derecognizes goodwill using the guidance in ASC 350. In accordance with this guidance, if an entire reporting unit is spunoff, all the goodwill associated with that reporting unit is allocated to the spinnee. When only a portion of a reporting unit that constitutes a business is spun off, the goodwill allocated to the spinnee is generally based on the relative fair values of the business being spun off compared to the business being retained by the spinnor.

If the spun-off business was never integrated into the reporting unit after its acquisition, it may be acceptable for a spinnor to allocate goodwill to the spinnee using a historical cost approach based on the specifically identified original goodwill value of the spun-off business from the original acquisition. However, before using this approach, the entity must consider the guidance in ASC 350-20-40-4 through 40-5.

B.6.1.4 Long-Lived Assets Impairment Tests by the Spinnor

FASB REFERENCES

ASC 360-10-40-4

A long-lived asset to be distributed to owners in a spinoff is accounted for as held and used until it is disposed of. As such, impairment testing should use estimates of future cash flows based on the use of the asset for its remaining useful life, using the assumption that the spinoff transaction will not occur. If the asset (group) is not recoverable, any impairment losses must be recognized before transferring the long-lived asset to the spinnee. Further, the spinnor must recognize an additional loss on disposal if the carrying amount of the disposal group exceeds its fair value at the date of the transfer.

B.6.2 Split-Offs

FASB REFERENCES

ASC 845-10-30-12 through 30-13, ASC 610-20-15-6

ASC 845-10-20

Split-off

> *A transaction in which a parent entity exchanges its stock in a subsidiary for parent entity stock held by its shareholders.*

Unlike a pro rata spinoff of the stock of a subsidiary that is a business, a split-off may involve a non-pro-rata distribution because some shareholders may not participate in the exchange. A split-off transaction usually involves a substantive parent entity offering its noncontrolling shareholders the ability to exchange any or all their equity shares of the parent entity for shares of a subsidiary at a specified exchange rate.

A non-pro-rata split-off is accounted for at fair value, even if the subsidiary being split off constitutes a business. However, a non-pro-rata split-off to a controlling shareholder, which is a common control transaction, is accounted for based on the recorded amount of the assets transferred (see Sections B.3 and B.4).

B.6.3 Dividends-In-Kind and Other Nonreciprocal Transfers of Nonmonetary Assets

FASB REFERENCES

ASC 845-10-30-1, ASC 845-10-25-3, ASC 845-10-30-10, and ASC 845-10-30-14

If an entity distributes loans receivable to its owners by forming a subsidiary, transferring those loans to the subsidiary, and then distributing the stock of the subsidiary to shareholders of the parent, the transaction is not a spinoff; instead, it must be accounted for at fair value as a dividend-in-kind.

Other nonreciprocal transfers of nonmonetary assets to owners are accounted for at fair value if the fair value of the nonmonetary asset distributed is objectively measurable and would be clearly realizable to the distributing entity in an outright sale at or near the time of the distribution. Reaching a conclusion about whether the fair value is objectively measurable and clearly realizable requires the application of professional judgment based on the facts and circumstances.

B.7 LEASES AND LEASEHOLD IMPROVEMENTS IN COMMON CONTROL ARRANGEMENTS

FASB REFERENCES

ASC 842-10-15-3A through 15-3B

Private company stakeholders raised concerns about the application of ASC 842 to common control arrangements (such as arrangements between sister entities controlled by a common owner). Concerns included determining whether a common control arrangement is or contains a lease based on the legally enforceable terms and conditions. For example, private companies adopting ASC 842 said challenges existed because the common control arrangements may be unwritten and, even when written, may be amended or not enforced by the common owner.

Additionally, stakeholders raised concerns about amortization of leasehold improvements in common control leases. Common control leases often have a short lease term (for example, one year), even if the lessee makes significant leasehold improvements with an estimated useful life significantly longer than the lease term (for example, 10 years). According to private company stakeholders, amortizing the significant leasehold improvements over the lease term does not result in economically faithful information when the lessee and lessor are under common control because the common control group benefits from the improvements, either by extending the lease with the lessee after the expiration of the initial lease or by transferring the assets to the lessor or another entity within the common control group.

In response to those concerns, the FASB issued ASU 2023-01, *Leases (Topic 842): Common Control Arrangements*.

B.7.1 Identifying and Accounting for Leases in Common Control Arrangements

FASB REFERENCES

ASC 842-20-35-12A

ASU 2023-01 provides nonpublic entities a practical expedient to use the written terms and conditions of a common control arrangement to determine whether a lease exists and, if so, to classify and account for that lease. Under the practical expedient, an entity assesses whether the written terms and conditions convey the practical right (rather than an enforceable right) to control the use of an identified asset for a period of time in exchange for consideration to determine whether a lease exists. If a lease exists, the entity classifies and accounts for the lease based on those written terms and conditions. The practical expedient may be applied on an arrangement-by-arrangement basis.

If no written terms and conditions exist, the entity cannot apply the practical expedient and it must use the enforceable rights and obligations to apply ASC 842 to the common control arrangement, like any arrangement between unrelated parties or related parties not under common control.

See Section 2.5 of our Blueprint, Accounting for Leases Under ASC 842, for more guidance on the accounting for leases in common control relationships.

B.7.2 Leasehold Improvements – Common Control Leases

ASU 2023-01 provides guidance for public and nonpublic entities to apply when amortizing leasehold improvements in common control leases. ASU 2023-01 states that:

- A lessee amortizes leasehold improvements associated with a lease between entities under common control over the useful life of those improvements to the common control group, regardless of the lease term, if the lessee controls the use of the underlying asset through a lease. If the lessor obtained the right to control the underlying asset’s use through a lease with another entity outside the common control group, then the amortization period cannot exceed the amortization period of the common control group determined in accordance with ASC 842-20-35-12.
- If the lessee loses control of the use of the leased asset to another entity in the common control group, the remaining balance of leasehold improvements is accounted for as a transfer between entities under common control through an adjustment to equity (or net assets for a not-for-profit entity).

While the FASB received concerns about the requirements in ASC 842 mostly from private company stakeholders, it concluded that these changes better reflect the economics of leasehold improvements in leases between entities under common control and therefore the changes apply to all entities.

See Section 5.6.3.2 of our Blueprint, Accounting for Leases Under ASC 842, for more guidance on the accounting for leasehold improvements in common control relationships.

Appendix C — Asset Acquisitions and Recapitalizations

C.1 OVERVIEW AND SCOPE

FASB REFERENCES

ASC 805-50-05-3 and ASC 805-50-15-3

The term "asset acquisition" is used to describe the acquisition of an asset or group of assets that does not meet the definition of a business under U.S. GAAP. Some asset acquisitions also include the assumption of liabilities. Although some asset acquisitions may be similar to business combinations, it is critical to determine whether the acquired set meets the definition of a business because the accounting for an asset acquisition is fundamentally different than the accounting for a business combination.

Business combinations are accounted for using the acquisition method, which generally requires measuring all elements of the transaction at fair value (with limited exceptions), including:

Consideration transferred	Section 5.4
Noncontrolling interests in the acquiree	Section 4.5
Previously held equity interests	Section 5.5
Identifiable assets acquired and liabilities assumed	Chapter 4

Asset acquisitions are accounted for under a cost accumulation model, with the cost being allocated to the acquired assets and liabilities assumed, based on relative fair values (with some exceptions). ASC 805-50 provides guidance for accounting for asset acquisitions.

C.1.1 Scope Exception for Variable Interest Entities

FASB REFERENCES

ASC 805-50-05-3, ASC 805-50-15-4, ASC 805-30-30-1, ASC 805-30-30-8, and ASC 810-10-30-1 through 30-4

As discussed in Section 2.2.1, some acquisitions involve VIEs. A primary beneficiary's initial consolidation of a VIE that is not a business is excluded from the scope of ASC 805-50. Instead, it is accounted for in accordance with ASC 810. Under that guidance, when a reporting entity becomes the primary beneficiary of a VIE and the reporting entity and

VIE were **not** under common control[26] before its initial consolidation of the VIE, the reporting entity must evaluate whether the VIE meets the definition of a business in ASC 805 (including by using the “screen” test discussed in ASC 805-10-55-5A through 55-5C) (see Chapter 3). The accounting is shown in the graphic:

The VIE is a business → Apply the acquisition method in ASC 805, including recognizing goodwill. →

The VIE is not a business → Apply the acquisition method in ASC 805, but recognize a gain or loss instead of goodwill. →

Measure and recognize the assets, liabilities, and any NCI in accordance with the acquisition method in ASC 805 (generally at fair value, with some exceptions)

As illustrated above, if the VIE does not meet the definition of a business, the primary beneficiary does not recognize goodwill. Instead, the primary beneficiary of a VIE that is not a business recognizes a gain or loss, which is calculated as shown in the graphic.

The sum of:

1. The fair value of consideration paid, including contingent consideration
2. The fair value of any NCI
3. The carrying amount of any previously held interests (for example, equity method investments)

−

The net amount of the VIE’s identifiable assets and liabilities recognized and measured using ASC 805.

=

Gain or loss

An exception from the approach above is that the primary beneficiary initially measures assets and liabilities that it transferred to the VIE at, after, or shortly before the reporting entity became the primary beneficiary at the amounts at which the assets and liabilities would have been measured if they were not transferred. The reporting entity does not recognize a gain or loss for such transfers, which are similar to common control transactions.

MEASUREMENT OF PREVIOUSLY HELD INTERESTS

The measurement of previously held interests in the initial consolidation of a VIE that is not a business is different from the measurement of previously held interests in a business combination:

- ASC 810-10-30-4 specifies that the primary beneficiary of a VIE that is **not** a business must recognize its previously held interests at carryover basis.
- ASC 805-30-30-1 specifies that the primary beneficiary of a VIE that is a business must recognize its previously held interests at fair value.

See our Blueprint, Control and Consolidation Under ASC 810, for more guidance for evaluating whether an entity is a VIE and identifying the primary beneficiary.

[26] In accordance with ASC 810-10-30-1, if the primary beneficiary and the VIE are under common control, the VIE’s assets, liabilities, and NCI should be recorded initially at the amounts at which they were carried in the accounts of the reporting entity that controls the VIE (carryover basis (see Appendix B, Section B.3.1)).

C.1.1.1 Subsequent Accounting for In-Process Research and Development and Contingent Consideration for a Variable Interest Entity That is Not a Business

BDO INSIGHTS — SUBSEQUENT ACCOUNTING FOR IPR&D AND CONTINGENT CONSIDERATION FOR A VIE THAT IS NOT A BUSINESS

As noted in the previous section, ASC 810 requires the primary beneficiary to recognize the assets and liabilities of a VIE that is not a business using the guidance in ASC 805 (except that goodwill is not recognized). However, ASC 810 does not provide subsequent measurement guidance for the VIE's assets and liabilities. As such, for assets and liabilities for which the subsequent accounting differs depending on whether the acquired set is a business, professional judgment is required to determine the appropriate accounting.

For example, IPR&D acquired in a business combination is recognized as an indefinite-lived intangible asset regardless of whether it has an alternative use, and it is subsequently measured under the guidance for indefinite-lived intangible assets in ASC 350. On the other hand, IPR&D acquired in an asset acquisition is accounted for under ASC 730 and is immediately expensed if it does not have an alternative future use.

Because there is no guidance in ASC 810 for the subsequent measurement of IPR&D recognized upon the initial consolidation of a VIE that is not a business, diversity in practice has arisen. Some entities follow the subsequent accounting guidance for intangible assets acquired in a business combination in ASC 350 (see Section 4.4.2.8.1). Others believe that because the VIE is not a business they should follow the guidance in ASC 730 and immediately expense IPR&D if it does not have an alternative use (see Section C.4.4.2). Given the lack of guidance and diversity in practice, we believe either approach is acceptable.

Similarly, liability-classified contingent consideration is recognized at fair value in a business combination and is subsequently remeasured at fair value each period with changes in fair value being recognized through the income statement (see Section 5.4.5.3). However, in an asset acquisition, contingent consideration is often not initially recognized unless the contingent consideration is a derivative (see Section C.3.4.1). Because there is no guidance in ASC 810 for the subsequent measurement of contingent consideration recognized upon the initial consolidation of a VIE that is not a business, entities must apply a systematic and rational approach to account for contingent consideration. One acceptable approach would be to continue to follow the accounting model for contingent consideration in a business combination and remeasure the contingent consideration at fair value each period. There may be other acceptable approaches.

INITIAL ACCOUNTING FOR VIE THAT IS NOT A BUSINESS

When accounting for the initial consolidation of a VIE that is a business, the acquirer must apply the acquisition method under ASC 805, consistent with other business combinations. However, the accounting for the initial consolidation of a VIE that is not a business is different than the accounting for asset acquisitions that are not VIEs. The remainder of this appendix provides guidance for accounting for asset acquisitions that are not VIEs.

C.1.2 Key Differences Between Asset Acquisitions and Business Combinations

The following table summarizes key differences in accounting for an asset acquisition (other than the initial consolidation of a VIE that is not a business as discussed in Section C.1.1) versus accounting for a business combination:

	ASSET ACQUISITION (OTHER THAN THE INITIAL CONSOLIDATION OF A VIE THAT IS NOT A BUSINESS)	BUSINESS COMBINATION
General Principle	Cost Accumulation Model: ▶ The cost of the acquisition (which includes transaction costs) is allocated to the acquired assets and liabilities, generally based on relative fair values. As a result, the acquired assets may not be recognized at fair value (see Sections C.4 and C.4.1).	Fair Value Model: ▶ Assets acquired and liabilities assumed are accounted for at fair value with limited exceptions (see Section 4.4).
Goodwill	▶ An asset acquisition shall not give rise to goodwill (see Section C.4).	▶ The acquirer recognizes goodwill if the consideration transferred plus the fair values of any NCI and previously held equity interests exceeds the acquired net assets (see Section 5.2).
Bargain Purchases	▶ A bargain purchase gain is generally not recognized in an asset acquisition (see Section C.4).	▶ If the aggregate of the consideration transferred, the NCI, and the acquirer's previously held equity interest in the acquiree is less than the values assigned to the identifiable assets acquired and liabilities assumed, the acquisition represents a bargain purchase, and the acquirer recognizes a gain at the acquisition date (see Section 5.3).
Contingent Consideration	▶ If a cash-settled contingent consideration meets the definition of a derivative, it must be recognized at fair value at the acquisition date as a component of the costs incurred for the asset acquisition (see Section C.3.4.1). ▶ If the cash-settled contingent consideration does not meet the definition of a derivative, it is recognized as an additional cost of the acquisition either when it becomes probable and estimable, or when the contingency is resolved (see Section C.3.4.1). ▶ If the contingent consideration is an equity-linked instrument, it is initially recognized at fair value at the acquisition date as a component of the costs incurred for the asset acquisition, regardless of whether it is classified as equity or as a liability (see Section C.3.4.2).	▶ The acquirer recognizes contingent consideration at fair value at the acquisition date, regardless of whether it is classified as a liability or an asset (see Section 5.4.5.3) or as equity (see Section 5.4.5.4).

	ASSET ACQUISITION (OTHER THAN THE INITIAL CONSOLIDATION OF A VIE THAT IS NOT A BUSINESS)	BUSINESS COMBINATION
Acquisition-Related Costs or Transaction costs	▶ Transaction costs are included in costs capitalized for an asset acquisition (see Section C.3.5).	▶ Acquisition-related costs are not part of the fair value exchange between the buyer and seller for the business. As a result, acquisition-related costs incurred for a business combination must be expensed as incurred (see Section 6.3).
NCI	▶ ASC 805-50 does not provide guidance for the recognition and measurement of NCI in an asset acquisition. As such, there are differing approaches to account for NCI at the acquisition date: • Fair value: Analogize to the guidance for business combinations and measure NCI at fair value (see Section 4.5). • Carryover basis: Follow a cost accumulation approach by recognizing NCI at its carrying amount. ▶ An acquirer of an entity that is not a VIE can elect an accounting policy to apply either of these alternatives (see Section C.3.6.1).	▶ NCI is recognized at its acquisition-date fair value (see Section 4.5).
Previously Held Equity Interests	▶ ASC 805-50 does not provide guidance for the accounting for a previously held equity interest in an asset acquisition. As such, there are differing approaches: • Fair value – analogize to the guidance for business combinations and measure previously held equity interests at fair value (see Section 5.5). • Carryover basis – follow a cost accumulation approach by recognizing the previously held equity interest at its carrying amount. ▶ An acquirer of an entity that is not a VIE can elect an accounting policy to apply either of these alternatives (see Section C.3.6.2).	▶ Previously held equity interests in the acquiree are remeasured at fair value at the acquisition date (see Section 5.5).
Contingencies	▶ If the acquirer assumes a loss contingency or acquires a gain contingency as part of an asset acquisition, it accounts for the contingency in accordance with ASC 450 (see Section C.4.2).	▶ If the acquisition-date fair value is determinable during the measurement period, the acquirer recognizes the contingency as an asset or liability at fair value. ▶ If the acquisition-date fair value is not determinable during the measurement period, the contingency is recognized

	ASSET ACQUISITION (OTHER THAN THE INITIAL CONSOLIDATION OF A VIE THAT IS NOT A BUSINESS)	BUSINESS COMBINATION
		in accordance with ASC 450 (see Section 4.4.1.1).
Intangible Assets (Other Than IPR&D)	▶ An acquirer in an asset acquisition recognizes assets even if they do not meet either the contractual-legal criterion or the separability criterion. As a result, some assets that are not separately identifiable in a business combination must be separately recognized in an asset acquisition (see Section C.4.4).	▶ In a business combination, the acquirer recognizes only intangible assets that are separable or arise from contractual or other legal rights (see Section 4.4.2.7).
Assembled Workforce	▶ An assembled workforce is recognized as a separate asset (see Section C.4.4.1).	▶ An assembled workforce is not recognized as an identifiable asset in a business combination because it is neither separable nor does it arise from contractual or other legal rights; instead, it is subsumed into goodwill (see Section 4.4.2.7.3.1).
IPR&D	▶ IPR&D is recognized as an identifiable intangible asset with an amount allocated based on its relative fair value. ▶ The amount allocated to IPR&D is capitalized as an intangible asset and amortized as research and development expense only if the acquired IPR&D has an alternative future use. Conversely, if the IPR&D does not have an alternative future use, the amount allocated to it must be immediately expensed (see Section C.4.4.2).	▶ IPR&D is recognized as an identifiable intangible asset, measured at its acquisition-date fair value (see Section 4.4.2.8). ▶ IPR&D is accounted for as an indefinite-lived intangible asset until the project is completed or abandoned (see Section 4.4.2.8.1).
Lease Classification	▶ Because U.S. GAAP is not clear, we believe that, for asset acquisitions the acquiring entity could either reassess lease classification, or apply, by analogy, the guidance for business combinations for which lease classification is retained (see Section C.4.5).	▶ The acquirer retains the acquiree's lease classification. Lease classification is not reassessed in a business combination unless the lease is modified (see Section 4.3.1.1).
Deferred Income Taxes	▶ Deferred taxes for temporary differences and tax attributes acquired in an asset acquisition are recognized using the simultaneous equations method (see Section C.4.6).	▶ Deferred income taxes for most temporary differences and tax attributes acquired in a business combination are recognized with an offsetting adjustment to goodwill or bargain purchase gain.
	▶ In an asset acquisition, there is no concept of a measurement period, regardless of the size and	▶ In a business combination, the acquirer has up to one year after the acquisition

	ASSET ACQUISITION (OTHER THAN THE INITIAL CONSOLIDATION OF A VIE THAT IS NOT A BUSINESS)	BUSINESS COMBINATION
Measurement Period	complexity of the transaction (see Section C.5.1).	date to finalize its accounting for the business combination. This measurement period allows the acquirer time to obtain the information necessary to identify and measure the various elements of the business combination (see Section 4.6).
Exchange of Share-Based Payments	▶ We believe an acquirer may analogize to the guidance for replacement awards in a business combination; however, there is diversity in practice (see Section C.5.2).	▶ If an acquirer has an obligation to replace the share-based compensation awards, it must determine what portion of the replacement awards is consideration transferred and what portion is postcombination compensation (see Sections 6.4.3.2 6.4.3.3).
Pushdown Accounting	▶ Pushdown accounting cannot be elected in an asset acquisition (see Section C.5.3).	▶ The acquiree in a business combination may elect to continue to recognize its assets and liabilities at carryover basis, or it may choose to recognize its assets and liabilities at the acquirer's basis (see Appendix A).
Disclosures	▶ There are no specific disclosure requirements in ASC 805-50 for asset acquisitions. However, the acquirer should comply with the disclosure requirements in other parts of U.S. GAAP based on the nature of the assets acquired or the liabilities assumed (see Section C.6).	▶ There are extensive disclosure requirements for business combinations (see Chapter 8).

C.2 IS IT AN ASSET ACQUISITION?

The starting point for determining whether a merger or acquisition is a business combination, an asset acquisition, or a recapitalization is identifying the acquirer. Sometimes this determination is straightforward, but in some cases it may be less clear. Chapter 2 provides guidance for identifying the acquirer.

Once the acquirer has been identified, the acquirer must evaluate whether the acquired group of assets and liabilities (the acquired set) meets the definition of a business. If so, the transaction is accounted for as a business combination; if not, it must be accounted for as an asset acquisition or recapitalization. Chapter 3 provides guidance for determining whether an acquired set meets the definition of a business.

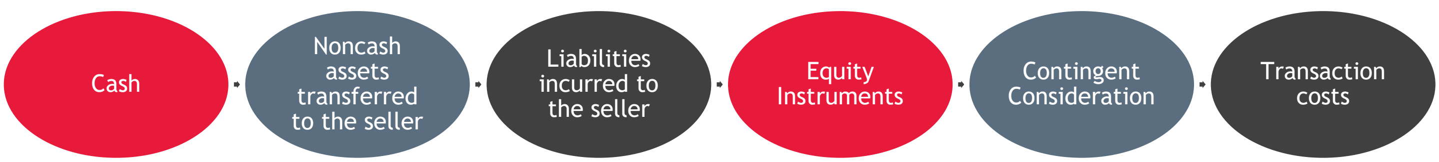
Chapters 1 through 8 provide guidance for accounting for business combinations. Section C.8 provides guidance for accounting for recapitalization transactions. The remainder of this appendix provides guidance on accounting for asset acquisitions.

C.3 DETERMINE THE COST OF THE ASSET ACQUISITION

FASB REFERENCES

ASC 805-50-25-1 and ASC 805-50-30-1 through 30-2

The cost of an asset acquisition may include the following:



Further, in some asset acquisitions, the acquirer may gain control of a separate legal entity that holds assets but does not meet the definition of a business. In such instances, the acquirer must also determine the appropriate amounts to recognize for the following:

- Previously held equity interests
- Noncontrolling interests

For transactions that include only cash consideration, determining the cost of the asset acquisition is straightforward. In such cases, the cost is measured by the amount of the cash paid, which generally includes the transaction costs of the asset acquisition. For other transactions, the acquirer must determine the appropriate amounts to measure the cost of the asset acquisition.

C.3.1 Noncash Assets Transferred to the Seller

FASB REFERENCES

ASC 805-50-25-1 and ASC 805-50-30-2

ASC 805-50 provides general guidance for measuring noncash assets transferred to the seller in an asset acquisition. That guidance indicates that the noncash assets transferred shall be measured based on the fair value of either the consideration given or the asset acquired, whichever is more clearly evident. However, this guidance applies only if no other U.S. GAAP applies to the exchange transaction.

ASC 805-50 references ASC 845, *Nonmonetary Transactions*, and ASC 610-20 as examples of other U.S. GAAP that could apply, but these examples are not exhaustive. The acquirer must account for the derecognition of the assets transferred to the seller based on the substance of the transaction. For example, if the net assets transferred by the acquirer to the seller are:

- Nonfinancial assets: ASC 610 or ASC 606 may apply.
- A business: The deconsolidation guidance in ASC 810 would typically apply (see Section 5.4.5.7).
- Financial assets, including equity-method investments: ASC 860 would apply.
- Other nonmonetary exchanges: ASC 845 may apply if no other U.S. GAAP applies.

C.3.1.1 Transfer of Nonfinancial Assets

FASB REFERENCES

ASC 805-50-30-1 through 30-2, ASC 610-20, and ASC 606-10-32-21 through 32-22

If the consideration transferred is in the form of nonfinancial assets (or in-substance nonfinancial assets), the exchange transaction may be in the scope of ASC 610-20 (if the counterparty is a noncustomer) or ASC 606 (if the transaction is the transfer of goods sold in the ordinary course of business to a customer). In such case, the assets acquired are treated as noncash consideration. This means the acquired assets are recognized at fair value, or at the standalone selling price of the goods transferred if an entity cannot reasonably estimate the fair value. Any gain or loss upon the derecognition of the nonfinancial assets (or in-substance nonfinancial assets) is recognized in accordance with the guidance in ASC 610-20 or ASC 606.

C.3.1.2 Noncash Assets Given as Consideration That Remain Within the Combined Entity After the Acquisition

FASB REFERENCES

ASC 805-30-30-8

BDO INSIGHTS — CONSIDERATION THAT REMAINS WITHIN THE COMBINED ENTITY

For some asset acquisitions, the acquirer transfers assets or liabilities to the acquiree rather than to the sellers. As a result, such assets or liabilities remain with the combined entity after the acquisition. ASC 805-50 does not provide guidance for accounting for such assets and liabilities; however, because the acquirer does not lose control over those assets and liabilities, we believe that the acquirer must continue to measure them at their carrying amounts immediately before the acquisition date (carryover basis) with no gain or loss recognized, which is consistent with the guidance for business combinations (see Section 5.4.2.1).

C.3.1.3 Transfer of a Business

FASB REFERENCES

ASC 610-20-15-4(b) and ASC 810-10-40-5

For some asset acquisitions, the consideration transferred by the acquirer to the seller may include a set of assets and liabilities that constitutes a business. In such cases, the guidance in ASC 810-10 for the deconsolidation of a business typically applies (see Section 5.4.5.7) rather than the guidance in ASC 845 or ASC 610-20. That guidance requires that the transferor recognize a gain or loss in net income for the difference between the carrying amount of the transferred business and the aggregate of:

- The fair value of any consideration received
- The fair value of any retained noncontrolling investment in the former subsidiary or group of assets at the date the subsidiary is deconsolidated or the group of assets is derecognized
- The carrying amount of any noncontrolling interest in the former subsidiary (including any accumulated other comprehensive income attributable to NCI) at the date the subsidiary is deconsolidated

(Fair Value of Consideration Received + Fair Value of Any Retained Noncontrolling Investment in the Former Subsidiary or Group of Assets + Carrying Amount of any NCI in the Former Subsidiary) − Carrying Amount of the Transferred Business = Gain (Loss) on the Transferred Business

C.3.1.4 Transfer of Financial Assets

FASB REFERENCES

ASC 610-20-15-4(e), ASC 610-20-15-5 through 15-8, ASC 860-20-05-1, and ASC 860-20-30-1

In some asset acquisitions, the consideration includes the transfer of financial assets from the acquirer to the seller. If a transfer includes both financial and nonfinancial assets, the acquirer must evaluate whether the financial assets are "in substance nonfinancial assets" under ASC 610-20-15-5 through 15-8. If so, the derecognition of the financial assets would be included in the scope of ASC 610-20 (see Section C.3.1.2). Otherwise, the transfer of financial assets is within the scope of ASC 860.

Under ASC 860, assuming that the derecognition criteria are met, the transferor measures the assets obtained (or liabilities incurred) in exchange for the financial asset at fair value.

C.3.1.5 Nonmonetary Exchanges

FASB REFERENCES

ASC 805-50-30-1 through 30-2 and ASC 845-10-30-3 through 30-4

If no other U.S. GAAP applies a nonmonetary exchange may be within the scope of ASC 845. Under ASC 845, nonmonetary exchanges are typically accounted for at fair value unless **any** of the following conditions apply:

- The fair values of both the asset(s) received and the asset(s) relinquished are not determinable within reasonable limits.
- 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.
- The transaction lacks commercial substance.

If any of these conditions apply, the nonmonetary exchange is measured at the recorded amount (after reduction for impairment, if appropriate) of the nonmonetary assets relinquished rather than the fair values of the exchanged assets.

BDO INSIGHTS — FAIR VALUE IS LIKELY DETERMINABLE

We believe it is unlikely that the first condition would ever be met, because it would be unusual to conclude that the fair values of both the assets received and the assets relinquished are not determinable within reasonable limits.

C.3.2 Liabilities Incurred to the Seller

FASB REFERENCES

ASC 805-50-25-1 and ASC 805-50-30-2

If the consideration for an asset acquisition includes noncontingent liabilities incurred to the seller, the liabilities are initially recognized at fair value (or at the fair value of the assets acquired if it is more clearly evident) at the acquisition date.

C.3.3 Equity Interests Issued to the Seller

FASB REFERENCES

ASC 805-50-25-1 and ASC 805-50-30-2

ASC 805-50 indicates that equity interests issued in exchange for assets shall be initially recognized at the acquisition date. As such, the acquirer typically measures and recognizes the equity it issues for an asset acquisition based on the fair value of either the equity instruments or the net assets acquired, whichever is more clearly evident.

However, under an alternative view, the issuance of equity interests in exchange for assets may represent a share-based payment to nonemployees in exchange for goods. Under this view, the acquirer would account for the share-based payment under the guidance of ASC 718, which may result in a grant date measurement that precedes the acquisition date.

BDO INSIGHTS — DIVERSITY IN PRACTICE FOR ACCOUNTING FOR EQUITY ISSUED IN EXCHANGE FOR ASSETS

The different views on accounting for equity issued in exchange for an asset acquisition have resulted in diversity in practice, which practitioners raised to the FASB. Based on FASB discussions at its March 3, 2021, agenda prioritization meeting, we believe that an acquirer may apply either alternative as a policy election that should be consistently applied.

C.3.4 Contingent Consideration

Contingent payment arrangements are commonly included in asset acquisitions to help buyers and sellers resolve differences in their views regarding the value of the acquired set. Such arrangements often include additional payments to be transferred if the acquired set can achieve specified results (such as targeted revenues, earnings, or EBITDA) or specific milestones (such as FDA approval of a drug candidate) or stock price targets.

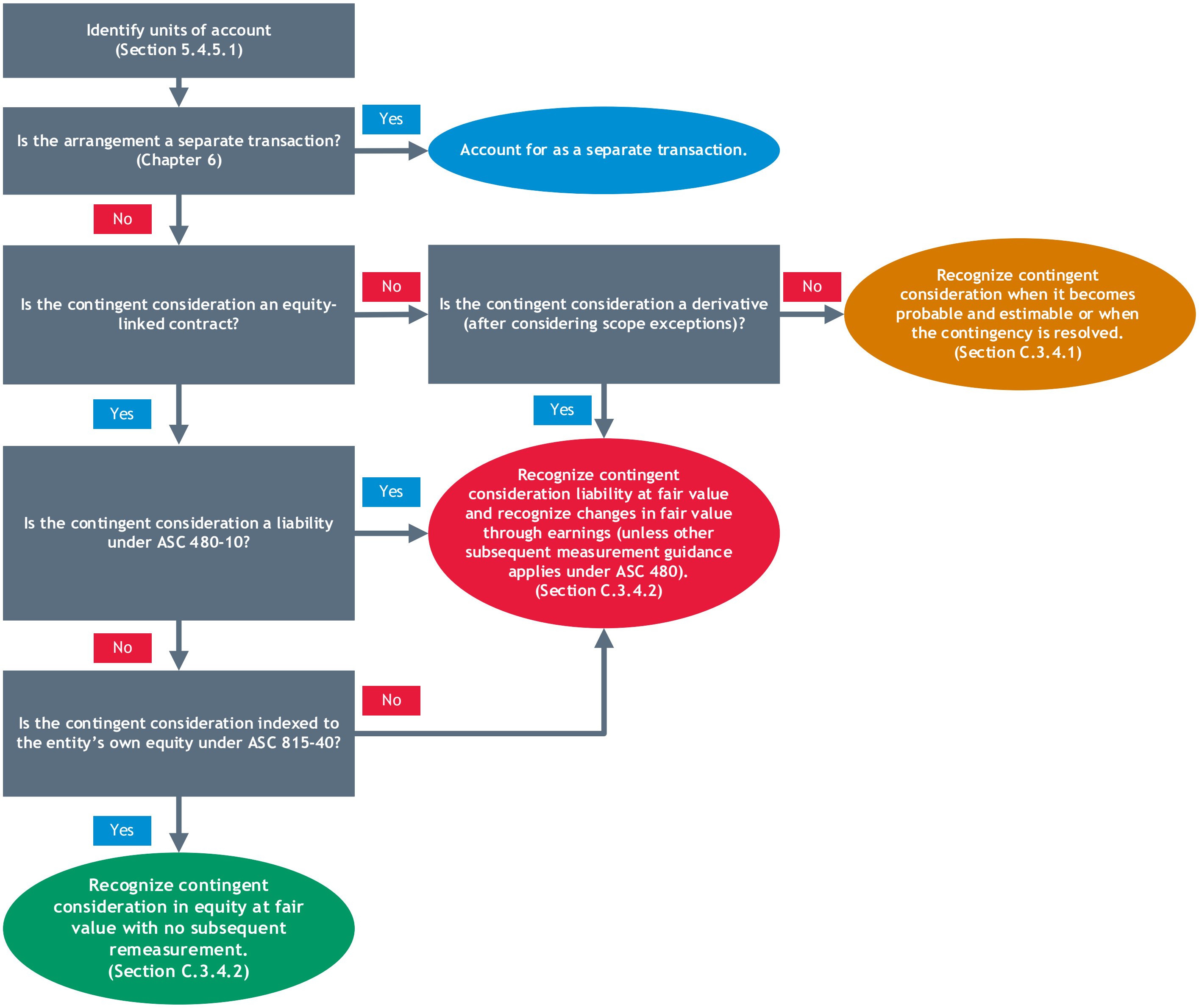
Some acquisitions include more than one contingent payment arrangement, or a contingent payment arrangement may have multiple triggers (or underlyings). As such, an assessment of the relevant facts and circumstances is necessary to determine whether the arrangement represents a single contingent payment arrangement with multiple triggers or whether there are multiple contingent payment arrangements. Section 5.4.5.1 provides guidance for evaluating the unit of account for contingent payment arrangements.

BDO INSIGHTS — CONTINGENT PAYMENT ARRANGEMENTS SHOULD BE EVALUATED TO DETERMINE IF THEY REPRESENT CONTINGENT CONSIDERATION OR A SEPARATE TRANSACTION

Not all contingent amounts payable to (or receivable from) the former owners are accounted for as contingent consideration. Each contingent payment arrangement must be evaluated to determine whether it should be accounted for as contingent consideration for the asset acquisition or as a separate transaction. Contingent payment arrangements that are determined to be separate from the asset acquisition must be accounted for in accordance with other U.S. GAAP (for example, ASC 710 or ASC 718). Chapter 6 provides guidance for identifying elements that are not part of a business combination, including evaluating whether payments to selling shareholders represent contingent consideration or compensation for services (see Section 6.4.2). We believe that such principles should also be applied when evaluating contingent payment arrangements for asset acquisitions.

For each unit of account determined to be contingent consideration the acquirer must determine the appropriate accounting. ASC 805-50 does not provide guidance for the recognition and measurement of contingent consideration in an asset acquisition, so other U.S. GAAP must be applied. The accounting analysis differs for cash-settled contingent consideration than for contingent consideration indexed to or settled in the acquirer's equity.

The following graphic summarizes the accounting for contingent consideration in an asset acquisition:



C.3.4.1 Cash-Settled Contingent Consideration

FASB REFERENCES

ASC 815-10-15-59

For cash-settled contingent consideration, an entity must first evaluate whether the arrangement meets the definition of a derivative under ASC 815. If so, the contingent consideration must be recognized at fair value at the acquisition date as a component of the costs incurred for the asset acquisition (unless a scope exception applies). Subsequent changes in the fair value of the derivative are recognized in earnings.

Two scope exceptions commonly apply to contingent consideration:

- ASC 815-10-15-59(b) provides a scope exception for non-exchange-traded contracts with an underlying whose settlement is based on the price or value of a nonfinancial asset of one of the parties to the contract, provided that the asset is not readily convertible to cash. This exception applies only if the nonfinancial assets are unique and are owned by the party that would not benefit under the contract from an increase in the fair value of the nonfinancial asset.

- ASC 815-10-15-59(d) provides a scope exception for non-exchange-traded contracts with an underlying whose settlement is based on a specified volume of sales or service revenues of one of the parties to the contract.

BDO INSIGHTS — JUDGMENT IS REQUIRED FOR CONTINGENT PAYMENT ARRANGEMENTS THAT DO NOT QUALIFY AS DERIVATIVES

If the cash-settled contingent consideration does not meet the definition of a derivative (or qualifies for a scope exception), the acquirer recognizes the contingent consideration as an additional cost of the acquisition **either** when it becomes probable and estimable (under the loss contingency model in ASC 450) or when the contingency is resolved (based on superseded guidance from paragraph 27 of FAS 141). Based on diversity in practice, we believe either model is acceptable, but that an entity should make a policy election that is consistently applied.

See Section C.4.4.2.1 for a discussion of the accounting for contingent consideration for the acquisition of IPR&D. See Section C.7.1 for a discussion of the accounting for contingent consideration after the acquisition date.

C.3.4.2 Contingent Consideration Indexed to or Settled in the Acquirer’s Equity

Unless a contingent payment arrangement that is indexed to or settled in the acquirer’s equity represents a separate transaction (see Sections C.3.4.1 and C.3.7), the entity must evaluate the contingent consideration as an equity-linked contract. As such, the entity must evaluate the arrangement under ASC 480-10 and ASC 815-40 to determine the appropriate classification and accounting for the contingent consideration. BDO’s publication, Understanding Complex Financial Instruments provides guidance for evaluating the accounting for equity-linked contracts.

Whether the contingent consideration is equity classified or liability classified, the equity-linked contract is initially recognized at fair value at the acquisition date as a component of the costs incurred for the asset acquisition. If the contingent consideration is liability classified, subsequent changes in the fair value of the liability are recognized in earnings. If the contingent consideration is equity classified, it is not remeasured after the acquisition date, and the subsequent settlement is accounted for as an equity transaction.

C.3.5 Transaction Costs

FASB REFERENCES

ASC 805-50-30-1

Transaction costs are the direct and incremental costs the acquirer incurs to effect an asset acquisition. ASC 805-50 indicates that transaction costs should be included in the consideration transferred for an asset acquisition, so those costs are included in the amounts capitalized for an asset acquisition. To qualify as a transaction cost, the cost should be directly related to the asset acquisition that would not otherwise have been incurred. Examples of such costs may include legal fees, appraisals, valuations, and finder’s fees. Internal costs, including salaries and other costs, are generally expensed as incurred.

Costs to issue debt and equity securities should not be capitalized as part of the cost of the net assets acquired but instead should be recognized in accordance with other applicable U.S. GAAP. Debt issuance costs are generally recognized as a discount against the face amount of debt and amortized as interest expense over the term of the debt in accordance with ASC 835. Similarly, direct and incremental costs of issuing equity securities are generally recognized as a reduction of the gross proceeds from the offering in accordance with SAB Topic 5.A. See Section 6.3.1 for discussion on costs to issue debt and equity securities.

ACCOUNTING FOR TRANSACTION COSTS IN A BUSINESS COMBINATION

The accounting for transaction costs in an asset acquisition is different than the accounting for acquisition-related costs in a business combination. Acquisition-related costs in a business combination are not part of the consideration in a business combination and generally must be expensed as incurred. See Section 6.3 for more guidance on acquisition-related costs for a business combination.

C.3.6 Acquisition of Separate Legal Entity That Holds Assets

An acquirer may obtain assets by acquiring a controlling interest in a separate entity that holds assets but does not meet the definition of a business. If the acquirer controls less than 100% of the equity interests of the entity, a noncontrolling interest in the subsidiary is created. Additionally, in some cases, the acquirer may have a previously held equity interest in the legal entity prior to the acquisition date.

C.3.6.1 Noncontrolling Interests

BDO INSIGHTS — RECOGNIZING NCI IN AN ASSET ACQUISITION

ASC 805-50 does not provide guidance for the recognition and measurement of NCI in an asset acquisition. As such, there are differing approaches to account for NCI at the acquisition date:

Fair value	Analogize to the guidance for business combinations and measure NCI at fair value (see Section 4.5).
Carryover basis	Follow a cost accumulation approach by recognizing NCI at its carrying amount.

We believe the acquirer of an entity that is not a VIE can elect an accounting policy to apply either of these alternatives (and that policy must be consistently applied). However, if the acquired entity is a VIE, a policy election is not available. Instead, the acquirer must recognize NCI at fair value (see Section C.1.1).

The amounts attributed to NCI are included in the consideration for the net assets acquired.

C.3.6.2 Previously Held Equity Interests

BDO INSIGHTS — RECOGNIZING PREVIOUSLY HELD EQUITY INTERESTS IN AN ASSET ACQUISITION

In some acquisitions, the acquirer gains control of a legal entity in which it had a previously held equity interest before the acquisition date. ASC 805-50 does not provide guidance for the accounting for a previously held equity interest in an asset acquisition. As such, there are differing approaches:

Fair value	Analogize to the guidance for business combinations and measure previously held equity interests at fair value (see Section 5.5).

Carryover basis	Follow a cost accumulation approach by recognizing the previously held equity interests at their carrying amounts.

We believe the acquirer of an entity that is not a VIE can elect an accounting policy to apply either of these alternatives (and that policy must be consistently applied). However, if the acquired entity is a VIE, a policy election is not available. Instead, the acquirer must recognize the previously held equity interests at their carrying value (see Section C.1.1).

The amounts attributed to the previously held equity interests are included in the consideration for the net assets acquired.

C.3.7 Transactions Separate From the Asset Acquisition

An acquirer may enter various arrangements with the sellers or acquiree in connection with an asset acquisition. Such arrangements require analysis to determine whether they should be accounted for as part of, or separately from, the asset acquisition. This is particularly important for transactions entered in close proximity to the asset acquisition.

There is no specific guidance for identifying separate transactions in connection with an asset acquisition. However, the principles in ASC 805 for identifying transactions that are separate from a business combination can be used for asset acquisitions (see Section 6.2). Generally, arrangements that primarily benefit the acquirer or combined entity are accounted for as separate transactions. Conversely, transactions that primarily benefit the acquiree or its former owners are typically part of the asset acquisition.

Determining whether an arrangement between an acquirer and seller is separate from the asset acquisition is important because any amounts attributable to transactions that are separate from the acquisition must be accounted for in accordance with other relevant U.S. GAAP. Only the consideration for the asset acquisition is accounted for under ASC 805-50. When there are multiple elements to account for, the acquirer must allocate the consideration between the asset acquisition and the transactions that are separate from the asset acquisition.

BDO INSIGHTS — ALLOCATING CONSIDERATION TO TRANSACTIONS SEPARATE FROM THE ASSET ACQUISITION

ASC 805-50 does not provide guidance for allocating the consideration transferred between the asset acquisition and the separate transactions. Absent specific guidance, there may be more than one reasonable approach. We generally believe that it would be appropriate to allocate consideration to the various elements using a relative fair value approach unless the fair value of one element cannot be determined, as noted in the SEC Staff speech excerpted below. However, any contingent payments that are automatically forfeited if employment terminates must be recognized as compensation for services in the postacquisition period, consistent with the principle in ASC 805-10-55-25 (see Section 6.4.2.1).

SEC STAFF GUIDANCE

[Remarks before the 2007 AICPA Conference on Current SEC and PCAOB Developments]

Eric C. West, Associate Chief Accountant, Office of the Chief Accountant

December 10, 2007

Accounting for Litigation Settlements

> *…we 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.*

C.3.7.1 Settlement of Preexisting Relationships

BDO INSIGHTS — SETTLEMENT OF PREEXISTING RELATIONSHIPS IN AN ASSET ACQUISITION

ASC 805-50 does not provide guidance for accounting for the effective settlement of preexisting relationships in connection with an asset acquisition. However, we believe an acquirer should apply the guidance for effective settlement of preexisting relationships in a business combination by analogy (see Section 6.5 and related subsections).

C.3.8 Determining the Cost of a Reverse Asset Acquisition

As discussed in Section 2.2.2, **if the legal acquiree is not a VIE**, the parties must determine which entity is the acquirer under the voting interest model. A reverse acquisition occurs when the legal acquirer is deemed the accounting acquiree and the legal acquiree is deemed the accounting acquirer. ASC 805-40 provides guidance for accounting for reverse acquisitions which are defined as follows:

FASB REFERENCES

ASC 805-40-20

Reverse Acquisition

> *An acquisition in which the entity that issues securities (the legal acquirer) is identified as the acquiree for accounting purposes based on the guidance in paragraphs 805-10-55-11 through 55-15. The entity whose equity interests are acquired (the legal acquiree) must be the acquirer for accounting purposes for the transaction to be considered a reverse acquisition.*

To determine whether to account for a transaction as a forward or a reverse acquisition, the combining entities must assess the factors in Section 2.2.2 to determine which entity is the accounting acquirer. Once the accounting acquirer has been identified, it must assess whether the acquired set meets the definition of a business (see Chapter 3). If the accounting acquiree is not a business, the acquisition would not be accounted for as a business combination; instead, it would be accounted for as an asset acquisition or a capital transaction, depending on its substance.

BDO INSIGHTS — DETERMINING CONSIDERATION IN A REVERSE ASSET ACQUISITION

ASC 805-50 does not provide specific guidance for measuring the consideration in a reverse asset acquisition. However, we believe it is appropriate to apply guidance for accounting for a reverse business combination (see Section 7.3.1) to determine the consideration for the reverse asset acquisition.

C.4 ALLOCATE THE COST OF THE ASSET ACQUISITION

FASB REFERENCES

ASC 805-50-30-3 through 30-4

Once the acquirer has determined the cost of the asset acquisition, it must allocate the cost to the individual assets acquired (and liabilities assumed). The allocation should generally be based on the relative fair values of the assets acquired and liabilities assumed (with some exceptions, as discussed in Section C.4.1). ASC 805-50 indicates that an asset acquisition shall not give rise to goodwill.

Because an asset acquisition cannot give rise to goodwill, any cost of the acquisition that exceeds the aggregate fair value of the net assets acquired must be allocated to the assets acquired on a relative fair value basis (with some exceptions, as discussed in Section C.4.1). However, before performing that allocation, the acquirer must reconsider whether it has appropriately concluded that the acquisition is not a business combination and whether it has appropriately determined the fair value of the assets acquired and liabilities assumed. For example, if there is more than an insignificant amount of goodwill, it may indicate that there is a substantive process in the acquired set, and the set may be business (See Chapter 3). The acquirer also must reevaluate whether to allocate any of the consideration to transactions that must be accounted for separately from the asset acquisition.

If the aggregate fair value of the net assets acquired exceeds the cost of the asset acquisition, such excess must be allocated as a reduction of the assets acquired. A bargain purchase gain is not recognized. The reduction in value must be allocated to the assets acquired on a relative fair value basis (with some exceptions, as discussed in Section C.4.1).

ALLOCATING THE COSTS OF AN ASSET ACQUISITION IS DIFFERENT THAN FOR A BUSINESS COMBINATION

The approach for allocating the costs of an asset acquisition is different than for a business combination. In a business combination, the assets acquired and liabilities assumed are recognized at fair value (with limited exceptions, as discussed in Section 4.4.1) and the acquirer recognizes goodwill or a bargain purchase gain, as discussed in Sections 5.2 and 5.3.

C.4.1 Exceptions to Pro Rata Allocation

BDO INSIGHTS — EXCEPTIONS TO PRO RATA ALLOCATION

As discussed in Section C.4, an acquirer generally allocates the costs of the asset acquisition to the acquired assets and liabilities based on their relative fair values. However, we do not believe any difference between the cost and fair value of the group of assets acquired and liabilities assumed should be allocated to the liabilities assumed.

Further, allocating the costs of the acquisition to all assets strictly based on relative fair values could result in an immediate recognition of gain or loss in accordance with other U.S. GAAP. As such, it would not be appropriate to allocate amounts to assets if it would result in an immediate recognition of a gain or loss under other U.S. GAAP (except for IPR&D assets with no alternative future use as noted in Section C.4.4.2).

As such, some assets must be recognized at the amounts required by other applicable U.S. GAAP (and cannot be adjusted by any allocation of amounts above or below the fair value of the aggregate assets acquired and liabilities assumed). Assets that do not qualify for adjustment (nonqualifying assets) include the following:

- Cash
- Financial assets (other than investments accounted for by the equity
- Derivatives
- Other current assets (including inventories)
- Assets held for sale
- Deferred tax assets
- Indemnification assets (see Section C.4.3)
- Contract assets recognized under Topic 606

Also, indefinite-lived intangible assets are subject to a fair value impairment test, so any amounts allocated to them in excess of fair value would result in an immediate impairment. Therefore, an acquirer should not allocate an amount greater than fair value to those assets.

However, if the aggregate fair value of the assets acquired and liabilities assumed exceeds the cost of the asset acquisition, an acquirer must allocate the excess fair value of the net assets acquired to reduce the value of any qualifying assets, including indefinite-lived intangible assets.

Examples C-1 and C-2 illustrate these concepts.

EXAMPLE C-1: ALLOCATION OF EXCESS COST OVER THE FAIR VALUE OF ASSETS ACQUIRED

FACTS

- Company A acquires a group of assets and liabilities from Company B for $6.9 million.
- In connection with the acquisition, Company A incurs legal fees of $0.1 million.
- The fair values of the assets acquired and liabilities assumed are:
  - Land: $3 million
  - Building: $6 million
  - Indefinite-lived intangible asset: $1 million
  - Inventory : $0.5 million

- Debt: ($4 million)
- Company A has determined that the assets do not meet the definition of a business.

CONCLUSION

Company A allocates the excess cost over the fair value of the assets acquired and liabilities assumed to the acquired long-lived tangible assets. It does not allocate any portion of the excess to the debt, inventory, or indefinite-lived intangible asset.

ANALYSIS

Because the acquired set is not a business, the excess cost over the fair value of the net assets acquired cannot give rise to goodwill, and must, instead be allocated to the assets acquired. After reconsidering whether it has appropriately identified and measured all the elements of the acquisition, the acquirer allocates the cost of the asset acquisition as follows:

	FAIR VALUE	PERCENTAGE OF FAIR VALUE*	ALLOCABLE COST**	ALLOCATED COST
Land	$ 3,000,000	33%	$ 9,500,000	$ 3,135,000
Building	6,000,000	67%	9,500,000	6,365,000
Indefinite-lived intangible	1,000,000			1,000,000
Inventory	500,000			500,000
Debt	(4,000,000)			(4,000,000)
	$ 6,500,000			$ 7,000,000

* Percentage of fair value is calculated based on the total assets that will be allocated a portion of the excess cost over fair value (so it includes land of $3 million and building of $6 million, but excludes the indefinite-lived intangible asset, inventory, and debt).

** The allocable cost for the qualifying assets (land and building) is determined after the liabilities and nonqualifying assets are recognized at fair value. It is calculated as consideration transferred ($6.9 million) plus transaction costs ($0.1 million) plus the fair value of the liabilities assumed ($4 million) less the fair value of the nonqualifying assets ($1.5 million).

EXAMPLE C-2: ALLOCATION OF EXCESS FAIR VALUE OF ASSETS ACQUIRED OVER THE COST

FACTS

- Company A acquires a group of assets and liabilities from Company B for $5.9 million.
- In connection with the acquisition, Company A incurs legal fees of $0.1 million.
- The fair values of the assets acquired and liabilities assumed are:
  - Land: $3 million
  - Building: $6 million
  - Indefinite-lived intangible asset: $1 million
  - Inventory : $0.5 million
  - Debt: ($4 million)
- Company A has determined that the assets do not meet the definition of a business.

CONCLUSION

Company A allocates the excess fair value of the assets acquired and liabilities assumed over the cost to the acquired long-lived tangible and intangible assets. It does not allocate any portion of the excess to the debt or inventory.

ANALYSIS

Because the acquired set is not a business, the excess fair value of the net assets acquired over the cost cannot give rise to a bargain purchase gain, and must, instead be allocated to the assets acquired and liabilities assumed. After reconsidering whether it has appropriately identified and measured all the elements of the acquisition, the acquirer allocates the cost of the asset acquisition as follows:

	FAIR VALUE	PERCENTAGE OF FAIR VALUE*	ALLOCABLE COST**	ALLOCATED COST
Land	$ 3,000,000	30%	$ 9,500,000	$ 2,850,000
Building	6,000,000	60%	9,500,000	5,700,000
Indefinite-lived intangible	1,000,000	10%	9,500,000	950,000
Inventory	500,000			500,000
Debt	(4,000,000)			(4,000,000)
	$ 6,500,000			$ 6,000,000

* Percentage of fair value is calculated based on the total assets that will be allocated a portion of the excess fair value over cost (so it includes land of $3 million, building of $6 million, and indefinite-lived intangible asset of $1 million, but excludes the inventory and debt).

** The allocable cost for the qualifying assets (the land, building, and indefinite-lived intangible asset) is determined after the liabilities and nonqualifying assets are recognized at fair value. It is calculated as consideration transferred ($5.9 million) plus transaction costs ($0.1 million) plus the fair value of the liabilities assumed ($4 million) less the fair value of the nonqualifying assets ($0.5 million).

C.4.2 Contingencies Assumed or Acquired

If the acquirer assumes a loss contingency or acquires a gain contingency as part of an asset acquisition, it accounts for the contingency in accordance with ASC 450. In other words, the acquirer recognizes a loss contingency if it is probable that a loss has been incurred and the amount can reasonably be estimated, but it does not recognize a gain contingency until the gain is realized or realizable (the contingency is resolved).

C.4.3 Indemnification Assets

FASB REFERENCES

ASC 805-20-25-27 through 25-28

In some asset acquisitions, a seller may agree to reimburse the acquirer for the negative outcome of a contingency or uncertainty related to all or part of a specific asset or liability (commonly referred to as “seller indemnification”). For example, a seller might guarantee that the amount the acquirer must pay related to a contingent liability will not exceed a stated amount by agreeing to reimburse the acquirer for any excess.

BDO INSIGHTS — RECOGNIZING INDEMNIFICATION ASSETS IN AN ASSET ACQUISITION

ASC 805-50 does not provide guidance for recognizing indemnification assets in an asset acquisition. However, the business combination guidance in ASC 805 requires that an indemnification asset be recognized at the same time and measured using the same basis as the indemnified item (subject to the need for a valuation allowance for uncollectible amounts). We believe it is appropriate to apply this business combination guidance (see Section 4.4.1.4) by analogy in an asset acquisition.

C.4.4 Intangible Assets

FASB REFERENCES

ASC 350-30-25-4

The identification and recognition of intangible assets in an asset acquisition differs from identification and recognition of intangible assets in a business combination. In a business combination, the acquirer recognizes only intangible assets that are separable or that arise from contractual or other legal rights (see Section 4.4.2.7). However, there is a lower threshold for recognizing assets in an asset acquisition. In other words, the acquirer in an asset acquisition recognizes assets that exist, even if they do not meet either the contractual-legal criterion or the separability criterion. As a result, some assets that are not separately identifiable in a business combination must be separately recognized in an asset acquisition.

The following sections provide guidance for assets that may be accounted for differently in an asset acquisition than in a business combination.

C.4.4.1 Assembled Workforce

FASB REFERENCES

ASC 350-30-25-4 and ASC 805-20-55-6

ASC 805 defines an assembled workforce as *"an existing collection of employees that permits the acquirer to continue to operate an acquired business from the acquisition date."* An assembled workforce is not recognized as an identifiable asset in a business combination because it is neither separable nor arises from contractual or other legal rights; instead, it is subsumed into goodwill. In an asset acquisition, however, an assembled workforce is recognized as a separate asset.

The presence of an assembled workforce may indicate that the acquired set is a business (see Section 3.4) because it may indicate that a substantive process has been acquired. As such, before separately recognizing an assembled workforce intangible asset, the acquirer should verify that the acquisition is not a business combination (see Chapter 3). Reaching a conclusion about whether a transaction is a business combination or an asset acquisition requires the use of professional judgment based on the facts and circumstances.

C.4.4.2 In-Process Research and Development

FASB REFERENCES

ASC 350-30-25-4 and ASC 730-10-25-2(c)

An acquirer that purchases IPR&D in an asset acquisition must allocate a portion of the costs of the acquisition to IPR&D based on relative fair value (see Section C.4). However, the subsequent accounting for the IPR&D depends on whether it has an alternative future use.

Acquired IPR&D in an asset acquisition is accounted for under ASC 730. That guidance indicates that the amounts allocated to IPR&D should be capitalized as an intangible asset and amortized as research and development expense only if the acquired IPR&D has an alternative future use. Conversely, if the IPR&D does not have an alternative future use, the amounts allocated to it must be immediately expensed.

The requirement to immediately expense IPR&D that does not have an alternative future use is different than the accounting treatment of IPR&D in a business combination, which requires the acquirer to capitalize the fair value of IPR&D as an indefinite-lived intangible asset, regardless of whether it has an alternative future use (see Section 4.4.2.8).

BDO INSIGHTS — ALTERNATIVE FUTURE USE

The AICPA IPR&D Guide, in paragraphs 3.13 – 3.20, provides guidance for assessing whether acquired IPR&D has an alternative future use. Under that guidance, an alternative future use would exist only if both of the following conditions are met:

- It is reasonably expected (a greater than 50% likelihood) that the reporting entity will use the asset acquired in the alternative manner and anticipates economic benefit from that alternative use.
- The reporting entity's use of the acquired asset is not contingent on further development of the asset after the acquisition date (that is, the asset can be used in the alternative manner in the condition in which it existed at the acquisition date).

The following are examples that do not have an alternative future use:

- The asset is expected to be used only in one or more R&D projects that have already commenced at the acquisition date (as opposed to a future R&D activity).
- The asset is expected to be used (in its future completed condition) in a future R&D project if the completion of the current project is successful.
- The asset is used solely as a defensive asset to protect other IPR&D projects.

As a result of this guidance, we believe there will be limited circumstances in which acquired IPR&D will be deemed to have an alternative future use. However, reaching a conclusion about whether IPR&D has an alternative future use requires professional judgment based on the facts and circumstances.

C.4.4.2.1 Contingent Consideration With IPR&D

It is common for an acquirer to enter contingent consideration arrangements (for example, milestone payments) in connection with an asset acquisition that includes IPR&D. If the contingent consideration is recognized at fair value at the acquisition date (that is, equity-classified contingent consideration or a derivative), it is included in the consideration transferred and any amounts allocated to IPR&D are immediately expensed unless the IPR&D has an alternative future use (see Section C.4.4.2).

As discussed in Section C.3.4.1, if contingent consideration for an asset acquisition is recognized after the acquisition date (that is, cash-settled contingent consideration that is not a derivative), the additional cost should be capitalized and allocated to the acquired assets based on their relative fair values at the acquisition date (see Section C.4). When the acquired assets included IPR&D, any contingent consideration amounts that are recognized subsequently and allocated to IPR&D must be expensed as incurred as long as the IPR&D remains unfinished and has no alternative future use. However, once the IPR&D project is completed and represents an asset, the amounts allocated based on its relative fair value at the acquisition date must be capitalized as part of the intangible asset. For example, if there is a milestone payment due to the sellers upon the final FDA approval of a drug candidate, the amounts allocated based on the relative fair value of the IPR&D at the acquisition date are capitalized because the acquired technology is no longer IPR&D.

Example C-3 illustrates this concept.

EXAMPLE C-3: ALLOCATION OF CONTINGENT CONSIDERATION FOR IPR&D ACQUIRED IN AN ASSET ACQUISTION

FACTS

- Company A enters an exclusive license to develop and commercialize two early-stage drug candidates in exchange for an upfront payment of $10 million and contingent consideration of $15 million if either compound receives FDA approval.
- The fair values of the assets acquired are:
  - IPR&D – Compound #1: $8 million
  - IPR&D – Compound #2: $2 million
- Company A has determined that the assets do not meet the definition of a business.
- The IPR&D does not have an alternative future use.
- Company A has adopted an accounting policy to recognize contingent consideration that does not meet the definition of a derivative when the contingency is resolved.

CONCLUSION

Because the IPR&D does not have an alternative future use, the entire upfront cost of the asset acquisition must be expensed immediately. Upon resolution of the contingency, Company A treats the contingent consideration as an additional element of cost and allocates the payment to the acquired assets based on the relative fair values of the IPR&D at the acquisition date.

ANALYSIS

Because the acquired set is not a business, the cost must be allocated to the assets acquired based on their relative fair values. On the acquisition date, the acquirer allocates the initial cost of the asset acquisition as follows:

	ACQUISITION DATE FAIR VALUE	PERCENTAGE OF FAIR VALUE	UPFRONT COST OF ACQUISITION	ALLOCATED COST
IPR&D – Compound #1	$ 8,000,000	80%	$ 10,000,000	$ 8,000,000
IPR&D – Compound #2	2,000,000	20%	10,000,000	2,000,000
	$ 10,000,000			$ 10,000,000

- Because the IPR&D does not have an alternative future use, the entire upfront cost of $10 million must be expensed immediately.
- The acquirer evaluates whether the contingent consideration must be recognized at the acquisition date but determines that the contingent consideration qualifies for the derivative scope exception in ASC 815-10-15-59(b). This is because the IPR&D is unique and is owned by the party that does not benefit under the contract from an increase in the fair value of the nonfinancial asset, meaning the buyer does not benefit because it must pay the seller. Therefore, Company A does not recognize the contingent consideration at the acquisition date.
- Two years after the acquisition, Company A receives final FDA approval of Compound #1 and pays the $15 million contingent payment to the sellers. Company A continues to develop Compound #2 and determines that it does not have an alternative use.
- Upon resolution of the contingency, Company A treats the contingent consideration as an additional element of cost and allocates the payment to the acquired assets based on the relative fair values of the IPR&D at the acquisition date, as follows:

	ACQUISITION DATE FAIR VALUE	PERCENTAGE OF FAIR VALUE	CONTINGENT CONSIDERATION	ALLOCATED COST
IPR&D – Compound #1	$ 8,000,000	80%	$ 15,000,000	$ 12,000,000
IPR&D – Compound #2	2,000,000	20%	15,000,000	3,000,000
	$ 10,000,000			$ 15,000,000

Because Compound #2 is not finished and does not have an alternative future use, the $3 million allocated to it is expensed immediately. However, because Compound #1 is no longer IPR&D (it has been completed), the $12 million allocated to it is capitalized as an intangible asset.

C.4.4.3 Defensive Intangible Assets

FASB REFERENCES

ASC 350-30-25-5 and ASC 805-50-30-3

An intangible asset acquired in an asset acquisition that the acquirer does not intend to use, but instead acquires to prevent others from using it, is referred to as a "defensive asset" or a "locked-up asset." For example, an acquirer may retire the brand name of an acquired competitor. Although the asset is not being actively used, it likely contributes to an increase in the value of other assets owned by the acquirer.

A defensive asset is recognized based on its relative fair value (see Section C.4). When determining fair value, the acquirer considers its highest and best use by market participants using an appropriate valuation methodology in accordance with ASC 820.

C.4.4.4 Reacquired Rights

FASB REFERENCES

ASC 805-20-30-20

If, before the asset acquisition, the acquirer had granted rights to use its assets (whether recognized or unrecognized), the reacquisition of such rights could result in the acquirer's recognition of an intangible asset (a "reacquired right"). Examples of such rights include a right to use the acquirer's trade name under a franchise agreement or the acquirer's technology under a licensing agreement.

However, before recognizing a reacquired right, the entity must determine whether the transaction truly represents the acquisition of a reacquired right (an asset acquisition) and not simply a cancellation or rescission of a contract with a customer. If the transaction is determined to be the cancellation of a contract with a customer, the guidance in ASC 606 would apply.

BDO INSIGHTS — REACQUIRED RIGHTS IN AN ASSET ACQUISITION

ASC 805-50 does not provide guidance for accounting for reacquired rights in an asset acquisition. However, a reacquired right may qualify to be recognized as an asset. If so, it may be appropriate to analogize to the business combination guidance in ASC 805-20 to determine the value of a reacquired right. Under that guidance the reacquired right is measured based on the remaining contractual term without considering the effect of potential renewals (see Section 4.4.1.7.2). The value of the reacquired right should be used in place of fair value when allocating the consideration based on relative fair values (see Section C.4).

C.4.5 Lease Classification

BDO INSIGHTS — REASSESSING LEASE CLASSIFICATION IN AN ASSET ACQUISITION

ASC 805-50 and ASC 842 do not specify whether classification of an acquired lease in an asset acquisition should be reassessed or retained like in business combinations (see Section 4.4.1.5.1). An acquired lease is typically measured as if it were a new lease of the acquirer; and for a new lease, one of the steps an entity performs is assessing classification. However, because U.S. GAAP is not clear, we believe that, for an asset acquisition, the acquiring entity could either reassess lease classification, or apply, by analogy, the guidance for business combinations for which lease classification is retained. Entities are encouraged to discuss classification of leases acquired in an asset acquisition with their accounting consultants and auditors.

C.4.6 Deferred Income Taxes

FASB REFERENCES

ASC 740-10-25-49 through 25-52 and ASC 805-740-30-3

If the amounts recognized for financial reporting differ from the tax bases of the acquired assets, the acquirer must recognize deferred taxes at the acquisition date. However, because there is no goodwill or bargain purchase gain recognized in an asset acquisition, the acquirer must use the simultaneous equations method to measure the deferred taxes.

A reduction in the acquirer’s deferred tax valuation allowance that is directly attributable to the asset acquisition is not recognized as part of the asset acquisition; rather, it is generally recognized in earnings as an income tax benefit.

C.5 OTHER TOPICS

C.5.1 Measurement Period

In a business combination, the acquirer is allowed a period up to one year after the acquisition date to finalize its accounting for the business combination. This measurement period allows the acquirer time to obtain the information necessary to identify and measure the various elements necessary to account for the business combination (see Section 4.6).

In an asset acquisition, there is no concept of a measurement period, regardless of the size and complexity of the transaction. Acquirers should not analogize to the measurement period guidance for business combinations when accounting for an asset acquisition.

C.5.2 Exchange of Share-Based Payments in an Asset Acquisition

BDO INSIGHTS — EXCHANGE OF SHARE-BASED PAYMENTS IN AN ASSET ACQUISTION

Although there is no guidance in ASC 805-50 regarding the measurement of replacement awards issued in exchange for the acquiree’s awards in an asset acquisition, we believe an acquirer may analogize to the guidance for replacement awards in a business combination. These situations may arise in capital-intensive sectors, such as real estate or extractive industries, in which a single asset represents substantially all the value of the acquired entity. Under ASC 805, if an acquirer has an obligation to replace the awards, the acquirer must determine what portion of the replacement awards is accounted for as consideration and what portion is recognized as postacquisition compensation (see Sections 6.4.3.2 and 6.4.3.3). Conversely, if the acquirer does not have an obligation to replace the awards, the full amount of the replacement awards must be recognized as compensation in the postacquisition period.

While some entities analogize to the business combination guidance, others treat the awards issued by the acquirer as new awards (rather than as replacement awards) and recognize the full amount of the new awards as compensation in the postacquisition period. We believe that either approach is acceptable. An entity should make an accounting policy election and apply it consistently. Determining how to account for replacement awards in an asset acquisition requires the use of professional judgment based on the facts and circumstances.

An acquirer may also issue share-based payment awards concurrent with an asset acquisition that are not replacement awards. Any such awards are accounted for as transactions separate from the asset acquisition in accordance with ASC 718.

C.5.3 Pushdown Accounting

FASB REFERENCES

ASC 805-10-15-4, ASC 805-50-15-10 through 15-11, and ASC 805-50-25-4

When an acquirer accounts for a business combination, it recognizes the assets and liabilities of the acquiree at fair value (with limited exceptions) rather than at their previous carrying amounts. This change in the amounts of the assets and liabilities is commonly referred to as a “step-up” or “new basis.”

Under the guidance in ASC 805-50, the acquiree in a business combination may elect to continue to recognize its assets and liabilities at carryover basis or it may choose to recognize its assets and liabilities at the acquirer’s basis. The use of the acquirer’s basis in the preparation of an acquiree’s separate financial statements is called “pushdown accounting” (see Appendix A).

Although pushdown accounting can be elected by the acquiree in a business combination, it **cannot** be elected in an asset acquisition. Therefore, an acquiree in an asset acquisition must continue to report its separate financial statements using its historical basis.

C.6 DISCLOSURES FOR ASSET ACQUISITIONS

There are no specific disclosure requirements in ASC 805-50 for asset acquisitions that do not meet the definition of a business. However, the acquirer should comply with the disclosure requirements in other parts of U.S. GAAP based on the nature of the asset acquisition and the assets acquired or the liabilities assumed. For example:

NATURE OF THE ASSET ACQUISITION	RELEVANT U.S. GAAP
Intangible assets	ASC 350
Depreciable assets	ASC 360
Contingencies	ASC 450
Research and development	ASC 730
Subsidiaries that are not businesses (including VIEs)	ASC 810
Derivatives	ASC 815

If the asset acquisition includes contingent consideration, the acquirer must disclose how it intends to account for the contingent consideration (see Section C.3.4.1). The acquirer may also consider disclosing its expectations regarding the resolution of the contingencies. If the acquirer has recognized indemnification assets (see Section C.4.3), it should provide the disclosures for an indemnification asset recognized in a business combination (see Section 8.6.5.1).

For asset acquisitions that resemble business combinations, an acquirer may also provide some of the disclosures prescribed for business combinations (see Chapter 8), such as disclosing the reason for the acquisition and the amounts recognized for each major class of assets acquired and liabilities assumed.

C.6.1 SEC Reporting for Asset Acquisitions

The SEC definition of a business differs from the U.S. GAAP definition (see Section 3.7), so it is possible for an acquisition to be a business for SEC reporting, but not for accounting purposes. As such, when an SEC registrant acquires an asset or group of assets, it must determine whether the acquired set is a business in accordance with Rule 11-01(d) of Regulation S-X. If so, it must comply with the SEC reporting requirements for the acquisition of a business, even if it does not meet the U.S. GAAP definition of a business.

C.7 SUBSEQUENT ACCOUNTING IN AN ASSET ACQUISITION

The initial measurement of the acquired assets and liabilities assumed does not affect the subsequent accounting for the asset or liability. As indicated in ASC 805-50-35-1, after the acquisition, the acquirer accounts for the asset or liability in accordance with other U.S. GAAP.

C.7.1 Changes in Contingent Consideration After an Asset Acquisition

As discussed in Section C.3.4, the accounting for contingent consideration will vary based on the facts and circumstances. Contingent consideration is sometimes accounted for at fair value at the acquisition date as a derivative or an equity-linked contract. In other cases, it may be recognized at the acquisition date if it is probable and estimable, and the entity elects to apply the loss contingency model in ASC 450 (see Section C.3.4.1). Or there may be no initial accounting for contingent consideration. As such, the subsequent accounting for changes in contingent consideration depends on the determinations made for the initial accounting.

For contingent consideration that is accounted for as a derivative (under ASC 815-10) or as a liability-classified equity-linked contract (under ASC 480-10 or ASC 815-40), subsequent changes in fair value are recognized in earnings. As such, there is no impact on amounts previously recognized for the assets acquired in the asset acquisition.

If the contingent consideration is equity classified, it is not remeasured after the acquisition date, and the subsequent settlement is accounted for as an equity transaction. As such, there is no impact on amounts previously recognized for the assets acquired in the asset acquisition.

For cash-settled contingent consideration that is not accounted for as a derivative, there are often no amounts recognized at the acquisition date (because the acquirer's policy is to recognize the contingent consideration when the contingency is resolved, or because it is not probable and estimable at the acquisition date, as discussed in Section C.3.4.1). However, if an acquirer's policy is to recognize contingent consideration under the loss contingency model in ASC 450, an acquirer would recognize a liability at the acquisition date if it is probable and estimable. In either case, if the contingent consideration is recognized (or adjusted) after the asset acquisition date, the changes are reflected as an adjustment to the cost basis of the acquired assets, generally based on their relative fair values at the acquisition date (see Section C.4).

Additionally, when costs are allocated to long-lived or intangible assets after the acquisition date, the acquirer must also adjust the depreciation and amortization for such assets. There is diversity in practice regarding whether to account for such adjustments prospectively or with a cumulative catch-up entry as if the amount had been capitalized as of the acquisition date. We believe that either method is acceptable.

See Section C.1.1.1 for guidance for accounting for subsequent changes in contingent consideration after the initial consolidation of a VIE that is not a business.

C.8 RECAPITALIZATION TRANSACTIONS

An operating company may combine with another company that holds only financial assets and does not have substantive operations. In such case, the substance may be a capital transaction in which the operating company issues its equity in exchange for the financial assets of the nonoperating company. For an in-substance capital transaction, the equity is typically recognized at the fair value of the net assets acquired.

However, in some cases the financial instruments (including bifurcated derivatives) issued by the operating company are liability classified and must be recognized at fair value each reporting period. If the fair value of instruments that will be marked to market each period exceeds the value of the financial assets received, it may be appropriate to recognize a loss in earnings for the excess amount, assuming there are no other assets obtained in the transaction, as noted in the following SEC Staff speech:

SEC STAFF GUIDANCE

[Remarks before the 2014 AICPA National Conference on Current SEC and PCAOB Developments]

Hillary H. Salo, Professional Accounting Fellow, Office of the Chief Accountant

December 8, 2014

Allocation of Proceeds when the Fair Value of a Liability Required to be Measured at Fair Value Exceeds the Net Proceeds Received for a Hybrid Instrument

> *…US GAAP provides allocation guidance for certain types of transactions. For instance, Topic 815 requires reporting entities to record an embedded derivative at fair value and assign the remainder of the proceeds to the carrying value of the host contract. In addition, Topic 470 requires that proceeds from the sale of a debt instrument with equity-classified detachable warrants be allocated between the two elements based on their relative fair values. However, for those transactions where the hybrid instrument is not issued at fair value, and the financial liabilities required to be measured at fair value exceed the net proceeds received, the staff acknowledges that judgment is required to determine the allocation of proceeds.*
>
> *As a result, the staff believes that when reporting entities analyze these types of unique fact patterns, they should first, and most importantly, verify that the fair values of the financial liabilities required to be measured at fair value are appropriate under Topic 820. If appropriate, then the reporting entity should evaluate whether the transaction was conducted on an arm's length basis, including an assessment as to whether the parties involved are related parties under Topic 850. Lastly, if at arm's length between unrelated parties, a reporting entity should evaluate all elements of the transaction to determine if there are any other rights or privileges received that meet the definition of an asset under other applicable guidance.*
>
> *In the fact patterns analyzed by the staff, we concluded that if no other rights or privileges that require separate accounting recognition as an asset could be identified, the financial liabilities that are required to be measured at fair value (for example, embedded derivatives) should be recorded at fair value with the excess of the fair value over the net proceeds received recognized as a loss in earnings. Furthermore, given the unique nature of these transactions, we would expect reporting entities to provide clear and robust disclosure of the nature of the transaction, including reasons why the entity entered into the transaction and the benefits received.*
>
> *Additionally, some people may wonder whether the staff would reach a similar conclusion if a transaction was not at arm's length or was entered into with a related party. We believe those fact patterns require significant judgment; therefore, we would encourage consultation with OCA in those circumstances.* [Footnotes omitted]

Transaction costs incurred for an in-substance capital transaction are recognized as a cost of raising equity as a reduction of the total amount of equity raised. However, if transaction costs exceed the total equity raised, the excess transaction costs must be expensed.

See Section 7.3.7 for guidance for a merger of a non-operating public shell company with an operating company and Section 7.3.8 for guidance for SPAC mergers.

Appendix D — Initial Accounting by a Joint Venture

D.1 OVERVIEW

FASB REFERENCES

ASC 805-60-65-1

Historically, there was no specific authoritative guidance for the accounting by a joint venture upon its formation, so there was diversity in practice, with some joint ventures initially measuring their net assets at carryover basis (that is, the carrying amount of those assets in the financial statements of the venturer that contributed them) and others measuring them at fair value.

In August 2023, the FASB issued ASU 2023-05, *Business Combinations – Joint Venture Formations (Subtopic 805-60): Recognition and Initial Measurement*, which provides guidance for the accounting by a joint venture at its formation date. ASC 805-60 requires a joint venture (as defined in U.S. GAAP) to apply a new basis of accounting at its formation date, in which it recognizes and initially measures its assets and liabilities at fair value (with exceptions consistent with the business combinations guidance). The joint venture recognizes goodwill if the fair value of the joint venture as a whole exceeds the total identifiable assets and liabilities recognized by the joint venture at the formation date. The formation date fair value of the joint venture as a whole is equal to the fair value of 100 percent of the joint venture's equity (including any noncontrolling interests in the joint venture's subsidiaries) immediately after the formation, measured in accordance with ASC 820.

ASC 805-60 applies only to the initial accounting by a joint venture. It does not change the accounting by a venturer for its investment in a joint venture. That is, the venturer applies other U.S. GAAP to account for its contribution to the joint venture (for example, the equity method in accordance with ASC 323).

ASC 805-60 is effective prospectively for all joint ventures with a formation date on or after January 1, 2025. Early adoption is permitted in any interim or annual period in which financial statements have not been issued (or made available for issuance).

Also, a joint venture that was formed before the issuance of ASU 2023-05 can apply the guidance retrospectively as if it had applied ASC 805-60 to its formation transaction if it has sufficient information to do so. A joint venture that elects to apply ASC 805-60 retrospectively must:

- Recognize the cumulative effect of initially applying ASC 805-60 as an adjustment to the opening balance of retained earnings (or other appropriate components of equity in the statement of financial position) at the initial application date.
- Apply any relevant guidance other than ASC 805-60 (for example, for measuring identifiable assets, liabilities, and any noncontrolling interest in accordance with ASC 805-20) as it existed at the formation date.
- Apply the transition provisions as of the beginning of the earliest comparative period presented.
- Include disclosures from ASC 250-10-50-1 through 50-3.

D.2 SCOPE

FASB REFERENCES

ASC Master Glossary: Joint Venture, ASC 805-60-15-4

ASC 805-60 is applicable for the initial formation of a joint venture. In practice, the term "joint venture" is often used loosely to refer to many different types of arrangements that often do not meet the definition of a joint venture under U.S. GAAP. However, to be a joint venture under U.S. GAAP the entity must have **all** the following characteristics:

CHARACTERISTICS OF A JOINT VENTURE
It is a separate legal entity.
The venturers have joint control over the legal entity.
A small group of investors (the joint venturers) own and run the legal entity as a separate and specific business or project for their mutual benefit.
Its purpose 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.
Each joint venturer has rights to participate in the management of the joint venture, directly or indirectly.
Joint venturers have an interest or relationship other than as passive investors.

Also, the ownership of a joint venture seldom changes, and its equity interests are usually not traded publicly; however, a minority public ownership does not preclude an entity from being a joint venture.

BDO INSIGHTS — DEFINITION OF A JOINT VENTURE

Joint control is required for an entity to be a joint venture. Joint control occurs when unanimous consent or agreement is required for all decisions about all activities that significantly impact the legal entity's economic performance.

Although the master glossary definition of a joint venture does not explicitly require joint control, the SEC staff has stated that it *"would object to a conclusion that joint control is the only defining characteristic of a joint* *venture,"* implying that joint control is required. The FASB acknowledged in paragraph BC90 of the Basis for Conclusions to ASU 2023-05 that joint control is a characteristic of a joint venture.

JOINT VENTURES ARE RARE IN U.S. GAAP

The term "joint venture" is used loosely in practice and may refer to a structure conducted in one or more legal entities or to an arrangement between two parties that does not involve a separate legal entity. Many such entities and arrangements do not have all the characteristics of a joint venture in U.S. GAAP. Reaching a conclusion that a reporting entity meets the definition of a joint venture requires the application of professional judgment based on the facts and circumstances.

The guidance in ASC 805-60 does not apply to:

- Transactions between a joint venture and its owners other than the formation of a joint venture
- Formations of NFP entities
- Combinations between entities, businesses, or nonprofit activities under common control (see Appendix B)
- Entities in the construction or extractive industries that may be proportionately consolidated by any of their investor-venturers
- Collaborative arrangements within the scope of ASC 808, *Collaborative Arrangements* (except for any part of the arrangement conducted in a separate legal entity that meets the definition of a joint venture)

BDO INSIGHTS — ENTITIES THAT DO NOT MEET THE DEFINITION OF A JOINT VENTURE

As discussed above, ASC 805-60 applies only for entities that qualify as joint ventures for accounting purposes. ASC 805-60 does not provide guidance for the initial formation of entities that do not qualify as joint ventures. As such, determining the appropriate accounting for entities that are not joint ventures requires the application of professional judgment based on the facts and circumstances (see Section D.10).

D.3 FORMATION DATE

FASB REFERENCES

ASC Master Glossary: Formation Date, ASC 805-60-25-3 through 25-5

ASC 805-60 requires a joint venture to apply a new basis of accounting at the formation date, in which it recognizes and initially measures its assets and liabilities at fair value (with exceptions consistent with the business combinations guidance). The formation date is the date an entity initially meets the definition of a joint venture (which is not necessarily the legal entity formation date). The formation date functions similarly to the acquisition date in a business combination. It is the date that the joint venture recognizes and measures all the contributed assets and liabilities that are part of the joint venture formation.

Determining the formation date is generally straightforward if there is a single arrangement that formed the joint venture and all contributions are made on the same date. However, if the formation of the joint venture involves multiple arrangements or multiple contribution dates, more judgment may be required.

Factors that may indicate that the joint venture should account for multiple arrangements as a single transaction, include:

- The multiple arrangements are entered into at the same time or in contemplation of one another.
- The multiple arrangements form a single transaction designed to achieve an overall commercial effect.

- The occurrence of one arrangement is dependent on the occurrence of at least one other arrangement.
- One arrangement considered on its own is not economically justified, but multiple arrangements are economically justified when considered together.

D.4 DETERMINING WHAT IS PART OF A JOINT VENTURE FORMATION

FASB REFERENCES

ASC 805-10-55-24 through 55-26 and ASC 805-60-25-6 through 25-9

At the formation date, a joint venture and its owners may enter one or more arrangements that are separate from the formation of the joint venture. For example, a joint venture may enter an agreement to compensate the venturer or others for future services.

To determine whether such arrangements are part of the joint venture formation, the joint venture must apply the guidance in Section 6.2 for evaluating whether transactions are separate from a business combination, including understanding the reasons for the arrangement, who initiated the arrangement, and when the parties entered the arrangement. Any transactions that are not part of the formation of a joint venture are accounted for separately in accordance with other U.S. GAAP.

Because the formation of a joint venture is the formation of a new entity for financial reporting (although not necessarily a new legal entity), ASC 805-60 prohibits the joint venture from analogizing to the following guidance for business combinations:

- The settlement of preexisting relationships in a business combination (see Section 6.5)
- Acquisition-related costs and transactions that reimburse the acquiree or its former owners for paying the acquirer's acquisition-related costs (see Section 6.3.2)

D.4.1 Exchange of Share-Based Payment Awards

FASB REFERENCES

ASC 805-60-25-8, ASC 805-60-30-5, and ASC 805-60-55-2 through 55-14

If, upon formation, a joint venture issues share-based payment awards to replace awards held by grantees of the contributed entities, it must allocate the value of the replacement awards between preformation vesting and postformation compensation by applying the guidance for accounting for replacement awards in a business combination (see Section 6.4.3). Any amounts allocated to postformation vesting are recognized as compensation in the joint venture's postformation financial statements. The joint venture accounts for the preformation vesting as a reallocation of APIC (or similar equity account, such as members' equity) to either APIC-share-based payments or "share-based payment liabilities," depending on the classification of the replacement awards. The reallocation from APIC does not affect goodwill recognized by the joint venture upon formation.

Examples D-1 and D-2 illustrate this concept.

EXAMPLE D-1: (ADAPTED FROM ASC 805-60-55-2 THROUGH 55-6 AND 805-60-55-11 THROUGH 55-14) EQUITY CLASSIFIED REPLACEMENT AWARDS UPON FORMATION OF A JOINT VENTURE

FACTS

- Two venturers each contribute a business to a newly formed corporation (New Venture) in exchange for equity interests. New Venture meets the definition of a joint venture.

- Before considering any liabilities for share-based payments, the formation date fair value of the joint venture as a whole is $100 million, including a $5 million noncontrolling interest.
- The formation-date fair value of the identifiable assets is $120 million and the fair value of the liabilities (excluding any liabilities for share-based payments) is $40 million.
- New Venture issues replacement awards with an ASC 718 value of $20 million that it was obligated to issue to the employees of the contributed businesses at the joint venture formation date.
- The original employee awards also have an ASC 718 value of $20 million at the acquisition date.
- The replacement awards require one year of postformation vesting.
- At the original grant date, the original employee awards had a requisite service period of four years.
- At the formation date, the employees had rendered two years of service since the grant date and would have had to render two additional years of service after the formation date for their original awards to vest.
- New Venture has estimated that there will be no forfeitures.
- Assume the awards are equity classified and there is only an explicit service period.

CONCLUSION

New Venture attributes $10 million to preformation vesting and $10 million to postformation compensation. As a result, New Venture records the following entries (in millions):

Debit	Identifiable assets recognized	$	120		
Debit	Goodwill		20		
Credit	Liabilities recognized			$	40
Credit	NCI				5
Credit	APIC				95
	(to record initial formation of the joint venture, before reallocation of share-based payments attributable to preformation vesting)				
Debit	Additional paid-in capital	$	10		
Credit	Additional paid-in capital – share-based payments (preformation vesting)				10
	(to reallocate $10 million attributable to preformation vesting to additional paid-in capital – share-based payments)[27]				

ANALYSIS

- New Venture calculates the amounts attributable to preformation vesting and postformation compensation as follows:
  - **Total service period** = 2 years (the portion of the requisite service period for the original employee awards completed before the formation date) + 1 year (the postformation requisite service period for the replacement awards) = 3 years
  - **Greater of the total service period or original service period of the original award** = 3 years (total service period) < 4 years (service period of the original employee award) = 4 years
  - **Preformation vesting percentage** = 2 years (preformation service period) / 4 years (service period of the original employee award) = 50%
  - **Amount attributable to preformation vesting** = 50% (preformation vesting) x $20 million (ASC 718 value of the original awards at the formation date) = $10 million

[27] For equity-classified share-based payment awards, the journal entry to reallocate amounts attributable to preformation vesting may not be necessary if a company does not have more than one APIC account.

- **Amount attributable to postformation compensation** = $20 million (ASC 718 value of replacement awards at the formation date) - $10 million (amount attributable to preformation vesting) = $10 million

- New Venture will recognize $10 million as compensation in its postformation financial statements over the postformation requisite service period of one year in accordance with ASC 718.
- Because the replacement share-based awards are classified as equity, total liabilities equal $40 million. Because there are no share-based liabilities, the fair value of New Venture as a whole is $100 million.
- New Venture calculates goodwill as follows (in millions):

Fair value of New Venture as a whole (including $5 NCI)	$ 100
Less: Net fair value of identifiable assets and liabilities recognized ($120 assets - $40 liabilities)	(80)
Goodwill recognized by New Venture at formation date	$ 20

- New Venture calculates APIC, excluding APIC attributable to share-based payments as follows (in millions):

Net assets recognized by New Venture, excluding share-based payment liabilities ($120 identifiable assets - $40 liabilities + $20 goodwill)	$ 100
Less: The fair value of NCI	(5)
Initial APIC recognized by New Venture at the formation date	95
Less: The reallocation of the fair value of preformation vesting replacement share-based payments classified as equity	(10)
APIC recognized by New Venture at the formation date (after reallocation of APIC attributable to preformation vesting share-based payments)	$ 85

EXAMPLE D-2: (ADAPTED FROM ASC 805-60-55-2 THROUGH 55-10) EQUITY CLASSIFIED REPLACEMENT AWARDS UPON FORMATION OF A JOINT VENTURE

FACTS

Assume the same facts as Example D-1, except that the replacement awards are liability classified.

CONCLUSION

New Venture attributes $10 million to preformation vesting and $10 million to postformation compensation. As a result, New Venture records the following entries (in millions):

Debit	Identifiable assets recognized	$ 120	
Debit	Goodwill	20	
Credit	Liabilities recognized (excluding share-based payment liability)		$ 40
Credit	NCI		5
Credit	APIC		95
	(to record initial formation of the joint venture, before reallocation of share-based payments attributable to preformation vesting)		

Debit	APIC	$ 10	
Credit	Share-based payments liability (preformation vesting)		10
	(to reallocate $10 million attributable to preformation vesting to share-based payments liability)		

ANALYSIS

- New Venture calculates the amounts attributable to preformation vesting and postformation compensation using the same method as in Example D-1. New Venture will recognize $10 million as compensation in its postformation financial statements over the postformation requisite service period of one year in accordance with ASC 718.
- Because the replacement share-based awards are classified as liabilities, total liabilities equal $50 million ($40 million + $10 million). When taking the share-based liabilities into account, the fair value of New Venture as a whole is $90 million ($100 million - $10 million).
- New Venture calculates goodwill as follows (in millions):

Fair value of New Venture as a whole (including $5 NCI)	$ 90
Less: Net fair value of identifiable assets and liabilities recognized ($120 assets - $50 liabilities)	(70)
Goodwill recognized by New Venture at formation date	$ 20

- New Venture calculates APIC, excluding APIC attributable to share-based payments as follows (in millions):

Net assets recognized by New Venture, excluding share-based payment liabilities ($120 identifiable assets - $40 liabilities + $20 goodwill)	$ 100
Less: The fair value of NCI	(5)
Initial APIC recognized by New Venture at the formation date	95
Less: The allocation of the fair value of preformation vesting replacement share-based payments classified as a liability	(10)
APIC recognized by New Venture at the formation date (after allocation to preformation vesting share-based payments)	$ 85

D.5 RECOGNITION AND MEASUREMENT OF NET ASSETS CONTRIBUTED TO THE JOINT VENTURE

FASB REFERENCES

ASC 805-60-25-9 through 25-11 and ASC 805-60-30-1

ASC 805-60 requires a joint venture to apply a new basis of accounting using the guidance for business combinations in ASC 805-20 (see Section 4.4). At its formation date, a joint venture must recognize and measure its assets and liabilities at fair value (with exceptions consistent with the business combinations guidance). The joint venture recognizes goodwill if the fair value of the joint venture as a whole exceeds the total identifiable assets and liabilities recognized by the joint venture (see Section D.6). Unlike a business combination, the formation of a joint venture does not result in the identification of an acquirer because neither party gains control over the other. Rather, the joint venture itself is viewed as analogous to the acquirer in a business combination.

A joint venture applies the guidance in ASC 805-60, regardless of whether the assets or group of assets recognized by the joint venture constitute a business.

D.5.1 In-Process Research and Development

FASB REFERENCES

ASC 805-60-25-10 through 25-11 and ASC 805-60-30-1

Because a joint venture applies the guidance in ASC 805-60 regardless of whether the assets or group of assets recognized by the joint venture constitute a business, it must apply the guidance for recognizing IPR&D in a business combination (see Section 4.4.2.8). As such, IPR&D is recognized at fair value at the joint venture formation date as an indefinite-lived intangible asset until it is completed or abandoned.

ACCOUNTING FOR IPR&D IS DIFFERENT FOR A JOINT VENTURE THAT IS NOT A BUSINESS THAN FOR AN ASSET ACQUISITION

Even if the assets contributed to the joint venture do not meet the definition of a business, the joint venture must apply the guidance for recognizing IPR&D in a business combination (see Section 4.4.2.8). This guidance differs from the guidance for recognizing IPR&D in an asset acquisition, which requires that the IPR&D be expensed immediately unless it has an alternative use (see Appendix C, Section C.4.4.2).

D.5.2 Transfers of Financial Assets

FASB REFERENCES

ASC 805-60-25-15

If a venturer transfers financial assets within the scope of ASC 860-10 to the joint venture upon formation, the joint venture must apply the guidance in ASC 860-10 to determine whether the transfer results in the recognition of the financial assets by the joint venture.

D.5.3 Contingent Payments

FASB REFERENCES

ASC 805-60-30-6

If the formation of the joint venture includes contingent payment arrangements between the joint venture and one or more of the venturers, the contingent payments are measured by the joint venture at fair value (in accordance with ASC 820) at the formation date and recognized as a liability or an asset of the joint venture rather than as an adjustment to the fair value of the joint venture. This differs from the accounting for contingent consideration in a business combination, which treats contingent consideration as part of the consideration transferred (thus affecting the fair value of the acquired business).

D.5.4 Initial Recognition of a Variable Interest Entity at Formation Date

FASB REFERENCES

ASC 805-60-25-11 and ASC 810-10-30-4

As discussed in Section D.5, a joint venture applies the guidance in ASC 805-60 regardless of whether the assets or group of assets recognized by the joint venture constitute a business or are in a VIE or voting interest entity (that is, within the joint venture's newly consolidated subsidiary). As such, if a joint venture obtains a controlling financial interest in a VIE at the formation date, the joint venture must apply the guidance for the initial consolidation of a VIE in a business combination (see Appendix C, Section C.1.1), even if the VIE is not a business.

As such, goodwill is recognized if the fair value of the joint venture as a whole exceeds the total identifiable assets and liabilities recognized by the joint venture at the formation date, regardless of whether the VIE meets the definition of a business. This represents an exception from the guidance in ASC 810-10-30-4, which does not allow goodwill to be recognized upon the initial consolidation of a VIE that is not a business.

If a joint venture becomes the primary beneficiary of a VIE as part of a separate transaction that was not part of the joint venture formation, it applies the guidance in ASC 810, not the guidance in ASC 805-60, to initially recognize that VIE. See our Blueprint, Control and Consolidation Under ASC 810,for more guidance.

D.5.5 Accounting for Leases at the Formation Date

FASB REFERENCES

ASC 842-10-55-11

At the formation date, a joint venture must recognize and measure its assets and liabilities at fair value (with exceptions consistent with the business combinations guidance). As such, the joint venture's accounting for leases acquired or assumed as part of the joint venture formation is consistent with the accounting for leases in a business combination (see Section 4.4.1.5 and related subsections). Consistent with that guidance, the joint venture should retain the contributing venturer's previous lease classification, unless the lease is modified, and that modification is not accounted for as a separate contract. This guidance applies whether the acquired or assumed lease contract is as a lessee or a lessor. If there is a modification that is not accounted for as a separate contract, the joint venture should reassess classification. See Chapter 4 of our Blueprint, Accounting for Leases Under ASC 842, for lease classification guidance.

BDO INSIGHTS — MODIFICATIONS TO LEASES THAT ARE ADMINISTRATIVE IN NATURE

An acquired or assumed lease may be amended to change only the names of the parties in the lease. We believe such a change is administrative in nature and is not a modification because it does not change the scope of or consideration for the lease.

D.6 GOODWILL

FASB REFERENCES

ASC 805-60-25-13 and ASC 805-60-30-2 through 30-3

The joint venture recognizes goodwill if the fair value of the joint venture as a whole exceeds the total identifiable assets and liabilities recognized by the joint venture at the formation date. The formation date fair value of the joint venture as a whole is equal to the fair value of 100 percent of the joint venture's equity (including any noncontrolling interests in the joint venture's subsidiaries) immediately after the formation, measured in accordance with ASC 820.

The requirement to recognize goodwill in a joint venture formation applies regardless of whether the assets or group of assets recognized by the joint venture constitutes a business. However, the presence of more than an insignificant amount of goodwill would be unusual if, at formation, the assets recognized by the joint venture do not meet the definition of a business.[28]

If, upon formation, the value of the identifiable assets (net of liabilities) exceeds the fair value of the joint venture as a whole, the excess is recognized as an adjustment to APIC (or similar equity account, such as members' equity) rather than as a bargain purchase gain.

D.6.1 Private Company Alternatives

FASB REFERENCES

ASC 805-60-25-12, ASC 805-60-35-2

A joint venture that is a private company can elect the private company accounting alternatives for intangible assets (see Section 7.2.4) and for amortizing goodwill (see Section 7.2.2).

D.7 MEASUREMENT PERIOD

FASB REFERENCES

ASC 805-60-25-14, ASC 805-60-50-3

In a business combination, the acquirer is allowed a period of up to one year after the acquisition date to finalize its accounting for the business combination. This measurement period allows the acquirer time to obtain the information necessary to identify and measure the various elements necessary to account for the business combination (see Section 4.6).

Similarly, if the initial accounting for a joint venture formation is incomplete by the end of the reporting period, the joint venture may apply the measurement period guidance for a business combination.

A joint venture that applies the measurement period guidance must provide the following disclosures:

- The reasons why the initial accounting is incomplete
- The assets, liabilities, NCI, or the formation-date fair value of the joint venture as a whole for which the initial accounting is incomplete
- The nature and amount of any measurement period adjustments recognized during the reporting period, 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 was recognized as of the formation date

[28] ASC 805-60-25-13

D.8 PRESENTATION AND DISCLOSURES

FASB REFERENCES

ASC 805-60-45-1

To satisfy the requirements in paragraph 805-60-50-2(e), a joint venture may, in lieu of disclosure in the notes to financial statements, present a statement of financial position as of the formation date that reflects the amounts recognized by the joint venture for each major class of assets and liabilities as a result of its formation.

ASC 805-60-50-1

A joint venture shall disclose information that enables users of its financial statements to understand the nature and financial effect of the joint venture formation in the period in which the formation date occurs.

ASC 805-60-50-2

In the period of formation, a joint venture shall disclose the following:

a. The formation date

b. A description of the purpose for which the joint venture was formed (for example, 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)

c. The formation-date fair value of the joint venture as a whole

d. A description of the assets and liabilities recognized by the joint venture at the formation date

e. The amounts recognized by the joint venture for each major class of assets and liabilities as a result of accounting for its formation, either presented on the face of financial statements or disclosed in the notes to financial statements (see paragraph 805-60-45-1)

f. A qualitative description of the factors that make up any goodwill recognized, such as expected synergies from combining operations of the contributed assets or businesses, intangible assets that do not qualify for separate recognition, or other factors.

ASC 805-60-50-3

If the initial accounting for a joint venture formation is incomplete (see paragraph 805-60-25-14) for particular assets, liabilities, noncontrolling interests, or the formation-date fair value of the joint venture as a whole and the amounts recognized in the financial statements for the joint venture formation thus have been determined only provisionally, the joint venture shall disclose the following information:

a. The reasons why the initial accounting is incomplete

b. The assets, liabilities, noncontrolling interests, or the formation-date fair value of the joint venture as a whole for which the initial accounting is incomplete

c. The nature and amount of any measurement period adjustments recognized during the reporting period, 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 was recognized as of the formation date.

D.9 SUBSEQUENT MEASUREMENT

FASB REFERENCES

ASC 805-60-35-1

After the formation date, a joint venture accounts for assets and liabilities recognized upon formation in accordance with the requirements for the acquirer in a business combination.

D.10 ENTITIES THAT DO NOT MEET THE DEFINITION OF A JOINT VENTURE

FASB REFERENCES

ASC 805-60-25-1

As discussed in Section D.1, ASC 805-60 applies only to entities that qualify as joint ventures for accounting purposes. It does not change the accounting by a venturer for its investment in a joint venture, meaning the venturer applies other U.S. GAAP to account for its contribution to the joint venture (for example, the equity method in accordance with ASC 323).

ASC 805-60 also does not provide guidance for the accounting at initial formation by entities that have some (but not all) characteristics of joint ventures and therefore do not qualify as joint ventures for accounting purposes (non-JV entities). For example, a non-JV entity could have three investors and a governance structure that requires a simple majority of the investors to agree on decisions for the entity. Such an entity would not qualify as an accounting joint venture because unanimous consent is not required for all decisions that significantly impact the legal entity's economic performance.

To determine the appropriate accounting by a non-JV entity, the non-JV entity must understand and evaluate the nature of the formation transaction. Depending on the facts and circumstances, it may be appropriate to consider the following guidance:

INITIAL ACCOUNTING BY NON-JV ENTITIES	
Business Combinations (ASC 805)	▶ If the non-JV entity is a substantive entity (see Section 2.2.2.4), the contribution of a business (or businesses) from one or more of the venturers may be a business combination (if the contributing venturer does not control the non-JV entity), with the non-JV entity as the acquirer (see Section 2.2.2.4.1). ▶ If the non-JV entity is not a substantive entity (see Section 2.2.2.4), and more than one of the venturers contributes a business to the non-JV entity, the transaction may be a roll-up transaction, with one of the contributed businesses deemed the acquirer (see Section 1.1.3).
Pushdown Accounting (ASC 805-50)	▶ If one of the venturers gains control of the non-JV entity that is a business or a nonprofit activity, the non-JV entity may elect pushdown accounting for the acquired business or nonprofit activity (see Appendix A). ▶ Pushdown accounting does not apply to the acquisition of an asset or group of assets that does not constitute a business.
Common Control Transactions (ASC 805-50)	▶ If one of the venturers retains control of the non-JV entity, a contribution of a business or assets to the non-JV entity by that venturer would be accounted for as a common control transaction by the receiving non-JV entity (see Appendix B).
Asset Acquisitions (ASC 805-50)	▶ If one or more of the venturers contributes net assets that do not constitute a business, it may be appropriate for the non-JV entity to account for the transaction as an asset acquisition (if the contributing venturer does not control the non-JV entity), with the non-JV entity as the acquirer (see Appendix C, Section C.3.3).
Share-based Payments (ASC 718)	▶ If the non-JV entity issues equity instruments in exchange for goods or services, the transaction may be a share-based payment transaction (see Appendix C, Section C.3.3).
Equity Issuance (for example, ASC 505, ASC 480, ASC 815)	▶ The non-JV entity must evaluate the appropriate accounting for the equity instruments it issues in connection with its formation.

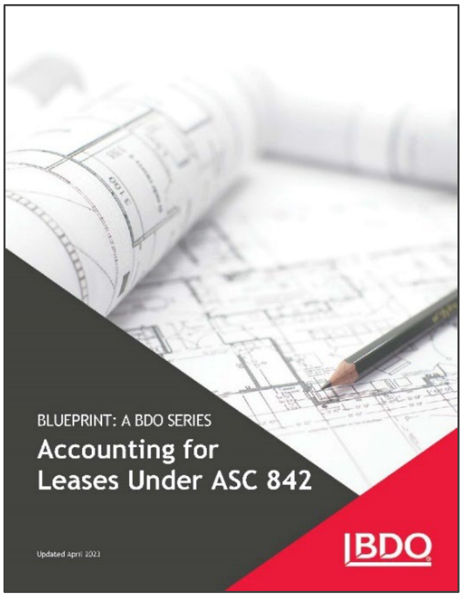
THE ACCOUNTING BY THE NON-JV ENTITY MAY BE DIFFERENT FOR CONTRIBUTIONS RECEIVED FROM EACH INVESTOR

The preceding table provides potential guidance that may apply to the non-JV's accounting at its initial formation. Depending on the nature of the assets contributed to (obtained by) the non-JV entity, the accounting by the non-JV entity for each of the contributions received from its investors may be different. For example, if one investor controls the non-JV entity, its contribution of assets to the non-JV entity would be accounted for by the non-JV entity as a common control transaction, while the contribution from a different investor may be accounted for by the non-JV entity as an asset acquisition or a business combination.

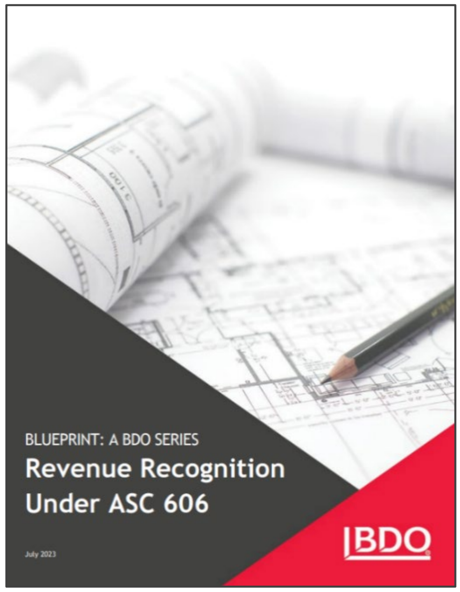
Determining the appropriate accounting by a non-JV entity upon its initial formation requires the application of professional judgment based on the facts and circumstances.

Appendix E — BDO Blueprints

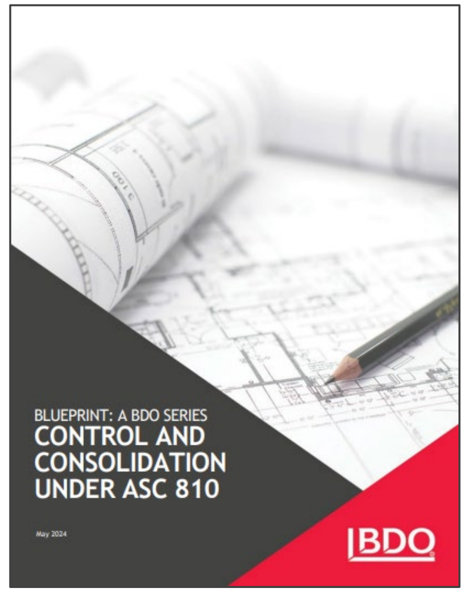
Other publications in BDO's Blueprint series are available on the BDO Center for Accounting Standards and Reporting Matters.



Accounting for Leases Under ASC 842



Revenue Recognition Under ASC 606



Control and Consolidation Under ASC 810

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